On what do economists agree and disagree about the effects of taxes on economic growth?

Economists generally agree that people and businesses respond to taxes and that large tax changes can move the economy. But economists have not (and probably cannot) pin down exactly how the economy works and how responsive people and businesses are to policy changes. As a result, economists often disagree about what models and parameters to use to analyze tax policies. Those scientific disagreements are sometimes amplified by value judgments about appropriate policy.

AREAS OF AGREEMENT

Economists often agree about the general effects of tax policy. For example, they agree that people respond to incentives, taxes can change incentives, and therefore taxes can change behavior. A tax on cigarettes reduces smoking and shifts some purchases to untaxed markets. The Earned Income Tax Credit brings more low-wage single parents into the workforce. Investors are less likely to realize capital gains when tax rates are high. Businesses shift their legal structures, and sometimes the location of their activity, to lower tax burdens. When faced with a scheduled tax increase or decrease, people and businesses move income into the lower-taxed periods. And so on.

Economists also generally agree that large tax changes can move the economy. When the economy is operating far below potential, for example, tax cuts can help stimulate activity, while tax increases can hamper it. In the longer run, a tax system with low rates and a broad base is more likely to promote prosperity than one with high rates and a narrow base.

Within those broad areas of agreement, economists often disagree about the size and importance of potential effects.

THE LIMITS OF ECONOMIC SCIENCE

In practice, economics blends scientific rigor with value judgments. The science tries to understand how the economy works. The philosophy draws inferences about what better and worse policies may be.

The science part is incomplete. There is no consensus, for example, on what assumptions to use to analyze the macroeconomic effects of tax policy. The Congressional Budget Office (CBO) and the Joint Committee on Taxation each use multiple models with different assumptions of how forward-looking people are (ranging from complete myopia to perfect foresight), how the United States connects to the global economy, and other dimensions.

Within any modeling framework, moreover, there is significant uncertainty about the size of potential effects. In modeling the short-run consequences of fiscal policy, for example, CBO estimates that the fiscal "multiplier" for a two-year tax cut to lower- and middle-income households is 0.3 to 1.5—a fivefold difference. Such wide ranges exist because the evidence is inadequate to pin down key parameters. And the resulting uncertainty is amplified because there are good reasons to believe that the economy has changed sufficiently to make the past an imperfect predictor of the future.

VALUE JUDGMENTS

For those reasons, there is substantial scope for scientific disagreement about the economic effects of tax policy. But that is not the only reason economists disagree. Value judgments can also color views about tax policy.

In an IGM Forum survey of leading economists, 90 percent either agreed or strongly agreed that one "reason why economists often give disparate advice on tax policy is because they hold differing views about choices between raising average prosperity and redistributing income."

In principle, economists should be able to distinguish such value differences from objective analysis. In practice, however, the two blur. Opponents of redistributional policies often argue, for example, that the policies will have large negative side effects, while advocates often argue that those effects are small. Some of that difference is sincere. If you believe the negative side effects of a policy are large, it makes more sense to oppose it, and vice versa. However, the causality can also run the other way, with analysts emphasizing the estimates most consistent with their values.

FURTHER READING

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