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A Slippery New Rule for Gauging Fiscal Policy

By N. Gregory Mankiw

How should Congress's economists open a can of worms? Keith Hall, the new director of the Congressional Budget Office, is likely to be grappling with that odd question very soon.

Let's start with some background. For the last six years, Douglas Elmendorf has been the director of the C.B.O. By my judgment, he has done a remarkable job of shepherding the institution through times that have been both economically and politically difficult. (Full disclosure: Mr. Elmendorf is a friend and former student of mine, so I am not entirely objective. But many prominent policy wonks endorsed his reappointment.)

Nonetheless, the new Republican leadership in Congress decided to appoint someone new to head the C.B.O. That decision is entirely understandable. Mr. Elmendorf has a long affiliation with Democrats, and the Republicans want someone who shares more of their perspective. As President Obama once said, elections have consequences. That includes the Republican sweep of 2014. So, on Friday, congressional leaders appointed Mr. Hall, a veteran of the Bush administration, to be the new head of the budget office.

We don't yet know how Mr. Hall's leadership will differ from Mr. Elmendorf's but we do know that he will face a big challenge. House Republicans have recently changed the rules: The Congressional Budget Office and Joint Committee on Taxation are now required to use "dynamic scoring" when evaluating major changes in tax and spending policy. This is the can of worms that awaits Mr. Hall as he takes on his new job.

Until now, conventional budget analysis has used a process called static scoring, which assumes that the path of gross domestic product remains the same when the government changes taxes or spending. This procedure has the virtues of simplicity and transparency.

Yet the assumption of unchanged G.D.P. also has one notable drawback: It is patently false. Much economic theory and empirical research confirm that fiscal policy influences the course of the economy.

Indeed, having an economic impact is a big part of why policy makers use the tools at their disposal, whether it is the tax cuts of Ronald Reagan and George W. Bush or the stimulus package of Mr. Obama. It seems somehow churlish for Congress's economists to assume that a policy change won't accomplish its goal simply to make their jobs easier.

Moreover, static scoring biases the analysis of proposed policy changes. If a tax cut promotes growth, for example, it will lose less revenue than an estimate based on unchanged G.D.P. suggests. For most cases, this effect is not large enough to make tax cuts pay for themselves, but it often makes tax cuts less costly than they first appear.

Perhaps more important, the biases inherent in static scoring are not the same for all possible policy changes, making comparison of alternative options less reliable. For example, suppose one member of Congress proposes a cut in the corporate tax rate, while another proposes an increase in the child tax credit to help middle-income families.

Because the corporate tax is often considered one of the most distortionary taxes in the federal arsenal, cutting it would promote economic growth. The true cost of the tax cut, as estimated by dynamic scoring, would most likely be much less than its static score.

An increased child tax credit would have a very different effect on G.D.P. Because the child credit is targeted at the middle class, a family gradually loses eligibility for the credit when its income increases. As a result, a family keeps less of each additional dollar it earns. In economics-speak, this tax cut actually increases the family's effective marginal tax rate. The disincentive from higher marginal rates could reduce G.D.P., making the true cost of the proposal greater than its static score.

For all these reasons, the case for dynamic over static scoring is strong in theory. Yet three problems make the task difficult in practice.

First, any attempt to estimate the impact of a policy change on G.D.P. requires an economic model. Because reasonable people can disagree about what model, and what parameters of that model, are best, the results from dynamic scoring will always be controversial. Just as many Republicans are skeptical about the models of climatologists when debating global warming, many Democrats are skeptical about the models of economists when debating tax policy.

Second, accurate dynamic scoring requires more information than congressional proposals typically provide. For example, if a member of Congress proposes a tax cut, a key issue in estimating its effect is how future Congresses will respond to the reduced revenue.

This raises important questions for which we have no easy answers. In the coming years, will these Congresses respond quickly to the revenue shortfall, or will they let budget deficits fester? When they act to close the budget gap, will they increase taxes, or will they cut spending? If they cut spending, will it be on consumption items, such as health care for the elderly, or on growth-promoting investments, such as education for the young? The impact of the initial tax cut depends crucially on the answers to these questions, but budget analysts usually have little to go on but speculation.

Third, dynamic scoring matters most over long time horizons. Some policy changes, such as those aimed at encouraging capital investments, take many decades to have their full impact on economic growth. Yet congressional budgeting usually looks only five or 10 years ahead. If we want to take dynamic scoring seriously, we have to think about how policy affects the next generation, not just the next election.

So there are good reasons for the economists hired by Congress to pursue dynamic scoring. But there are also good reasons to be wary of the endeavor.

In short: How do you open a can of worms? Very carefully.