

**Representative Paul Ryan**  
**Testimony before House Rules Committee**  
**May 9, 2002**

I spent much of last winter in Wisconsin explaining that the tax relief legislation signed into law last year did not cause the federal budget deficit. In fact, it was the huge estimating error by the CBO that absorbed much of the difference between what was projected to be a \$281 billion surplus and turned out to be a \$127 billion. The most significant reason for the federal deficit was the recession. The difference between projected government revenue and actual revenue collected was 71 percent. In other words, nearly three-quarters of the loss of the surplus is due to miscalculating the growth in the economy due to the recession and the resulting technical corrections made by CBO. In fact, between 1997 and 2001, technical corrections accounted for 41.6 percent of the revisions made to the 2001 surplus estimates made by CBO.

**Why Government Clings to Static Economic Analysis**

While many economists complain, rightly, that it is impossible to model our economy over a period of ten years, the experience last year showed that it is incredibly difficult to model our economy on a yearly basis. Congressman Cox drove this point home in his testimony today.

Yet, incredibly, Congress is a slave to these models. Congress does not make a fiscal policy decision without first determining the score, which in our case is a static score that assumes no behavioral change in economic markets. Static scoring is a simple accounting ledger addition or subtraction from the annual budget and subsequent budgets – the entrepreneur is absent in this model. Static scoring is functional, but it does not show us the ultimate effects of Congress' policy decisions. As far as Congress' current econometric models are concerned, the economic actions of individuals are completely separate from the actions of the federal government.

Unfortunately, the reliance on economic forecasts, and currently static scoring, is built into the budget rules of Congress and our procedures for action on both tax laws and spending laws, and there is no way around it. Quite frankly, I'm not surprised. Dynamic scoring – an intertemporal modeling of the economic feedback effect of a revenue or spending measure – inherently must take into account individuals' actions in the market. This is because reducing a person's taxes on the margin changes his or her incentives to work, to save, and to invest.

Fundamentally, in most of the things it does, the federal government has a difficult time correlating individuals' independent actions with its own central goals and functions. I believe the reason static scoring is relatively easy – and so hard to get rid of – is that it concentrates information, authority and decision-making to those of us here in Washington. In fact, and I'll discuss this a little later, from what I can tell there are gaping holes in the data collected by our statisticians in order to implement a proper dynamic scoring econometric model because of our inability to link "unplanned" entrepreneurship with tax reductions.

To this end, static scoring does not make for sound fiscal policy. I would argue that it biases Congress toward small, targeted tax cuts, which have no impact on economic growth, and away from broad-based marginal tax cuts that have a tremendous effect on the economy, which would be considered if dynamically scored. When they are not, the “cost” to the federal government for such a tax reduction – one that reduces tax burdens on vast majority of taxpayers, not just a select few – is tallied to be very expensive.

### **CBO, JCT and the Example of Capital Gains Taxes**

I understand that the Congressional Budget Office, who is here with us today, deals mostly with spending measures and Joint Committee on Taxation deals with revenue measures. As a member of Ways and Means, I have strong opinions about the dynamic scoring of the tax side of things. I believe that JCT’s inability to work with CBO on varying baseline budget projections resulting from proposed tax legislation due to the lack of dynamic modeling – prevents the full economic effects, and thus revenue effects, of a tax reduction from being used in Congress’ decision-making. Regardless, even with the ability for the two entities to work together, CBO’s faulty forecasts should ensure that the fate of certain revenue measures be summarily dismissed because of their budget score.

One of the biggest objections to dynamic analysis is that it is too complex and there is too much disagreement over the macroeconomic effects of government policy in order to develop a widely accepted econometric model. The latter point is the same argument that prevents the current modelers and certain economists from accepting that there is cause and effect between government actions, individual behavior and our economy. History has shown us that when taxes are reduced, Americans work harder and invest more, our economy grows, and tax revenues roll in. Why not start with that? At the very least, they cannot forecast any worse than they have been, so why not give it a shot.

While there has been debate over how a capital gains tax cut would effect taxpayer behavior, and lead to increasing government revenues, I believe that a significant case can be made that cuts in the capital gains tax rate have paid for themselves, and any future cuts would as well.

I believe this is possible for three reasons: first, historical data shows that Congress consistently underestimates the level of capital gains realizations and tax revenue increases following a capital gains tax cut; second, the historical data supports a relatively strong elasticity for taxpayer behavior in realizing gains following a tax cut (unlocking effect); and finally, the reduction of the cost of capital from reducing the tax burden on savings and investment causes both short and longer term economic growth that will generate additional revenue for the federal government (economic feedback).

I understand and respect the controversy surrounding these issues. Regardless, I believe the economic case, on balance, supports the idea that a reduction in the capital gains tax can pay for itself. More than any other tax reduction, especially those meant to stimulate consumption rather than savings and investment, a cut in the capital gains tax

rate deserves dynamic scoring because of its direct effect on financial markets. A capital gains tax cut would increase savings, induce productive investment and capital formation, raise productivity growth, increase jobs, and raise national output. In contrast, I would not make these arguments to defend dynamic analysis for that child tax credit, which does little to stimulate growth and costs federal revenue.

During the late 1980s and early 1990s, capital gains tax reduction was an intensely debated issue. I have reviewed the literature from this period, which found opposing analysis by the Treasury's Office of Tax Analysis (OTA) and Congress' Joint Committee on Taxation (JCT) of President George Bush's proposed capital gains tax cut. As you know, OTA estimated that the capital gains tax cut proposed by Bush in 1990, which included an exclusion of up to 30 percent of long-term gains, was estimated to raise \$12.5 billion over a five-year period, while the JCT estimated the proposal to lose \$11.4 billion over the same period.

Although there were differences in the methodology between the two analyses (notably that the JCT uses time series analysis and the OTA uses cross section analysis), I believe that since JCT must work with the U.S. economic performance baseline generated by the Congressional Budget Office, JCT cannot accurately calculate total revenue generation because it is unable to account for broader economic effects from changes in tax rates. Only CBO can make such revisions. This technical problem seems to preclude consideration of the economic growth effects from a decrease in any tax rate, and especially for the behavior-sensitive capital gains tax rate.

### *Historical "Real-World" Analysis*

When the capital gains tax rate has been reduced in the past, it has resulted in improved economic performance, higher income tax collections, and even higher capital gains collections. These real-world results have been clearly documented.

In contrast, JCT, in the past, has underestimated the actual real-world results. When the capital gains tax rate was reduced to 20 percent in 1983, revenues from the tax rose over the next five years by 385 percent – from \$12.9 billion to \$49.7 billion. Yet JCT had predicted that the rate cut would lead to a major loss in tax revenue. The same was true in 1978, when the tax rate on capital gains was reduced from 49 percent to 28 percent. According to testimony before the Senate Finance Committee, JCT estimated that the 1978 rate cut would lose \$6.2 billion over five years. Actually, it rose by billions of dollars every year thereafter – until the tax rate was increased and revenues fell.

The converse has also shown to be true: In 1986, the JCT predicted that an increase in the capital gains tax would increase realizations by \$270 billion by 1992, with a correspondingly large increase in tax revenues. Instead, by 1992, realizations had fallen to \$127 billion and tax revenues fell 34 percent in the first year after the increase. Only by 1996, ten years after the tax hike, did capital gains tax revenues begin to recover.

### *Elasticity of the Taxpayer Response*

A reduction in the rate of tax on capital gains will affect federal revenues in several ways. Most obviously, a reduction in the capital gains tax rate will subject realizations to a lower rate of tax, altering investors' desire to hold on to assets.

Under the existing capital gains tax rate, many investors find it prudent to forestall realizing capital gains in order to avoid the tax. Instead, investors hold on to the assets until death when they can bequeath them to heirs at a stepped-up basis, avoiding taxes on any capital gains. If the capital gains rate were lowered, some of these investors would find it advantageous to realize gains. A reduction in the capital gains tax rate is therefore likely to increase both capital gains realizations and tax collections in the short term. Following past capital gains tax reductions, this has proven to be the case. There was significant unlocking.

At first glance, it would appear likely that as a result of the "unlocking effect," reduction of the capital gains tax rate would move some realizations forward in time, thus lowering long-term realizations and consequently long-term realizations and long-term capital gains tax receipts. However, this effect would be partially offset since lowering the capital gains tax will likely increase investment in capital assets, working to increase capital gains realizations over the long-term, relative to what they would otherwise be.

#### *Effect of Tax Reduction on the Cost of Capital*

I believe that the government will continue to see increased revenue in the long-run, even if not as strongly as immediately following a capital gains tax cut, because of the greater incentives for personal saving and investment. This savings and investment will translate into more capital investment, especially in equities, and a higher level of economic output. Additional economic growth would generate higher revenues from other sources of federal revenue, at least partially offsetting the static revenue loss projected from capital gains tax reduction in the out years.

Lower capital gains taxes lower the cost of capital (defined as the pre-tax return required by investors). The tax on capital gains can be thought of as a tax on retained income, which funds a large part of business investment. The higher the capital gains tax, the more difficult it is for businesses to retain earnings (rather than pay out dividends) for real investment in productive projects. A cut in the capital gains tax would increase the value of capital assets (ie., equities) and encourage investment in both established and new businesses.

Economists believe that a capital gains tax rate in the range of 15 to 20 percent would reduce the cost of capital by 4 to 8 percent. This is consistent with the Congressional Research Service's (CRS) estimation that a 5 percent reduction in the capital gains tax would result in a 7.5 percent reduction in the cost of capital. CRS estimates that for every 1 percent change in the cap gains tax, the cost of capital will fall by 1.5%.

Even if a capital gains tax cut results in a lower cost of capital, Americans must still be willing to invest and save in order to have an effect on the economy. A lower cost of capital, or a higher after-tax rate of return, should induce more private saving. Most of

the economic forecasting models, both general equilibrium models and macroeconomic models use a marginal propensity to save statistic to determine how much economic growth will occur following a tax cut. Unfortunately, there is little empirical analysis on the innovation and entrepreneurial effects of a capital gains tax reduction – or any tax reduction for that matter.

In August 1998, at the request of former Ways and Means Chairman Bill Archer, CBO calculated that private saving would rise by only 0.3 percent following a capital gains cut from 20 to 15 percent, adding about 0.06 percent to the capital stock after 10 years. The resulting increase in GDP would amount to about \$2 billion to \$3 billion in the 10<sup>th</sup> year, or about \$10 billion to \$15 billion over the decade. My understanding of economic theory leads me to believe that this may be a conservative estimate, to say the least.

A 1997 study conducted by Allen Sinai assumes greater personal savings with a capital gains reduction. He assumes an increase in savings by .75 percent following the tax reduction. He justifies this assumption because the marginal propensity to save is higher for high income earners and most realized capital gains accrue to high income families.

He believes that, in part, greater savings is generated by the increased income of a stronger economy in response to the reductions in the capital gains tax, but also is due to greater efficiency in capital markets resulting in higher capital realizations, especially at the individual level. Some of these funds return to the federal government at the new lower capital gains rate, but most are now available for spending or saving by individuals and, for corporations, on new investment. The additional higher savings rate is generated by increased realizations, both in the short run because of unlocking and over time because of a higher stock market and, thus more economic activity.

Partly because of this higher savings elasticity, the Sinai study estimates that a capital gains tax reduction, in this scenario a 50 percent exclusion for individual capital gains, would increase annual GDP growth by .1 percent. Although the magnitude of this effect is small, given the immense annual output of the U.S. economy, currently in excess of \$10 trillion, .1 percent amounts to an additional \$10 billion in output in the first year, but only \$2 billion of additional revenue. However, the compounding effects of the higher growth rate eventually produce over \$12 billion of additional revenue in the fifth year, and \$32 billion in added revenues in the 10<sup>th</sup> year after the change in tax policy. The Joint Economic Committee supports this conclusion.

## **Conclusion**

I believe that the explosion in start-ups, technological innovations and productivity, was related to the 1997 reduction in capital gains taxes from 28 to 20 percent. This effect on the economy brought increased capital gains tax receipts to Treasury – not as decrease as CBO and JCT wrongly predicted.

Right now, for example, a lower capital gains tax rate could help to fund more entrepreneurs and business growth by reducing the after-tax cost of capital, as well as increasing the after-tax rate of return on Americans' investments. Such a measure would immediately be capitalized into a higher stream of future earnings, which brings us full circle back to the argument that both CBO and, therefore, the JCT, do not adequately account for the feedback effect when scoring a capital gains tax reduction.

As I stated earlier, marginal tax reductions minimize the loss in net tax receipts, relative to the gains in economic activity, entrepreneurship, productivity and output. However, our institutional resistance to dynamic modeling is holding us back from implementing sound fiscal policy to promote economic growth. We need to stop talking about dynamic scoring and begin to work toward its implementation. There are still hurdles to jump, including greater transparency and better data. The 1998 CBO study referred to earlier presumes that the innovative enterprise effect may be significant because of the high productivity of these firms, but cannot be included in revenue calculations because of lack of empirical evidence.

With this in consideration, I would recommend that one of the first steps to an effective dynamic model would be to review personal savings elasticities and subsequent increases in entrepreneurial activity following tax cuts in order to begin the process of developing empirical data for future economic models and discussion. Further, CBO and JCT need a system to work together on economic forecasts and changes in government revenue so that Congress can reverse its propensity for consideration of tax cuts that do little to encourage economic growth, but can be fit into a static budget.