
CRS Study on Tax Rates and Growth Still Flunks the Test

By

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Studies issued by the Congressional Research Service are intended to inform the Congress as it develops public policy and enacts legislation. A recent CRS publication on the effect of the top statutory tax rates on economic activity may have influenced the debate over taxing the rich during the election and may have influenced the tax changes just enacted in the fiscal cliff legislation.¹

It is critical that such studies reflect the best guidance that the economics and tax professions can provide. The CRS study on the top tax rates did not meet that high standard. Its original release in the fall was met with widespread and justified disbelief, and it was withdrawn for review and examination of its methodology. It has now been reissued in an updated form. However, the re-issued CRS study does not contain any changes of note that would redeem the original report.

The paper purports to determine the link (or lack thereof) between changes in the top marginal tax rates on income and capital gains and the growth rate of the economy. Unfortunately, the method used to determine the relationship depends mainly on timing, looking to see if a change in the growth rate of the economy coincides with or follows soon after a rise or fall in the tax rates. The study makes no effort to determine the channels through which the tax changes ought to work to affect the economy, looks at the wrong measure of progress over the wrong time frame, and takes inadequate account of what other tax or economic events are occurring at the same time that might mask the results.²

Looking at only part of the picture

Other factors can either hide the effect or exaggerate the effect of tax rate changes. Very few taxpayers have incomes that reach the top tax rates, and while these people earn a great deal of money, and contribute a

¹ Thomas Hungerford, *Taxes and the Economy: An Economic Analysis of the Top Tax Rates Since 1945 (Updated)*, CRS Report for Congress R42729 (Dec. 12, 2012).

² For a broad review of the literature on the subject of the impact of taxes on economic growth, see William McBride, *What is the Evidence on Taxes and Growth?*, TAX FOUNDATION SPECIAL REPORT NO. 207 (Dec. 18, 2012), <http://taxfoundation.org/article/what-evidence-taxes-and-growth>.

great deal to economic output, they still represent a fraction of total economic activity. Other changes in taxes and other influences on the economy occurring at the same time can easily hide or counteract the effect of the top tax rate changes alone. It is often impossible to hold other things constant to allow one to see the impact of the single item one wants to assess. When these other influences are omitted from the model, the "missing variables" problem poisons the results.

For example, consider the reduction in the top income tax rate in the Tax Reform Act of 1986. That Act reduced the top income tax rate from 50 percent to 28 percent (except for a 33 percent "bubble" rate on a range of income to "recapture" the benefits of lower tax rates and produce a flat rate of 28 percent for the highest income earners). Other things being equal, that should have increased the rate of growth of GDP for a few years in the late 1980s. But growth slowed in that era compared to the 1983-1985 period. Should we conclude that low tax rates retard growth?

The trouble with that procedure and conclusion is that other things were *not* equal. The 1986 Act also raised the maximum capital gains tax rate from 20 percent to 28 percent, lowered the dividend tax rate from 50 percent to 28 percent, ended the investment tax credit and slowed the taking of deductions for the cost of plant and equipment, reduced the corporate tax rate from 46 percent to 34 percent, reduced access to saving incentives for high income taxpayers, and eliminated a number of real estate investment incentives. Many of these other changes had a more powerful impact on capital formation, some for the good, and some for the bad. How can we disentangle these variables?

The first step is to calculate the "service price" of capital. That is the rate of return, or earnings, on capital needed to cover the cost of the asset, pay any taxes, and leave an investor with enough income after taxes to justify the investment. If one compares the service price for various assets under the old and new laws, one finds that the 1986 Act as a whole raised the service price and reduced the after-tax income from capital investment, which ought to have discouraged capital formation and retarded economic growth. That is exactly what happened following the 1986 Act. If one ignores the other changes in the law, one might say that the 1980s experience indicates that a lower top income tax rate caused the GDP to slow, when in fact, taken by itself, it made GDP larger.

For another example, note the Kennedy tax cuts in the early 1960s. The Kennedy individual income tax cuts lowered the top tax rate from 91 percent to 70 percent (and reduced other marginal tax rates by a similar proportion). The economy did surge following the 1963 enactment, as the rate cuts took effect in 1964 and 1965. One could say, on that basis, that the top rate cut had an enormously strong effect on economic growth. But that would be exaggerating the effect of the rate reduction. In 1962, Kennedy had increased the investment tax credit and had accelerated the deductions for plant and equipment. Furthermore, the 1963 Act lowered the corporate tax rate from 52 percent to 48 percent in 1964-65, along with the individual rates. About 55 percent of the positive impact on economic growth came from the business provisions, while

about 45 percent came from the rate cuts, and only a part of the effect of the individual rate cuts came from the cuts at the top.

The key to predicting what a change in the tax code does to the economy is to understand what buttons have to be pushed to affect the level of output and income. The service price is one such button. If a tax rate change lowers the service price, it raises the amount of capital that people want to create and own. There is an abundance of evidence that changes in the service price affect output. Another metric is the marginal tax rate on labor income. Lower marginal tax rates make it more rewarding to work and expand a business; higher rates discourage work and entrepreneurship. One can simulate the effect of each provision in a tax bill, or for the bill as a whole, by measuring its effect on the service price and marginal tax rate on labor income without the difficulty of tracing and correcting for the innumerable conflicting influences on the GDP statistics in a given year.

Looking for the wrong result

Following a tax cut on capital income, the growth rate will surge for a while as additional capital is created by means of increased investment. Once the additional capital is in place, the GDP will return to a more normal rate of growth, but it will be expanding from the new, higher base level as workers have more capital to work with, enhancing their productivity and output. Thus, one should look at the long-term change in the capital stock and the ultimate level of output, not the short-term rise in investment and the short-term change in the growth rate. If one looks only at the growth rate, and not at the level of GDP, one could conclude that the tax rate change has only a temporary benefit, when in fact it is permanently helpful. Conversely, the income tax rate increases in the first term of the Clinton administration should have reduced the growth rate of the economy briefly, after which growth would have resumed, but from a lower base level. Claiming that the rate hike did no damage because growth resumed after the tax hit misses the permanent loss in the level of GDP. (There were also offsetting tax reductions later in the Clinton years, such as the cut in the capital gains tax rate enacted in 1997.) Looking at the wrong measure of success leads to considerable confusion, as in "the operation was a success but the patient died."

Looking at the wrong timeframe

It takes about five years to fully build up the amount of equipment in the economy following a cut in taxes and about a decade for plant, commercial, and residential buildings. Looking only at the amount of investment triggered in the year following the tax change misses the point. The same holds true in the opposite direction for a tax increase. It takes years to retire through attrition the excess capital made redundant by a tax increase. Looking only at the change in investment in the year after the tax cut, rather than the cumulative increase in the stock of capital over time, misses about 95 percent of the impact. You can't predict this fall's apple crop by counting the number of seedlings planted this spring.

Conclusion

The CRS study omits important variables and poisons its results by not holding other factors constant. The variables it does examine are indirectly related to the relationship one should be studying, but the study does not follow them for long enough to get the whole picture. The study is as weak now as it was when it was first issued. Grade: F.

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