Written Testimony of Senator Phil Gramm

Before the Joint Economic Committee

Washington, D.C.

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It is a great honor to be asked to testify before the Joint Economic Committee today, especially because I served with Chairman Coats for many years in the Senate and Vice-chairman Brady is an old friend of mine from Texas.

During my time in the House and Senate, I focused mostly on the economy and the budget. Anyone who spends any significant time studying the US budget comes to realize that changes in America's economic performance have a profound impact on the budget of the country. Economic changes often overwhelm the expected static impact of even the largest policy changes.

Until we learn how to incorporate the impact of our policy changes on the economy and the budget, we won't have a real understanding of the costs and benefits of our proposed policy changes. When we have a strong reason to believe that a policy change is likely to affect the economy, based upon a logically consistent theory, and good empirical evidence that similar policies have had significant effects on the economy in the past, we should always attempt to employ dynamic scoring.

Dynamic scoring is about finding a way to gauge the full impact that policies might have in increasing or decreasing government revenues and government expenditures. It seems to me that there are three conditions that should be met before dynamic scoring can be used.

First, there must be a clear and established economic theory suggesting a causative link between specific policy changes and a substantial macroeconomic effect of sufficient magnitude to alter revenues or outlays in the federal budget. Second, there should have to be a good reason to believe that the macroeconomic effects would alter government spending or revenues within the years that you are budgeting for, which is normally 10 years or less. Third, there must be convincing empirical evidence that the implementation of these policies in the past has produced both the economic and the budgetary effects that the theory would suggest. On all these points, the burden of proof should fall on those who want to use dynamic scoring.

I'd like to discuss two compelling cases where the theory and evidence of macroeconomic effects and budgetary feedbacks are strongly supported. Both examples are bipartisan efforts and both relate directly to topics that are at the center of the public policy debate today.

The Balanced Budget Act and the Taxpayer Relief Act of 1997 was an agreement between the Republican Congress and President Bill Clinton to balance the budget through spending restraint while cutting taxes. These bills had significant macroeconomic effects that benefited the American people and the federal treasury alike.

In early 1995, CBO initially projected that balancing the budget by constraining spending would create a combined revenue and outlay dividend of $120 billion from 1995 to 2001, an estimate later increased to $222 billion. After two years passed in negotiating the details of a balanced budget deal, CBO reported in January of 1997 that much of the original dividend had been incorporated into their baseline so that any additional outlay and revenue dividend was just $43 billion for 1997 to 2001.

When we compare CBO's January 1997 GDP and revenue forecast prior to enactment of the Balanced Budget Act to the actual results achieved in the next five years, we find that both economic growth and revenue growth after the Balanced Budget Act became law far outperformed anything projected by CBO. Nominal GDP, from 1997 to 2001, surpassed CBO's projected GDP by an astonishing total of $2.4 trillion – equivalent to $4.7 trillion in today's economy (2014 GDP). That averaged out to $480 billion per year higher than CBO's original projections, providing an extra $8,609 in per capita GDP in those five years.

Revenues also rose beyond expectations, even after Congress and the President cut the capital gains tax rate and established the child tax credit. From 1997 to 2001, cumulative federal revenues were $1.015 trillion higher than projected before the enactment of these laws.   A similar revenue surge today would deliver an additional $368 billion per year to the government. The CBO reported in July 2000 that "projected revenues for [FY] 2000 are now $303 billion more than estimated in 1997… The primary contributors to that unexpected growth stems from the strength of the economy and changes in the characteristics of income."

The Tax Reform Act of 1986 was designed to be revenue neutral under static scoring by closing loopholes and limiting deductions in exchange for lowering tax rates from a top rate of 50% in 1986 to 28% starting in 1988. In comparison to CBO economic and revenue projections prior to the full marginal rate reductions, the Tax Reform Act produced a significant macroeconomic and budgetary impact. Its benefits are magnified by the fact that this occurred well into one of the strongest and longest postwar recoveries. By January 1988, the recovery was in its 62nd month, over a third longer than the average postwar recovery's length, with the economy averaging a scorching 4.6% growth and never less than 3.5% in any year.

Just prior to full implementation of the rate reductions, CBO's economic projections assumed much lower growth, with estimated real GDP growth of 2.3% and 2.6%, respectively, for 1988 and 1989, but actual growth rates hit 3.9% and 3% (subsequently revised to 4.2% and 3.7%).   Nominal GDP for those years surpassed CBO's projected GDP by a total of $286 billion, equivalent to $1 trillion in today's economy (2014 GDP). By averaging $143 billion per year higher, that benefited every man woman and child in America on average by an extra $1,163 in GDP during those two years. The Tax Reform Act gave a very strong second wind to the recovery, helping to deliver a 38% increase in real GDP in the 1982-90 recovery.

The stronger economy fed back into stronger revenues with Federal income in the first two years after the marginal rate reductions averaging $25 billion higher than expected. CBO reported that these higher revenues were due to stronger economic factors. As a share of 2014 revenues, that $25 billion corresponds to $80 billion today.

Based on the evidence of the bipartisan Balanced Budget Act of 1997, we could expect that any dramatic change in budget policy that substantially reduces the long term deficit through spending control, such as spending restraint and entitlement reform, could reasonably be expected to deliver substantial macroeconomic effects coming from improved business and consumer confidence. I believe a very strong case can be made that a comprehensive entitlement reform package that dramatically reduced the long-term deficit should receive a large positive dynamic score.

Similarly, based on our experience with the bipartisan Tax Reform Act of 1986, we should have confidence in believing that revenue-neutral tax reform that makes our tax system more economically efficient and lowers tax rates would have a substantially positive effect on GDP and, therefore, federal revenues. This is especially true today given that the recovery of 2009 has never taken off.

The Joint Committee on Taxation (JCT) has already projected a potential dynamic score of up to $700 billion over ten years from one version of pro-growth tax reform, which would correspond to an average annual revenue increase of $70 billion. With a dramatic tax simplification and rate reduction program, we could expect to achieve dramatically positive results.

It is important to remember that dynamic scoring is not a replacement for traditional static scoring, but rather an enhancement of it. CBO and JCT have decades of experience estimating the direct impact of legislative changes on the budget, but the largest revisions to their projections and final figures have come from a failure to fully predict and incorporate macroeconomic effects in their estimates. Yet it is those very macroeconomic effects that have been so powerful as to swamp the static estimates of the largest legislative changes.