



## Tax Policy: A Behavioral Science -- Part 2

### Tax Notes

May 8, 2006

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This week's column is intended to be the second of a three-part series on the origins, purposes, and inner workings of dynamic analysis. (For the first part, see [Tax Notes, Apr. 3, 2006, p. 97.](#))

As dynamic analysis continues to emerge from the "black box" of political intrigue in which it has been hidden for years, it turns out there is nothing mysterious about the process of predicting and reasonably well quantifying the future economic consequences of changes in the tax code. It isn't even very hard and it certainly is not new. Wall Streeters and others who deal with real money have been doing it for years.

An econometric model is useful in aggregating the interactions between the economy and the altered tax code in numerous transactions, but the basic prediction of whether any particular tax change will have a plus or minus effect on the economy is mostly a matter of common sense and simple math. Nevertheless, most politicians have resisted using dynamic analysis as a formal legislative tool, for the obvious reason that it would expose to public view not only the tax changes made by Congress that help the economy, but those that hurt the economy as well.

Dynamic analysis can predict economic outcomes, and -- because of those outcomes -- it can also help predict political outcomes. For example, suppose that in an election the choice is between Candidate A, who promises to continue and make permanent the new maximum 15 percent tax rates for dividends and capital gains, and Candidate B, who promises to reinstate the higher rates of 35 percent for dividends and 20 percent for capital gains that applied before 2003. And further suppose that as the result of dynamic analysis, it is understood among the electorate that repeal of the 15 percent rates would on average reduce stock values by 10 percent. With the issue so framed, it is reasonable to assume a large portion of the 100 million voters who own stocks would vote against devaluing their portfolios.

That such a devaluation would occur is a matter of simple mathematics -- no black boxes required. For example, a hypothetical stock with an expected after-tax future dividend yield of \$4 per year now has a market value of \$100 -- which is the present value of that future dividend stream. But if the 15 percent tax rate is increased to 35 percent, the after-tax dividend yield drops to \$3.06 and the fair market value of the stock falls to \$76.50.

The most powerful function of dynamic analysis is to show voters they are vitally affected by changes in the tax code even if their own tax bill remains unchanged. For example, nearly 50 percent of all return filers have incomes below the taxable level -- but, ironically, they and other lower-income people are the ones whose jobs and wages are most sensitive to the changes in savings, investment, and gross domestic product that are brought about by the tax code. Those people and everybody else are entitled to know that reversing the dividend and capital gains rate cuts enacted in 2003 would reverberate throughout the economy, costing about \$200 billion per year in GDP growth, which means an average loss in income of about \$1,500 per family per year -- whether or not they own stocks and whether or not they pay income tax.

Voters are also entitled to know the collateral damage to them when Congress fails to reform well-known defects in the tax code. Take, for example, the case of first-year expensing versus depreciation of business capital equipment. Tax insiders and many members of Congress have long understood that because depreciation postpones and devalues deductions for the cost of capital equipment, it inhibits investment and, therefore, wage and jobs growth. But what if voters were let in on the secret and knew that Congress could, by amending the tax code to allow first-year expensing, increase the typical family's real wages (above inflation) by \$500 per year and add 750,000 new jobs?

There are a whole range of considerations that bear on decisions to make particular changes in the tax code. Those include positive and negative effects on tax revenues and, therefore, on spending -- which also affects voters both directly and indirectly. But in today's world, the tools exist by which the dynamic, real-life effects of both taxing and spending, and the interactions between the two, can be quickly quantified with reasonable accuracy and used as guidelines.

This column will continue to demystify both taxing and spending through dynamic analysis, sometimes using a newly updated neoclassical econometric model for maximum accuracy and detail -- but, in most cases, the correct result is so obvious and intuitive that it can be closely approximated by a few calculations on the back of an envelope.

The truth has been hidden -- right in plain sight -- for years.

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