

INSIDE THE CONGRESSIONAL BUDGET OFFICE:

STATIC VS. DYNAMIC BUDGET SCORING

Created in 1974 as part of the Congressional Budget and Impoundment control act, the Congressional Budget Office (CBO) is a non-partisan agency responsible for providing economic data and analysis to Congress. The CBO has two mandates to fulfill:

- Prepare “objective, nonpartisan, and timely analyses to aid in economic and budgetary decisions on the wide array of programs covered by the federal budget.”
- Prepare “the information and estimates required for the Congressional budget process. (1)”

These mandates make CBO the official scorekeeper of proposed bills and legislation in Congress through a process called “scoring.” During the scoring process the CBO tries to estimate the cost of any bill, any revenue collected as part of the bill, and finally the impact the bill will have on the deficit and the national debt.

STATIC SCORING: THE CURRENT METHOD

The CBO currently prepares its cost estimates using “static” analysis. Static scoring functions like basic arithmetic. All the costs of a proposal are calculated, all the changes in tax revenue are calculated, and the difference is the effect on the deficit. For instance, let’s assume that Congress creates a 10 percent tax on luxury automobiles. Static scoring would estimate the revenue produced by simply multiplying the number of luxury cars sold in a recent year by the new 10 percent tax. But what happens if households change their behavior as a result of the new tax and decide not to purchase luxury cars? Static scoring ignores this quite logical response. The absurd result is that static scoring considers a 100% tax to be the most efficient, as it assumes the tax would capture all of the targeted economic activity subject to the tax. We all know that a 100% tax would never achieve that outcome as behavior would shift in reaction. Because of its more limited analysis, static scoring by CBO tends to be biased against tax cuts and tends to favor tax increases.

DYNAMIC SCORING: A BETTER PICTURE FOR POLICYMAKERS?

Dynamic scoring, however, attempts to quantify the actual economic impacts of a bill, providing what many believe is a much more accurate “score” for a given proposal. Similar to static scoring, all costs and revenue changes are tabulated. However, the CBO then tries to estimate how the economy would react to the proposed changes in government policy. Dynamic scoring acknowledges the basic economic concept that individuals respond to incentives. While a tax cut results in a decrease in revenue under static scoring it could actually result in a revenue increase under dynamic scoring when individuals, households, and firms modify their behavior.

QUICK FACTS

- Static scoring systematically overestimates revenue raised from tax increases and underestimates revenue gained by tax cuts.
- Dynamic scoring attempts to model the real-world behavioral changes individuals, households, and firms make in response to changes in government policy.

NOTABLE & QUOTABLE

“Indeed, one of the most attractive aspects of dynamic scoring is its promise of allowing policymakers to distinguish between economically efficient tax policies that promote growth, and those that work to reduce the living standards of future generations.”

- **Douglas Holtz-Eakin**,
Former CBO Director

The capital gains tax is a good example. As the tax rate on capital gains falls, individuals are more likely to sell profitable stocks to realize gains. More revenue is generated on two fronts: from more “taxable events” (a higher number of qualifying capital gains to be taxed) and from the economic growth that results from a freer and more efficient allocation of capital. This effect is described by economists with the “Laffer Curve,” (2) and it is exactly what happened when capital gain tax rates were lowered in 2003. Capital gain tax rates fell from 20 percent to 15 percent, yet total capital gain tax revenue increased from \$50 billion to over \$100 billion (3). Dynamic scoring attempts to estimate this change of behavior and provide a more accurate accounting of the effects a policy proposal has on overall spending and revenue.

CBO’s current static scoring system fails to account for the behavioral changes that individuals, households, and firms make in response to new economic policies. This makes tax increases look better and tax cuts look worse than they really are

CONCLUSION

The Congressional Budget Office is an essential component of the federal budget process. However, CBO’s current static scoring system fails to account for the behavioral changes that individuals, households, and firms make in response to new economic policies. Adjusting to dynamic scoring accounts for these changes and provides better cost estimates for Congress to weigh its decisions.

Endnotes:

1. CONGRESSIONAL BUDGET OFFICE, Congressional Budget Office, Fact Sheet (online at <http://www.cbo.gov/aboutcbo/factsheet.cfm>) (accessed November 21, 2011).
2. THE LAFFER CENTER FOR SUPPLY-SIDE ECONOMICS, The Laffer Curve (online at <http://www.laffercenter.com/arthur-laffer/the-laffer-curve/>) (accessed November 21, 2011)
3. Brian Riedl, Bush Tax Cut Myths, HERITAGE FOUNDATION, Backgrounder No. 2001 (January 29, 2007) (online at <http://www.heritage.org/research/reports/2007/01/ten-myths-about-the-bush-tax-cuts>).

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