Analysis Deficit
By R. Glenn Hubbard
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Would you pay $15,000 for a car? Most of us would consider the question odd: It depends on which car. In the current tax cut debate, 10-year revenue costs of $350 billion and $550 billion are being debated, but the question should be: for what? President Bush's tax cut was designed to provide short-term growth insurance and enhance long-term growth. Does it deliver?

If you listen to the political rhetoric, the most controversial of the president's tax proposals is the elimination of the double tax on corporate income. This would not be the case if scientific analysis were introduced into the debate. So far, neither the administration nor the Joint Committee on Taxation has provided an element-by-element evaluation of the different proposals. Name-calling tends to break out when there is no substance to discuss.

When the Council of Economic Advisers considered the economic benefits of the president's entire proposal, the agency emphasized demand-side effects on consumer spending and investment in the near term. Using a conventional forecasting model, effects of the tax plan on job prospects, household disposable income, and incentives to invest were projected to raise real GDP by about $670 billion over the next five years. This increase in output would raise revenues by $133 billion over that period.

But even that analysis omits the long-run supply-side benefits. The dividend tax reduction has the strongest economic merits. Ending the double tax raises long-term income by increasing capital formation and improving the use of existing capital.

The first thing to track is the direct effect on investment. The dividend tax cut significantly reduces the cost of financing new investments. If businesses invest more, economic growth increases. The connection between the cost of finance and business investment is one of the least contentious areas of economic science, and cautious applications of the results from studies of tax policy and investment suggest that eliminating dividend taxation should add about a quarter of a percentage point to real GDP every year.

The indirect effect of the tax reduction is large as well. Eliminating the double tax puts the existing capital stock to better use. The 1992 Treasury Report projected that this gain in output would also be about a quarter of a percentage point of GDP annually.

Putting it together, the proposal to eliminate the double tax increases the long-run level of real GDP by about 0.5% per year. Between 2008 and 2013, this amounts to $360 billion in extra output -- about $85 billion of extra revenue. This improvement occurs because painful and destructive tax distortions are removed, not because of "costly" tax cuts.

Coupled with the short-term effects, the dividend plan clearly has significantly lower revenue costs than those figuring in the current debate. Other tax changes, like the child tax credit and removal of the marriage penalty are likely to have significantly lower economic impacts. Yet these less effective policies are the only ones that everyone agrees will become law. Small wonder when economic analysis does not have a seat at the table.

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