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CBO Demands a Leap of Faith on the Fiscal Cliff

By John H. Cochrane - Sep 3, 2012

Last month, the Congressional Budget Office released a report warning that the “fiscal cliff” would cause a new recession. It came to the right conclusion for all the wrong reasons.

Reasons matter. A policy response crafted to satisfy the CBO’s analysis would hurt the economy. Reports such as this one would be much more useful if the agencies that publish them were more transparent about the calculations, and explained the logic of their models.

This is the cliff: Unless Congress acts, the Bush-era income-tax cuts will expire, Social Security payroll taxes will increase, and capital-gains and dividend tax rates will rise sharply. Also, the estate tax will come back with a roar, “mandatory” spending cuts will take effect, the extension of unemployment insurance to 99 weeks will expire, and Medicare payment rates to physicians are supposed to be slashed.

The CBO projects that “such fiscal tightening will lead to economic conditions in 2013 that will probably be considered a recession, with real GDP declining by 0.5 percent between the fourth quarter of 2012 and the fourth quarter of 2013 and the unemployment rate rising to about 9 percent in the second half of calendar year 2013.”

Keynesian Projections

How does the CBO come up with these numbers? Its projections are Keynesian. If the government borrows $1 billion and spends it, the CBO will project that this action raises gross domestic product by $1.5 billion. Government workers are counted as “producing” what they cost, so borrowing money to keep them employed generates the same GDP as building a bridge. If the government just gives the money to people, this also raises the CBO’s GDP estimate. Reducing government spending and transfers has the opposite effect.

If, like me, you think that spending less money on useless projects is good for the economy, or that taking money from A and giving it to B has little overall effect, you would come to much different conclusions from the CBO’s.

Similarly, the CBO says raising tax rates hurts the economy because taxpayers will consume less, lowering “aggregate demand.” If, like me, you think that taxes hurt the economy not so much because of how much people have to pay rather than lend to the government, but because higher (marginal) rates discourage work, saving, investment, business formation and growth, then the CBO's numbers are meaningless to you.

The central distinction between Keynesian and regular economics is the assumption that people don't respond to incentives. In regular economics, prices and taxes first and foremost change incentives. Transfers, though important to the people who pay and get them, have much smaller effects on the overall economy. Keynesian economics and the CBO's analysis take the opposite view: Transfers matter, incentives don't.

A good example: What will be the effect of curtailing 99 weeks of unemployment insurance? To the CBO, it will reduce GDP because would-be beneficiaries will consume less. A standard economic analysis predicts that it will have the opposite effect, increasing GDP and bringing down unemployment. That's because unemployment insurance means some people choose to stay unemployed rather than take lower-paying jobs, or jobs that require them to move.

(Remember that the CBO and I aren't opining on what's good or bad. The point is only to project whether GDP and unemployment will go up or down. Some unemployment insurance can be a good thing even though it hurts GDP and raises unemployment.)

Tax Increases

To the CBO, tax increases and spending cuts have about the same effect. In my analysis, higher tax rates are more damaging than spending cuts. To me, a revenue-neutral tax reform that took in the same amount of money at much lower marginal rates would be a boon. It would have little effect at all in the CBO's analysis.

In my view, the bigger problem with the fiscal cliff is the utter chaos it reflects. What serious country decides its tax laws year by year, in one big crisis during the first few weeks of the year? The CBO's model doesn't assess chaos.

Moreover, this crisis atmosphere is a fiesta for lobbyists, tax lawyers and crony capitalists of all stripes. The CBO's list of expiring tax provisions gives a taste:

"Cellulosic Biofuel Credit, Credit for Past Minimum Tax Liability, Depreciation of Certain Ethanol Plant Property, Election to Accelerate AMT and R&E Credits in Lieu of Electricity Production Credit for Wind Facilities, Exclusion of Mortgage Debt Forgiveness, Indian Coal Production Credit."

The list goes on. Lobbyists will fight for each one in the middle of the night.

So, in my view, most of the CBO's analysis is wrong.

This matters most as we consider alternative policies. CBO- style analysis will encourage more ineffective "stimulus" spending. It won't lead to the all-important tax reform that stabilizes and simplifies the code and lowers marginal rates. It won't help reduce the vast amount of useless government spending.

(To the CBO's credit, it has been warning that skyrocketing debt poses a long-run threat. But higher long-term interest rates seem a distant worry to a still-struggling economy.)

Its analysis isn't logically wrong. If you accept its Keynesian logic and the absence of incentive effects, the CBO's assessment makes sense. It's those ifs that are wrong.

The deeper problem is that we really don't know how the CBO gets its numbers. You can search its website without finding a reproducible description of the calculation, or the computer program that produces numbers. My characterization comes only from talking to CBO staff.

Logical Pathways

This obscurity pervades government and its think-tank satellites. A report opines with great precision on the effects of policies. There is a model. But you can't find what's in the model or reproduce the numbers. Even where documentation exists, it's buried. Most of all, the report never explains the logical pathways, the necessary but controversial "ifs" needed to arrive at the numbers.

Economic models aren't engineering models. If you ask several aeronautical engineers to project how adding flaps affects an airplane's takeoff speed, their models will be complex, but they will come up with about the same, and reliable, answers. You don't need to know why.

But good economic models are quantitative parables, not authoritative black boxes. They only are trustworthy if they illustrate clearly understandable and explicitly stated pathways.

Numbers and models are important. The CBO needed to add up all the complex provisions of the law, and it is very good at doing this. If we retreat from numbers and models altogether, we cannot know, for example, that reversing the Bush-era income-tax cuts for "the rich" won't make a dent in the deficit, let alone provide revenue for new programs.

But economic numbers cannot stand without the logic that produces them. Clarity and transparency are far more important to a good quantitative parable than the illusion of authoritative precision.

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