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THE NATIONAL ECONOMIC COMMISSION'S "EXPLODING" FORECASTING MODEL

(Updating *Executive Memorandum* No. 216, "The National Economic Commission: A Tax-Hike Trojan Horse," September 30, 1988, and *Executive Memorandum* No. 217, "Immediate Test for Bush: Picking National Economic Commission Members," November 9, 1988.)

Econometric forecasting models are supposed to help Congress and the executive branch simulate the effects of various economic policy alternatives. Every schoolboy by now knows, of course, that in the world of computers "garbage in" yields "garbage out." This is certainly true with the econometric forecasting models recently presented before the National Economic Commission (NEC), the bipartisan body established by Congress to develop a plan to tackle the federal deficit. These models vastly understate the effects of tax incentives on the economy and are based on the simplistic and outdated Keynesian assumption that the performance of the economy is determined largely by the total level of spending, known as "aggregate demand," by private households and the public sector. By assuming that the balance between public and private spending, or the tax burden, is largely irrelevant as a factor in economic growth, the NEC's forecasting models are virtually programmed to recommend new tax increases as a solution to the budget deficit, despite the fact that most economists today, bolstered by the experience of the United States and other countries, recognize that new taxes would harm the economy seriously.

The NEC recently asked the Congressional Budget Office (CBO) to run four deficit reduction plans through three Keynesian econometric models. The packages, which totaled $120 billion to $130 billion per year in deficit reduction over the period 1990-1994, include the following elements:

Plan 1 restrains spending growth to 3.1 percent per year;

Plan 2 contains 70 percent spending cuts and 30 percent tax increases;

Plan 3 contains 50 percent spending cuts and 50 percent tax increases, including individual income tax hikes and an energy tax; and

Plan 4 contains 50 percent spending cuts and 50 percent tax increases, with no energy tax.

The CBO reported to the NEC last week that each of the econometric models indicates that any one of the deficit reduction measures, if accompanied by an easing of monetary policy, would strengthen the long-term outlook for the economy, increase real investment, expand exports, and reduce interest rates. The CBO's report gave would-be tax increasers what they want to hear. The CBO's conclusions, however, were predictable given a Keynesian aggregate demand framework. All the models assume that the budget and trade deficits are clear signs that

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Americans are "overconsuming." To cut back the "excess demand," Keynesian theory prescribes raising taxes or cutting government spending. To Keynesians, it does not really matter which, since both would reduce aggregate demand and since, the Keynesian models assume, tax rates have no effect on the economy.

Ignoring History. The remarkable dismissal of taxes as a factor in growth is particularly evident in the failure of each of the NEC models to distinguish between the economic consequences of tax increases and budget cuts as a means to reduce the deficit. According to the models, the deficit-reducing plan consisting solely of budget reductions (Plan 1) has an impact on the economy, interest rates, and exports broadly similar to plans containing various combinations and proportions of tax increases (Plans 2, 3A and 3B).

Failure to appreciate the incentives resulting from tax policy, however, is the Achilles heel of the econometric models and makes their conclusions and recommendations suspect. Tax rates affect investment and work decisions by Americans. If taxes are raised on labor, work effort is penalized; higher taxes on capital discourage saving, entrepreneurship, and new investment in plant and equipment. The disincentives of tax hikes may be so strong, according to a recent Treasury Department study, that the result could be to reduce saving and investment by more than the tax increase itself. Yet the NEC's models assume that taxation has no such effect, and that the level of government borrowing to finance budget deficits is the principal threat to savings and investment. The models ignore history, which proves that investment is "crowded out" by taxation, regardless of whether the budget is in balance.

Puzzled Keynesians. The true test of economic theories, of course, is their results. In the 1970s, higher taxes and loose money – the approach imbedded in the NEC models – led to simultaneous inflation and unemployment, the malady known as stagflation. Keynesians were puzzled. According to their theories, that result was impossible. Similarly, Keynesian econometric models predicted that the 1981 tax rate reductions would raise interest rates, increase inflation, and cause an economic collapse. They were wrong, of course. The U.S. economy is still enjoying its longest peacetime expansion in history, unaccompanied by renewed inflation.

Remembering how these previous predictions proved so wrong, NEC member Donald Rumsfeld asked the CBO official testifying before the Commission what economic pattern the NEC's econometric models would have predicted following the 1981 tax cuts. As the CBO official groped for an answer, Senator Pete Domenici, the New Mexico Republican, who is also an NEC member, quipped, "The model would have exploded."

An "exploding" forecasting model is an apt symbol for the current muddle in economic thinking at the NEC. Having tried every argument they can to persuade President-elect George Bush that tax hikes are the only answer to the deficit, many Commission members now seem willing to embrace econometric models based on faulty analysis that has led to economic disaster in the past. As long as Commission members insist on using such defunct models of the economy, policy makers would be better off reading the lips of George Bush than consulting the mystic demand-side equations NEC computer models.

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