10-29-2012

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http://thehill.com/blogs/congress-blog/economy-a-budget/270383-the-fiscal-cliff-policy-uncertainty-and-tax-reform

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By Seth H. Giertz, University of Nebraska and Jacob Feldman, George Mason University - 11/30/12 03:15 PM ET

The founding fathers purposefully designed a political system that perpetuates gridlock. Frictions in political decision-making should foster stable policies. However, in recent years, this has been turned on its head.

In recent decades, Congress has passed a series of budget control acts intended to impose discipline on the budget process. These acts, by encouraging policy phase-ins, phase-outs and expiration dates, have had the unintended consequence of policy uncertainty.

A growing literature is finding that policy uncertainty imposes substantial economic costs. Policy uncertainty leads individuals to misallocate resources or to incur added costs from planning for possible scenarios. Policy uncertainty, it is argued, leads investors to sit on the sidelines, rather than bet on whether or how Congress will act.

In a newly released study by the Mercatus Center, we find that investors may do worse than sit on the sidelines. We argue that policy uncertainty may decrease productive business activities, like research and hiring, while increasing resources spent on unproductive investments, like lobbying government.

We argue that policy uncertainty is a signal that government is open for business. With little policy uncertainty, higher returns may be sought from investing in productive activities. However, when government is receptive to policy changes, the returns from lobbying, political action committees, etc. may be more remunerative. We believe that this may be yet another important cost of policy uncertainty.

Our hypothesis builds on the work of William Baumol, who argued that entrepreneurship can be divided into productive, unproductive, and destructive activities. Baumol chronicles great innovations made over wide swaths of history, but notes that, in many cases, little effort was made to disseminate these inventions to the masses or to use the inventions to increase productivity. Baumol argues that political and cultural institutions play a key role in whether or not innovations are geared toward improved productivity and economic growth. In many preindustrial societies, the path to wealth was through rulers, and not the marketplace.

The fiscal cliff and chronic policy uncertainty in recent years underscore the need for fundamental tax (and spending) reform. The Tax Reform Act of 1986 was America's most recent fundamental tax reform. This reform closed loopholes, broadened the tax base, and lowered rates. On the downside, it was susceptible to constant tinkering. In fact, the report of the 2005 President's Advisory Panel on Federal Tax Reform noted that Congress had subsequently amended the tax code approximately 15,000 times!

In their detailed review of the effects of the Tax Reform Act for the Journal of Economic Literature, Alan Auerbach of the University of California and Joel Slemrod of the University of Michigan concluded that "Even the simplification potential of radical tax reform depends on how enduring a simple, broad-based tax can be, in the face of constant political pressure to reintroduce special 'encouragements' or to redistribute the tax burden." We argue that stability and resistance to constant tinkering should be a first order considerations in any tax reform, and a major lesson from the 1986 reform.

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