Response to Representative Ross Hunter

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Washington State House Representative Ross Hunter calls into question the use of economic models as a tool to better inform the public (and public servants) about the costs and benefits of tax policy.[1] In particular he is critical of Beacon Hill Institute's State Tax Analysis Modeling Program (STAMP®) suggesting it is unreliable and untrustworthy. His analysis is incorrect.

Representative Hunter skepticism about STAMP is based on his assumption that it is biased in some form. He writes that it "ALWAYS shows jobs losses from proposed public policy proposals" (emphasis original). This is incorrect. The STAMP model has been used in numerous situations where proposed public policies would provide economic benefits and job gains for the state.[2]

To support his distrust of models Representative Hunter cites an article by a University of Arizona economist. The referenced article compares the job loss findings of a STAMP analysis on a tax increase in Arizona to two other economic models, which find employment growth due to higher sales taxes. It does not go unnoticed that Representative Hunter has no problem suspending his distrust of economic modeling that produces results he agrees with.

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[1] Ross Hunter. Use of 'economic models' to mislead the public. March 3, 2014. http://www.rosshunter.info/2014/03/use-of-economic-models-to-mislead-the-public/.

[2] For Example: Pelican Institute. The Economic Benefits of Tax Reform in Louisiana. March, 2013. http://www.thepelicanpost.org/wp-content/uploads/2013/03/TaxReformLouisiana_3.2013_Final.pdf,
The Thomas Jefferson Institute for Public Policy. Tax Restructuring in Virginia. April 2012. http://www.thomasjeffersoninst.org/files/3/Tax_Restructure_narrative3.pdf,
The John Locke Foundation. An Economic Analysis of State Tax Changes in North Carolina. May, 2911. http://www.johnlocke.org/research/show/policy%20reports/230,
South Carolina Policy Council. Taxes in South Carolina: No Relief in Sight. November 2007. http://www.scpolicycouncil.org/wp-content/uploads/2013/10/BeaconHillStudy.pdf.

Four years ago, the Beacon Hill Institute reviewed and responded to the University of Arizona paper finding numerous errors with the critique.[3] In short, the critique came down to differences in methodology. The author of the paper subscribed to the idea that it is always better for the government to spend a dollar than an individual or business. This is because when the government spends that dollar it will have a larger 'impact' on the state economy.

The STAMP methodology is different insofar that it tries to understand what happens when that dollar is moved from the private to the public sector. When the government wants to raise an additional dollar, it creates distortions in underlying economic incentives, which in turn exert negative effects on the state economy. In other words taxpayers respond by changing their behavior; in the case of a higher sales tax, they will buy less than otherwise. In the case of both Arizona and Washington, a sales tax increase creates distortions by increasing the cost of goods. As with all normal goods, higher prices will reduce consumer demand for that good at the margin, resulting in negative effects on production and demand for factor inputs, that is labor and capital.

A higher sales tax also has a 'benefit', which is revenue for the state government to now spend on additional, and perhaps well-needed, services. And in this spending, or distribution, of the money the government will create some economic activity and new jobs in the state.[4]

But at the end of the day production will be lower in the state because of the negative effects of the tax on consumer demand, and fewer jobs will exist because the reduction in private sector production will almost always exceed the increase in production that the new government spending brings about. This increase in production should be seen as it is a consequence of a shrunken economy, not of some artificial stimulus provided as a gift from the government.

This concept, that the net effect of tax policy is an economic reduction, is not some myth, nor something where "(y)ou can say almost anything you want about economics" as Representative Hunter believes. Before a sales tax increase, the market for each good is at baseline equilibrium price, leading to some level of economic surplus split between consumers and producers. Increasing, or introducing, a sales tax shifts the supply curve for all taxed goods to the left, producing a new equilibrium at a smaller equilibrium quantity.

[3] The Beacon Hill Institute. The Beacon Hill Institute's Tax Analysis Modeling Program: A Response to Charney. April 2010, http://www.beaconhill.org/STAMP-Method/BHIRebuttalToCharneyAZ10-0422.pdf.
[4] See Ryan Murphy, Beacon Hill Institute. Fiscally Illiberal: State and Local Projects Cannot Create Jobs Responsibly. October 2013. http://www.beaconhill.org/OnTheIssue/Papers/StatesAreFiscallyIlliberal2013-0102RM.pdf.

This sales tax creates a tax wedge between the price that producers charge and the price consumers pay, reducing total demand for the good and in turn reducing total economic surplus. A share of this lost surplus becomes revenue to the state government, but some share is also lost and is referred to as a dead weight loss. The concept of dead weight exists in every major microeconomics text book.[5]

It will be up to the public, and the public servants who represent them, whether this shrinkage of the economy is an acceptable price to pay for the benefits of the new services the state spending would create. It is the job of economists, of which economic modeling is an important and widely used tool, to identify these costs and benefits. To dismiss this tool merely because it states that politicians cannot have his cake and eat it too is painful to read, and not trustworthy.

The Institute has always made available both the assumptions made in developing the model and the data used to generate results.[6] We would be more than happy to discuss with Representative Hunter the assumptions or reasoning of why higher taxes lead to lower economic opportunities.

[5] In this case we referenced our copy of The Principles of Economics: Forth Edition. Bernanke and Frank. McGraw-Hill Irwin. ©2009.

[6] The Beacon Hill Institute. How STAMP Works. http://www.beaconhill.org/STAMP_Web_Brochure/STAMP_HowSTAMPworks.html.