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How S & P Downgrade was Politically Motivated

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By Alan Reynolds

The infamous $2 trillion error involved in the Standard and Poor's downgrade was no mistake. It was largely the result of an unseemly urge to take sides in the partisan struggle over near-term tax policy, with no weight at all given to longer-term entitlement spending. "Our ratings," the agency later explained, "are determined primarily using a 3-5 year time horizon," and "the ratings decision to lower the long-term rating to AA+ from AAA was not affected by the change of assumptions regarding the pace of discretionary spending growth." In other words, it's all about taxes.

Amazingly, the S&P analysts adopted the Congressional Budget Office "alternative" scenario as their so-called baseline. In that scenario all Bush tax cuts remain in place until 2035 and (because bracket creep and cashed-out IRAs would nevertheless cause revenues to rise) "unspecified policy adjustments [i.e., tax cuts] will be made after 2021 to keep revenues constant as a share of GDP [18.4 percent]."

The reason for adopting that unlikely scenario as a the S&P baseline was to make an unsubtle political point. As the S&P analysts explained, "our revised base case scenario now assumes that the 2001 and 2003 tax cuts, due to expire by the end of 2012, remain in place. We have changed our assumption on this because the majority of Republicans in Congress continue to resist any measure that would raise revenues."

Standard and Poor's completely disregard the same baseline Congress and the Administration used, which assumes that *all* of the 2001-2003 tax cuts expire in 2013 as current law requires. That would mean doing away with such genuine revenue losers as $648 billion from cutting the lowest tax rate to 10 percent, $316 billion for marriage penalty relief, $238 billion from the enlarged child credit. Instead, the S&P "upside scenario" adopted a wildly optimistic view of the revenue potential of President Obama's hoped-for taxes on high earners: "Our revised upside scenario . . . incorporates $950 billion of new revenues on the assumption that the 2001 and 2003 tax cuts for high earners lapse from 2013 onwards, as the Administration is advocating."

In reality, the Obama health bill already imposes an extra 0.9 percent payroll tax on high earners and a 3.8 percent surtax on their investment income. The President's proposed taxes on higher incomes go far beyond a mere lapse of the 2003 tax cuts for high earners. In addition to reverting to phasing-out exemptions and deductions, for example, Obama's 2012 budget would have limited any remaining deductions to 28 percent, supposedly raising $293 billion.

There is no way to confirm or justify Standard & Poor's unsourced estimate of "$950 billion of new revenues on the assumption that the 2001 and 2003 tax cuts for high earners lapse." That $950 billion figure is an outright fabrication – indefensible even as matter of simplistic bookkeeping and quite absurd once tax avoidance (the elasticity of taxable income) is taken into account. Many have pointed to sloppy errors in the S&P analysis, but they neglect to mention that the alleged $950 billion revenue windfall from adopting the President's tax plans is one of those sloppy errors.

As Ezra Klein pointed out, correcting the mistake "improved our deficit outlook by more than [the wildly exaggerated estimate of] letting the high-end tax cuts expire, which S&P had said would raise enough money to stabilize our rating. If the numbers mattered, then by S&P's own logic, that should have changed their opinion of our finances."

If the real point of this ill-timed S&P publicity stunt was to promote a rosy scenario for Obama's tax plan, then the reputation of Standard & Poors has now been deeply downgraded.

Standard & Poor's $2 Trillion Error Was Political Lobbying, Not an Innocent Mistake is a post from Cato @ Liberty - Cato Institute Blog