Dynamic Scoring and Tax Reform

What We’ll Cover:

1. Tax cuts don’t pay for themselves
2. Smart tax reform can generate $300-$400 billion of dynamic growth
3. Debt-financed tax cuts have smaller growth effects
4. Models with most generous estimates don’t account for the economic cost of debt
Tax Cuts Don’t Pay For Themselves
Tax Cuts Can’t Generate Enough Growth to Self-Finance

To self-finance: $1 tax cut would need to produce $6 of growth
Reasonable estimates range from -$0.10 to +$1.25
Even Tax Foundation maxes out at $2.35
Cyclically-Adjusted Revenue After the 1981 & 2001/03 Tax Cuts

Source: Congressional Budget Office

Percent of Potential Gross Domestic Product

Year

1981-1989
2000-2007

Tax Cuts Enacted

19.3%
15.7%
16.9%
17.9%
17.8%

CRFB.org
Changes in Revenue from CBO’s 2001 Baseline

Source: Congressional Budget Office
Smart Reforms Can Generate $300-$400 Billion of Dynamic Revenue
Ranges of Dynamic Revenue Feedback

**Billions of Dollars**

- **Camp Tax Plan 2014**
  - Aggressive Rev.: $375B
  - Neutral: $430B
  - Across the Board Cut: $340B

- **Trump April 2017**
  - $109B (TPC)
  - -$183B (TPC)
  - -$474B (PWBM)

- **House GOP Better Way**
  - $64B (PWBM)
  - <$1B (TPC)

Source: CBO, JCT, Staff of JCT, Tax Policy Center (TPC), Penn Wharton Budget Model (PWBM), CRFB calculations.
Wide Range in Potential Dynamic Estimates

Dynamic Estimate of Revenue Loss from 10% Tax Rate Cut (Trillions over 10 years)

- Conventional Estimate: $1.56
- Low-Cost Estimate: $1.21
- High-Cost Estimate: $1.59

Source: 2005 CBO
Estimated Dynamic Feedback from “Unified Framework”

Billions in Dynamic Feedback over Ten Years

- $100
- $50
- $0
- $50
- $100

$71b
-$57b
$197b
$229b
$203b

Tax Policy Center (available details)
Wharton Model (available details)
Wharton (Option A)
Wharton (Option B)
Wharton (Option C)

Source: Tax Policy Center, Penn Wharton Budget Model
Note: This is dynamic feedback inclusive of interest only. The framework produces roughly $2.2 to $2.6 trillion in static revenue loss.
Debt-Financed Tax Cuts Generate Less Growth
Debt-Financing Hurts Long-Term Growth

- While lower tax rates promote work and investment, higher debt discourages investment and – by reducing wages – eventually discourages work.

- CBO estimates that every $1 debt ‘crowds out’ 33 cents of investment, leading to slower growth.

- Debt-financed tax cuts also drive up interest rates, increasing interest payments and offsetting revenue feedback
Debt-Financing Hurts Long-Term Growth

Fig. 4: Effect of Different Fiscal Paths on Per-Capita GNP in 2047 (in 2017 dollars)

- CBO Benchmark: $90,000
- CBO Baseline: $86,000
- $2 Trillion Deficit Increase: $84,000
- $2 Trillion Deficit Reduction: $89,000
- $4 Trillion Deficit Reduction: $91,000

Source: Congressional Budget Office. Benchmark shows the extended baseline before macroeconomic feedback.
Paid For Tax Reform Is Better for Growth

Percent increase in long-run GDP

- **Revenue-Neutral Tax Reform**
- **Revenue-Positive Tax Reform**

Source: JCT projections of generic tax reform generating $0 and $600 billion of net revenue.
Generous Feedback Estimates Often Ignore the Economic Cost of Debt
Two Types of Models, One YUGE Difference

- The long-term impact of tax reform is generally modelled using a **Macroeconomic Equilibrium Growth (MEG)** or an **Overlapping Generations Lifecycle Model (OLG)**

- Both models estimate impact of taxes on decisions of if and how to work and invest, but only OLG assumes foresight

- To assume foresight, the OLG model assumes future policymakers will finance tax cuts and stabilize the debt through future spending cuts, tax increases or both

- According to JCT, the OLG “average tax rates are higher and transfer payments are lower than they actually are”

- OLG models therefore estimate faster growth by assuming tax cuts will be paid for in the future
Generous Growth Estimates Assume Future Offsets

Estimates of the Tax Reform Act of 2014

- Overlapping Generations (OLG) model
- Macroeconomic Equilibrium Growth (MEG) model
  - Fed responds to rising income
  - Fed does not respond

Greater change in employment
Less change in employment
Greater change in employment, multinationals shift profits to avoid tax increase

Source: JCT, CRFB calculations
Table 3.
The Cumulative Impact on the Budget Surplus of a 10 Percent Cut in Federal Income Tax Rates

<table>
<thead>
<tr>
<th></th>
<th>First Five Years</th>
<th>Second Five Years</th>
<th>First 10 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conventional Estimate</td>
<td>-466</td>
<td>-775</td>
<td>-1,241</td>
</tr>
<tr>
<td>Additional Debt Service</td>
<td>-56</td>
<td>-261</td>
<td>-317</td>
</tr>
<tr>
<td>Total</td>
<td>-522</td>
<td>-1,035</td>
<td>-1,557</td>
</tr>
</tbody>
</table>

Macroeconomic Feedbacks Under Various Assumptions

- **No Foresight**
  - 6
  - -39
  - **-33**

- **Lifetime Foresight—Capital Immobile Across Borders**
  - Budget stabilized by cuts in government spending after 10 years: 77
  - Budget stabilized by increases in tax rates after 10 years: 82
  - Total: 184

- **Lifetime Foresight—Capital Flows Freely Across Borders**
  - Budget stabilized by cuts in government spending after 10 years: 98
  - Budget stabilized by increases in tax rates after 10 years: 104
  - Total: 240

- **Unlimited Foresight**
  - Budget stabilized by cuts in government spending after 10 years: 82
  - Budget stabilized by increases in tax rates after 10 years: 100
  - Total: 240

- **Global Insight’s Model**
  - 62

- **Macroeconomic Advisers’ Model**
  - 67
Some Outside Models Also Ignore Debt Impact

Tax Foundation
• Assumes unlimited supply of savings, resulting in no economic impact from even large amounts of debt
• Also ignores spending feedback, some possible Fed effects

GGM-Kotlikoff:
• Assumes debt-to-GDP stabilizes through efficient taxation inconstant with the current (or reformed) code

CEA:
• Estimate benefit of rate reduction without negative impact of financing (from debt or base broadening)
If Dynamic Growth Won’t Pay For Tax Cuts, What Are The Options To Do It
# Business Taxes

<table>
<thead>
<tr>
<th>Option</th>
<th>Current Law</th>
<th>Framework</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Repeal Business Tax Expenditures</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Modify or repeal the R&amp;E tax credit*</td>
<td>$70 to $135 billion</td>
<td>$60 to $110 billion</td>
</tr>
<tr>
<td>Repeal various energy related tax credits</td>
<td>$60 billion</td>
<td>$50 billion</td>
</tr>
<tr>
<td>Reform taxation of insurance companies</td>
<td>$80 billion</td>
<td>$45 billion</td>
</tr>
<tr>
<td>Repeal low-income housing tax credit*</td>
<td>$35 billion</td>
<td>$30 billion</td>
</tr>
<tr>
<td>Limit like-kind exchanges</td>
<td>$40 billion</td>
<td>$25 billion</td>
</tr>
<tr>
<td>Repeal deduction for ESOP dividends</td>
<td>$35 billion</td>
<td>$20 billion</td>
</tr>
<tr>
<td>Eliminate credit for employer-paid payroll taxes on tips</td>
<td>$20 billion</td>
<td>$15 billion</td>
</tr>
<tr>
<td>Repeal rehabilitation tax credits</td>
<td>$15 billion</td>
<td>$10 billion</td>
</tr>
<tr>
<td>Repeal other business tax breaks unrelated to cost-recovery or international taxation</td>
<td>$330 billion</td>
<td>$195 billion</td>
</tr>
<tr>
<td><strong>Eliminate Non-Tax Expenditure Base Provisions (NTEBPs)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Further reduce the net interest deduction for corporations</td>
<td>$10 billion/percent</td>
<td>$6 billion/percent</td>
</tr>
<tr>
<td>Eliminate the corporate state and local tax deduction</td>
<td>$290 billion</td>
<td>$165 billion</td>
</tr>
<tr>
<td>Repeal deduction for meals and entertainment</td>
<td>$140 billion</td>
<td>$80 billion</td>
</tr>
<tr>
<td>Limit net operating loss deduction to 90% of income</td>
<td>$100 billion</td>
<td>$60 billion</td>
</tr>
<tr>
<td>Limit deductibility of CEO compensation</td>
<td>$12 to $50 billion</td>
<td>$5 to $30 billion</td>
</tr>
<tr>
<td><strong>Modify Cost Recovery Provisions</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amortize 25% of advertising costs</td>
<td>$230 billion</td>
<td>$135 billion</td>
</tr>
<tr>
<td>Repeal expensing for R&amp;E costs</td>
<td>$185 billion</td>
<td>$105 billion</td>
</tr>
<tr>
<td>Repeal &quot;LIFO&quot; and &quot;Lower Cost of Market&quot; accounting methods</td>
<td>$100 billion</td>
<td>$60 billion</td>
</tr>
<tr>
<td>Repeal expensing of exploration &amp; development and use of percentage depletion allowance</td>
<td>$25 billion</td>
<td>$15 billion</td>
</tr>
</tbody>
</table>

Note: Estimates are rounded and rely on CRFB calculations and multiple sources, including CBO, JCT, Treasury, Tax Policy Center, and Tax Foundation. * = Inconsistent with certain Framework details.
## Individual Taxes

<table>
<thead>
<tr>
<th>Option</th>
<th>Current Law</th>
<th>Framework</th>
</tr>
</thead>
<tbody>
<tr>
<td>Replace the Cadillac tax with a cap on the exclusion of employer-provided health insurance ^</td>
<td>$100 to $300 billion</td>
<td>$90 to $265 billion</td>
</tr>
<tr>
<td>Reform or eliminate the exclusion of interest for public-purpose municipal bonds</td>
<td>$30 to $400 billion</td>
<td>$25 to $350 billion</td>
</tr>
<tr>
<td>Repeal deduction for &quot;cafeteria plans&quot;</td>
<td>$380 billion</td>
<td>$330 billion</td>
</tr>
<tr>
<td>Include employer-paid premiums for income-replacement insurance in taxable income</td>
<td>$335 billion</td>
<td>$300 billion</td>
</tr>
<tr>
<td>Cap remaining tax breaks for higher earners *</td>
<td>Varies</td>
<td>~$300 billion</td>
</tr>
<tr>
<td>Include investment income from life insurance and annuities in taxable income</td>
<td>$240 billion</td>
<td>$200 billion</td>
</tr>
<tr>
<td>Reform higher education tax preferences *</td>
<td>$105 to $195 billion</td>
<td>$95 to $170 billion</td>
</tr>
<tr>
<td>Repeal foreign earned income and housing exclusions</td>
<td>$105 billion</td>
<td>$90 billion</td>
</tr>
<tr>
<td>Include VA disability benefits in taxable income</td>
<td>$90 billion</td>
<td>$80 billion</td>
</tr>
<tr>
<td>Reduce IRA and 401(k) contribution limits *</td>
<td>$90 billion</td>
<td>$80 billion</td>
</tr>
<tr>
<td>Repeal exclusion for miscellaneous fringe benefits</td>
<td>$85 billion</td>
<td>$75 billion</td>
</tr>
<tr>
<td>Tax capital gains at death OR</td>
<td>$150 billion</td>
<td>$150 billion</td>
</tr>
<tr>
<td>Replace step-up basis of inherited assets with carryover basis</td>
<td>$70 billion</td>
<td>$70 billion</td>
</tr>
<tr>
<td>Repeal exclusion for employer-provided transportation benefits</td>
<td>$60 billion</td>
<td>$50 billion</td>
</tr>
<tr>
<td>Eliminate child and dependent care and elderly tax credits</td>
<td>$40 billion</td>
<td>$40 billion</td>
</tr>
<tr>
<td>Eliminate &quot;carried interest&quot; loophole</td>
<td>$20 billion</td>
<td>$20 billion</td>
</tr>
<tr>
<td>Require derivatives to be marked to market</td>
<td>$15 billion</td>
<td>$15 billion</td>
</tr>
<tr>
<td>Repeal the exclusion of allowances for federal employees abroad</td>
<td>$15 billion</td>
<td>$15 billion</td>
</tr>
</tbody>
</table>

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^ = Effect on income tax revenues only.
* = Inconsistent with certain Framework details.