Dynamic Scoring and Tax Reform

October 2017

Committee for a Responsible Federal Budget

Dynamic Scoring and Tax Reform

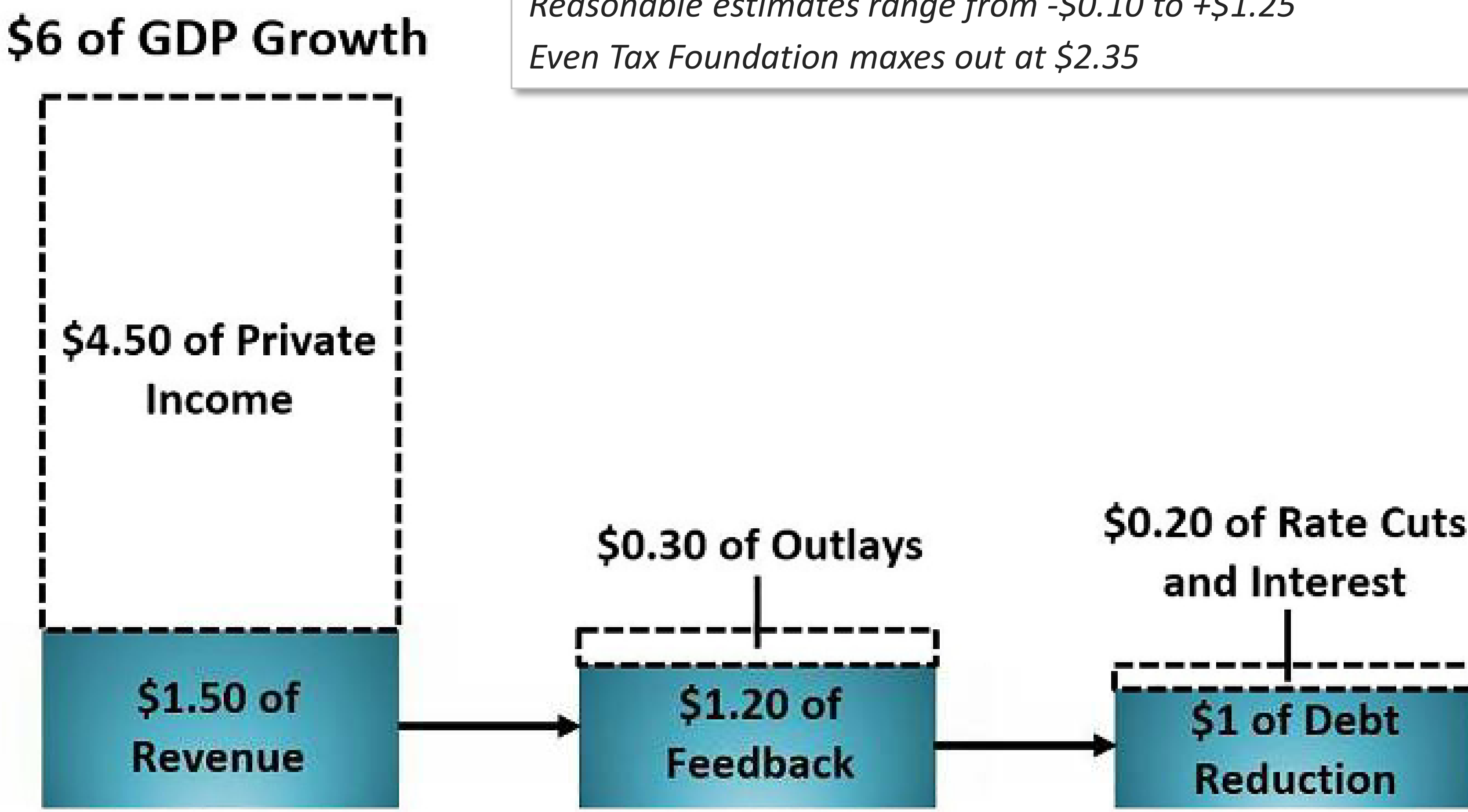
What We'll Cover:

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

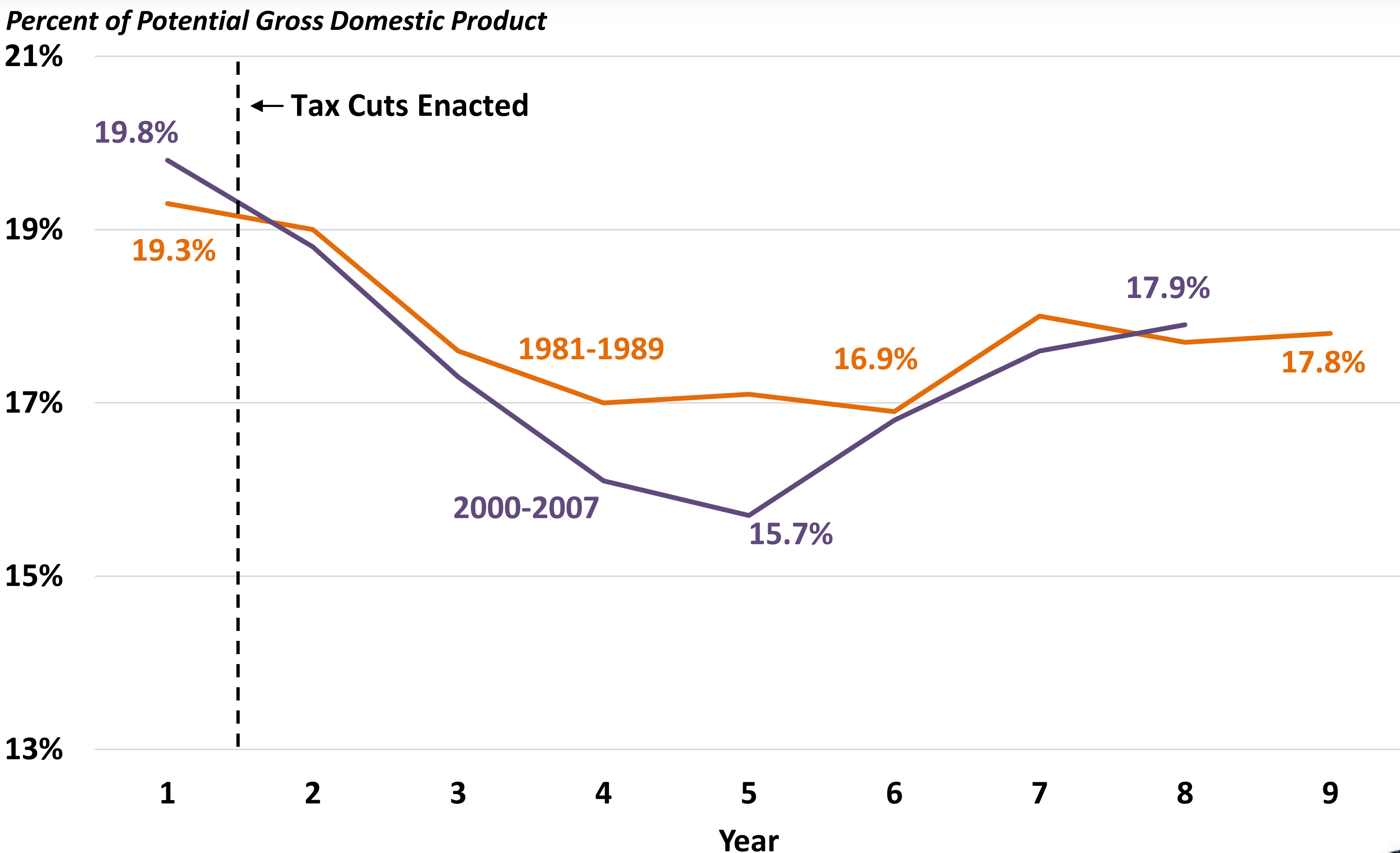
Tax Cuts Can't Generate Enough Growth to Self-Finance

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



Source: CRFB calculations and Congressional Budget Office. GDP = Gross Domestic Product

Cyclically-Adjusted Revenue After the 1981 & 2001/03 Tax Cuts



Source: Congressional Budget Office

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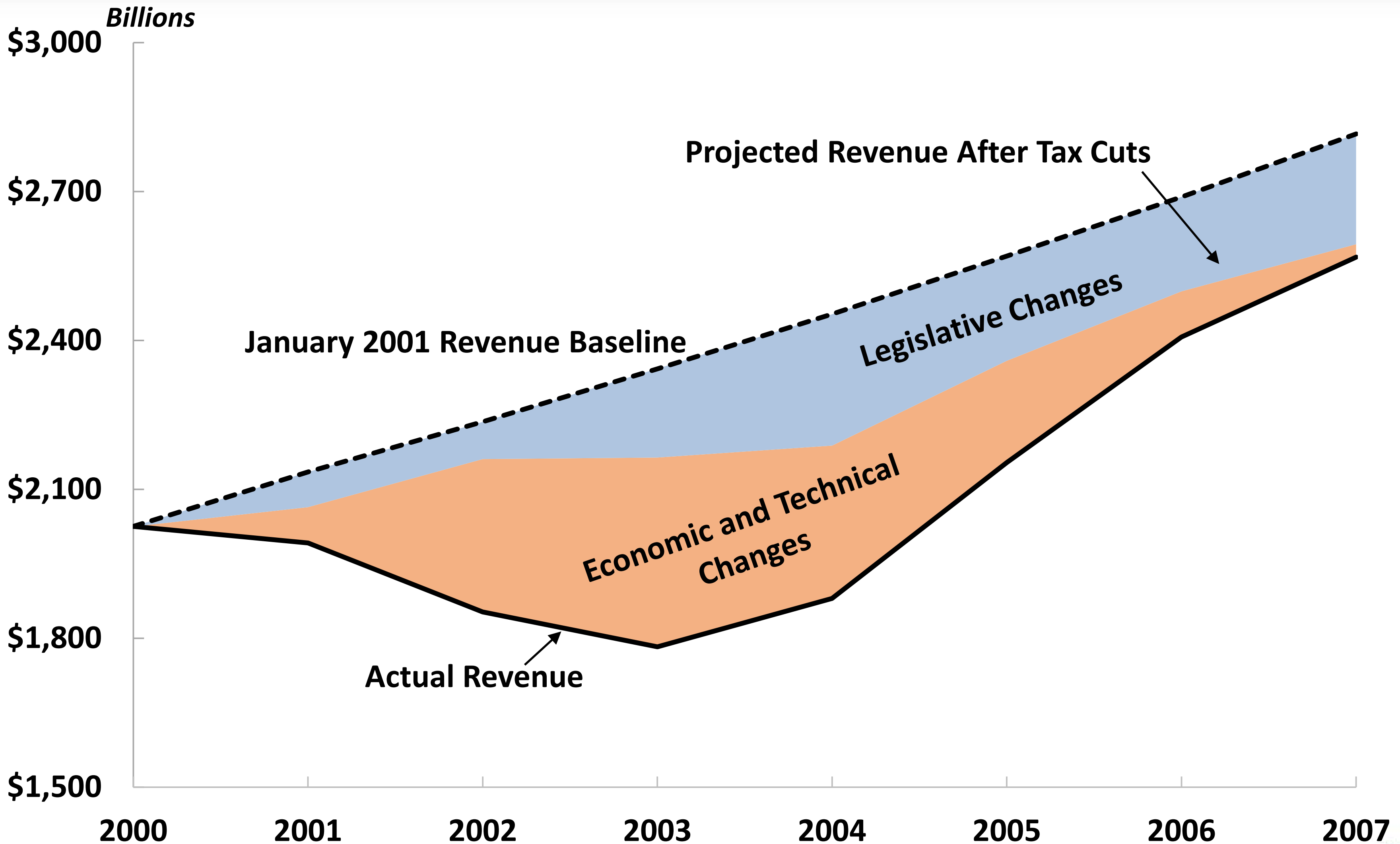
Changes in Revenue from CBO's 2001 Baseline



Source: Congressional Budget Office

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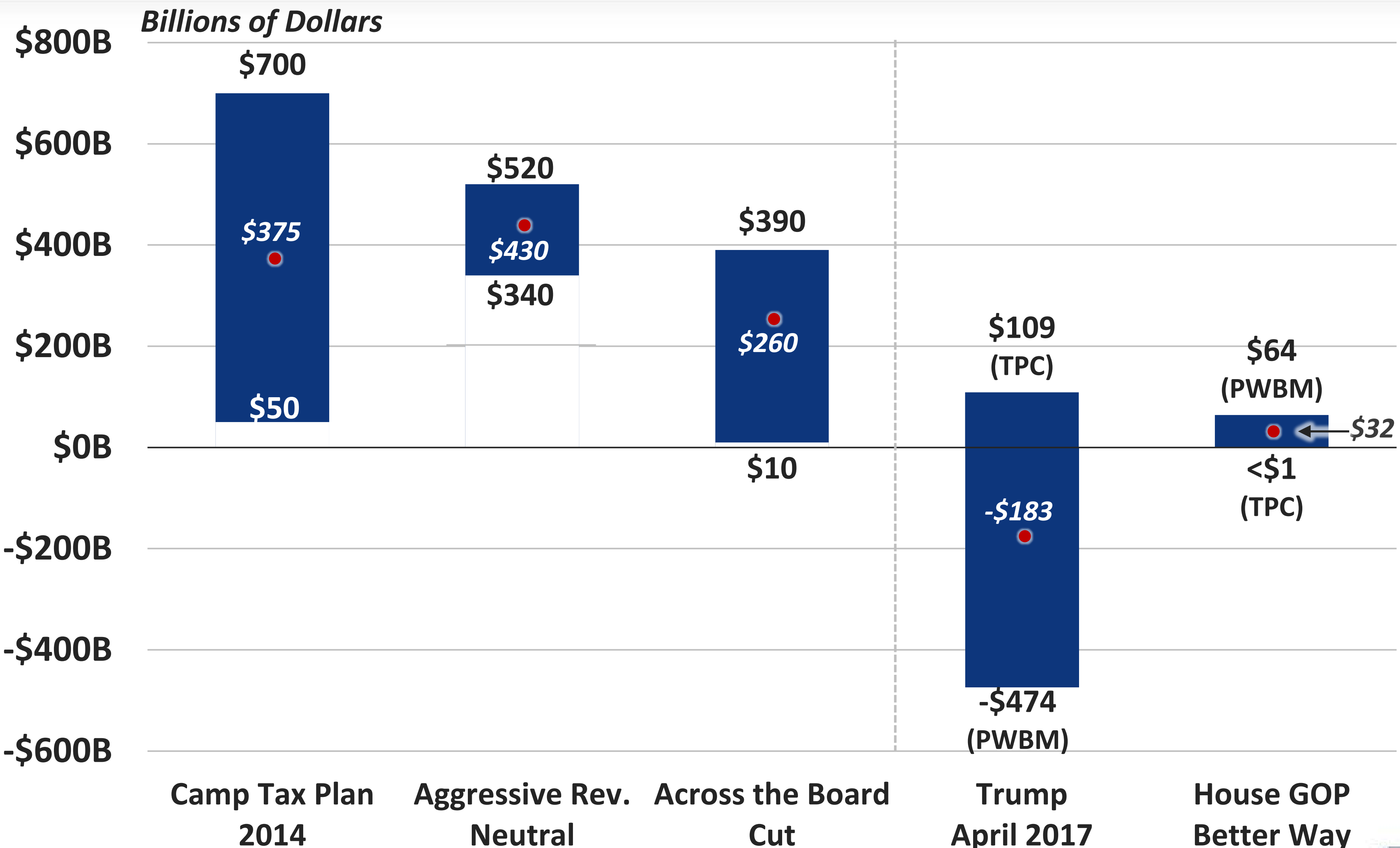
Smart Reforms Can Generate $300-$400 Billion of Dynamic Revenue

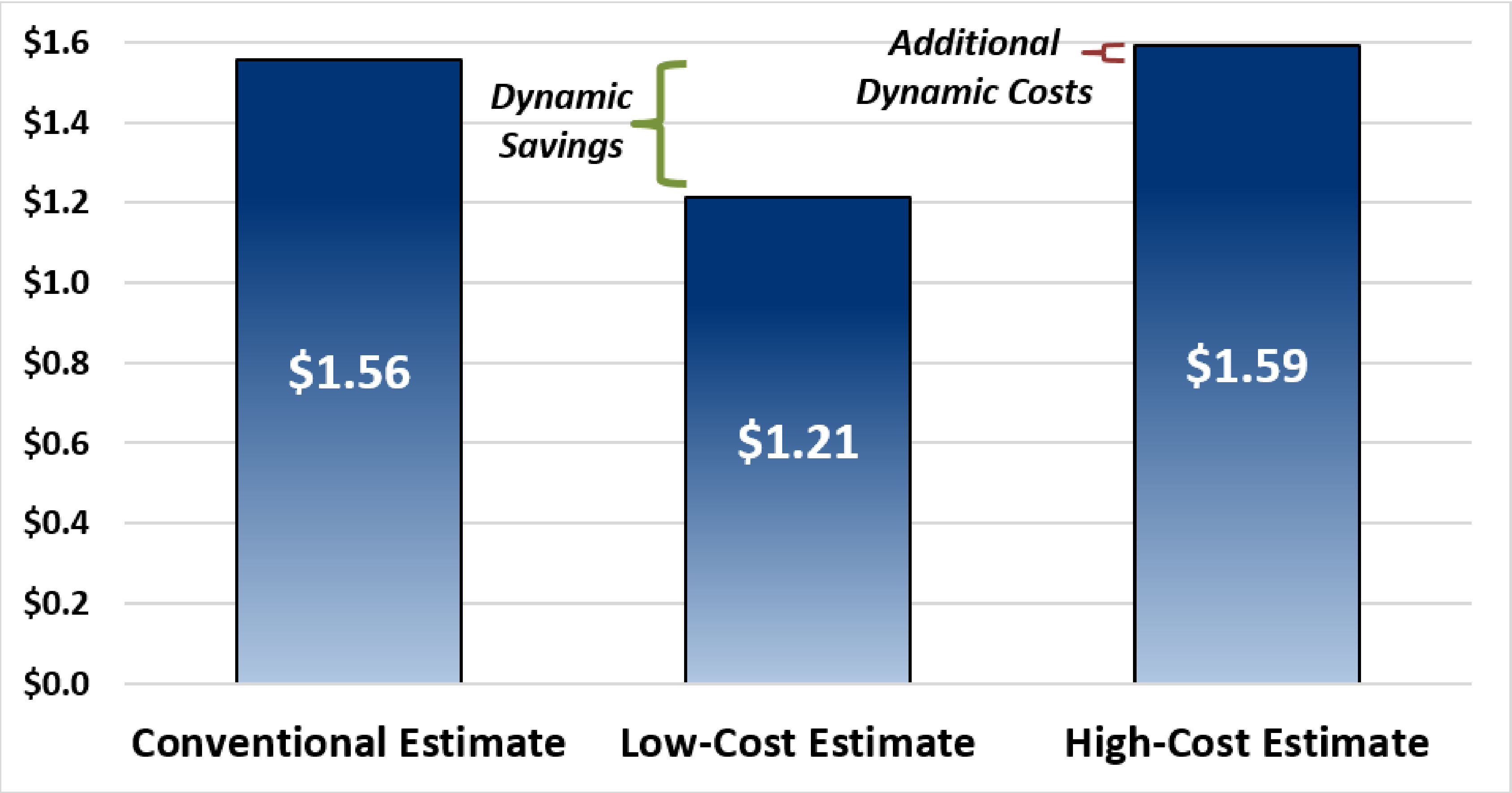
Ranges of Dynamic Revenue Feedback



Source: CBO, JCT, Staff of JCT, Tax Policy Center (TPC), Penn Wharton Budget Model (PWBM), CRFB calculations. CRFB.org

Wide Range in Potential Dynamic Estimates

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



Source: 2005 CBO

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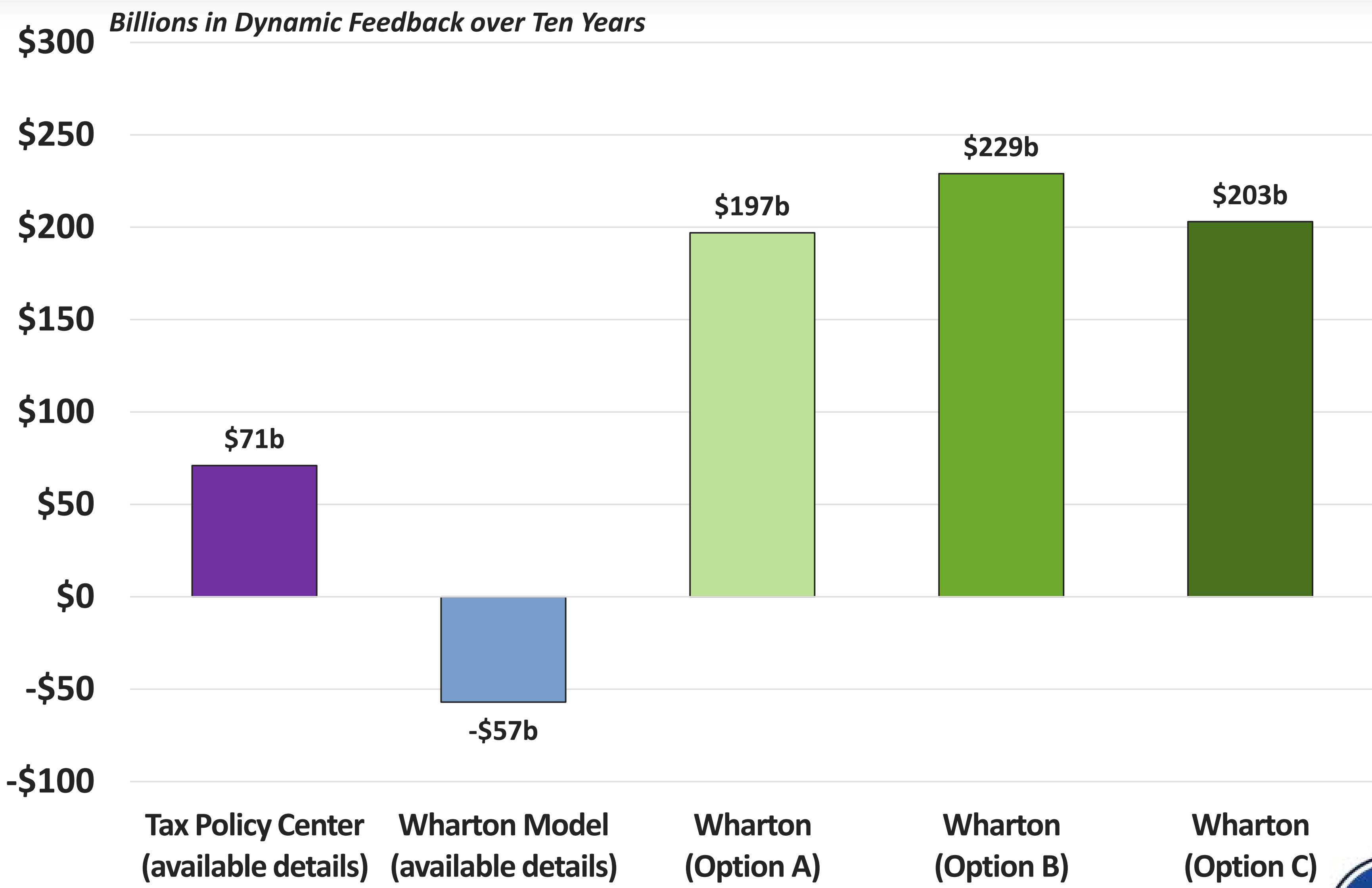
Estimated Dynamic Feedback from "Unified Framework"



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

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Debt-Financed Tax Cuts Generate Less Growth

Debt-Financing Hurts Long-Term Growth

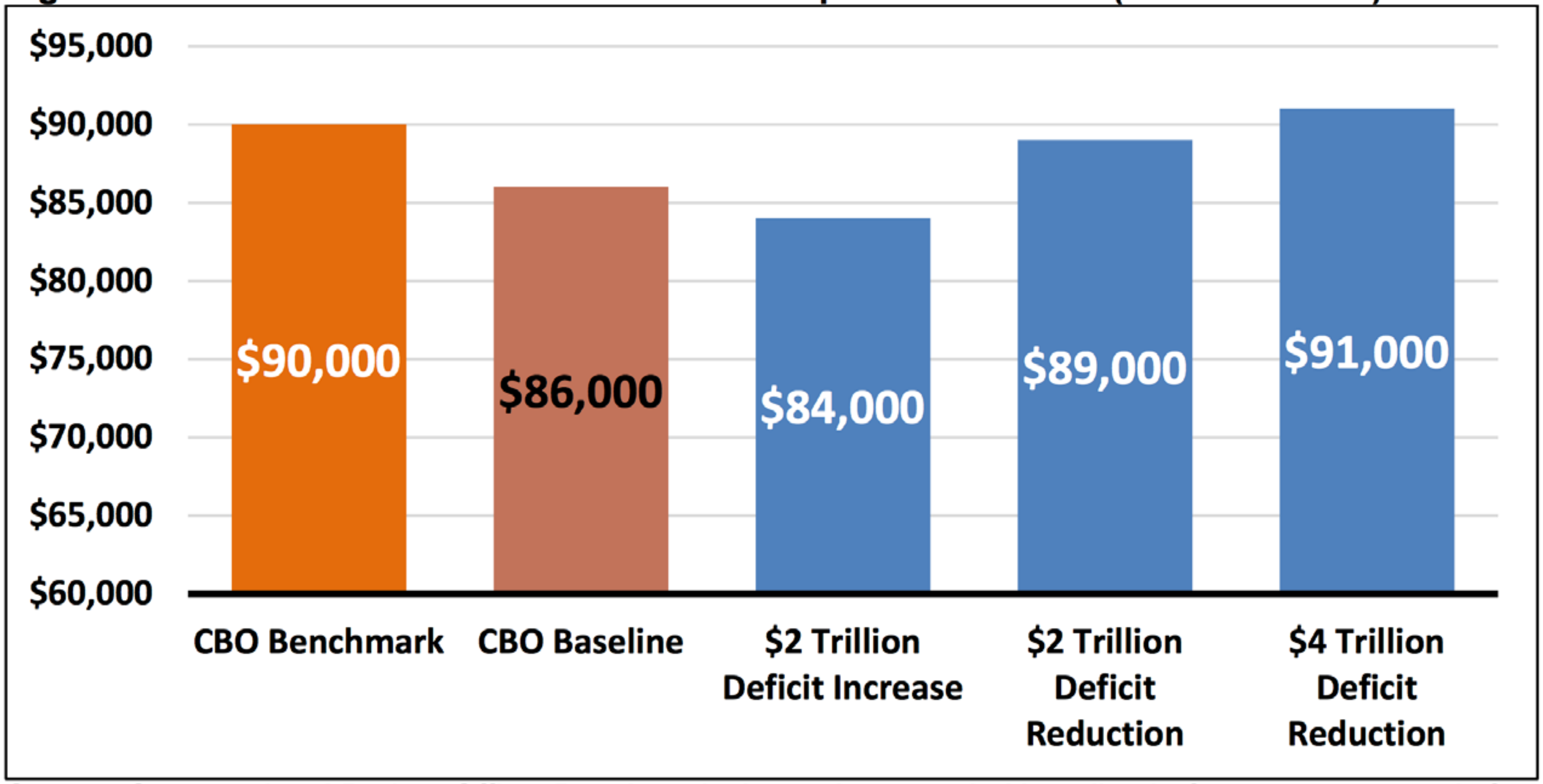
- While lower tax rates promote work and investment, higher debt discourages investment and – by reducing wages – eventually discourages work.

- 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

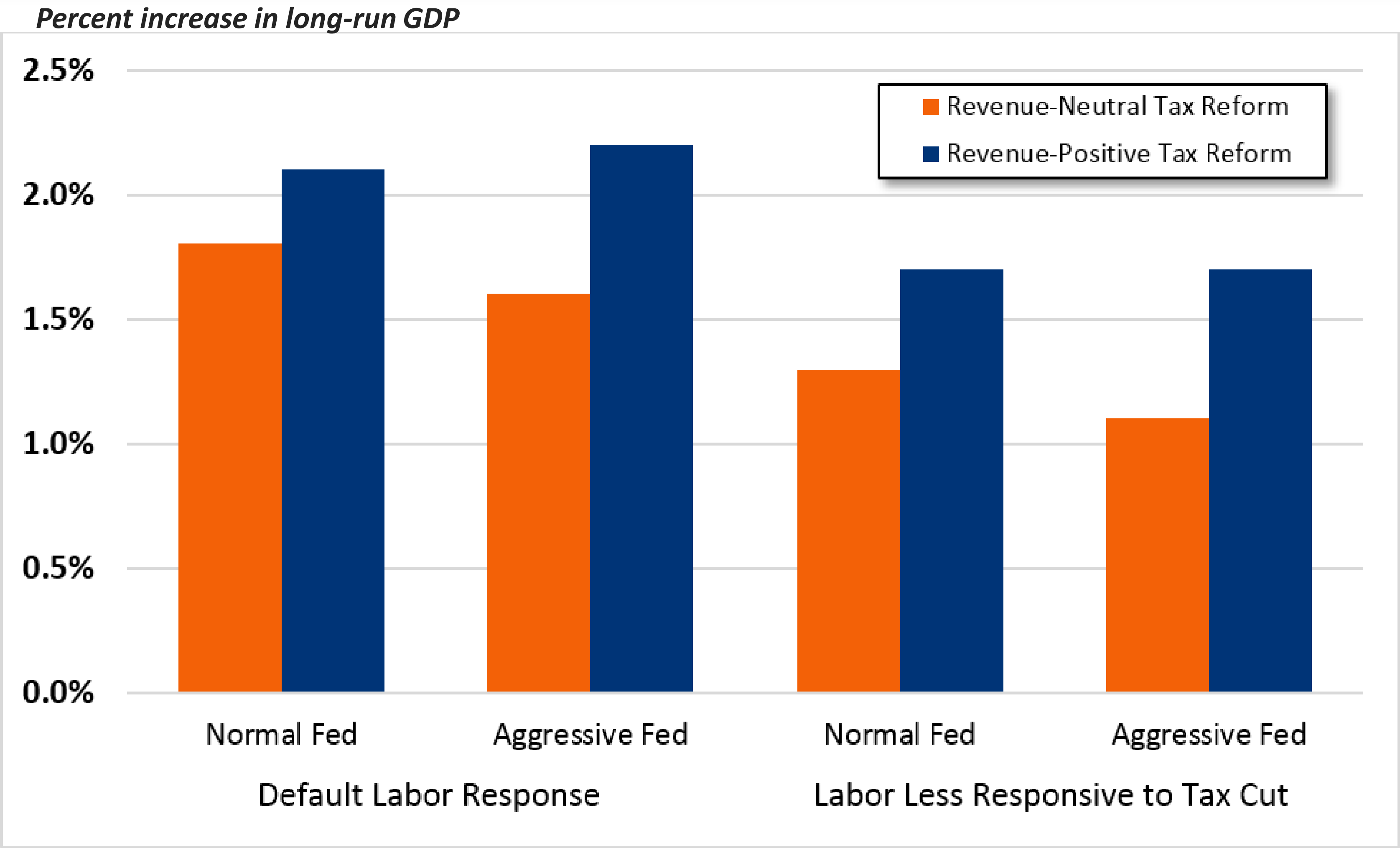
Debt-Financing Hurts Long-Term Growth

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



Source: Congressional Budget Office. Benchmark shows the extended baseline before macroeconomic feedback.

Paid For Tax Reform Is Better for Growth



Source: JCT projections of generic tax reform generating $0 and $600 billion of net revenue.

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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)**

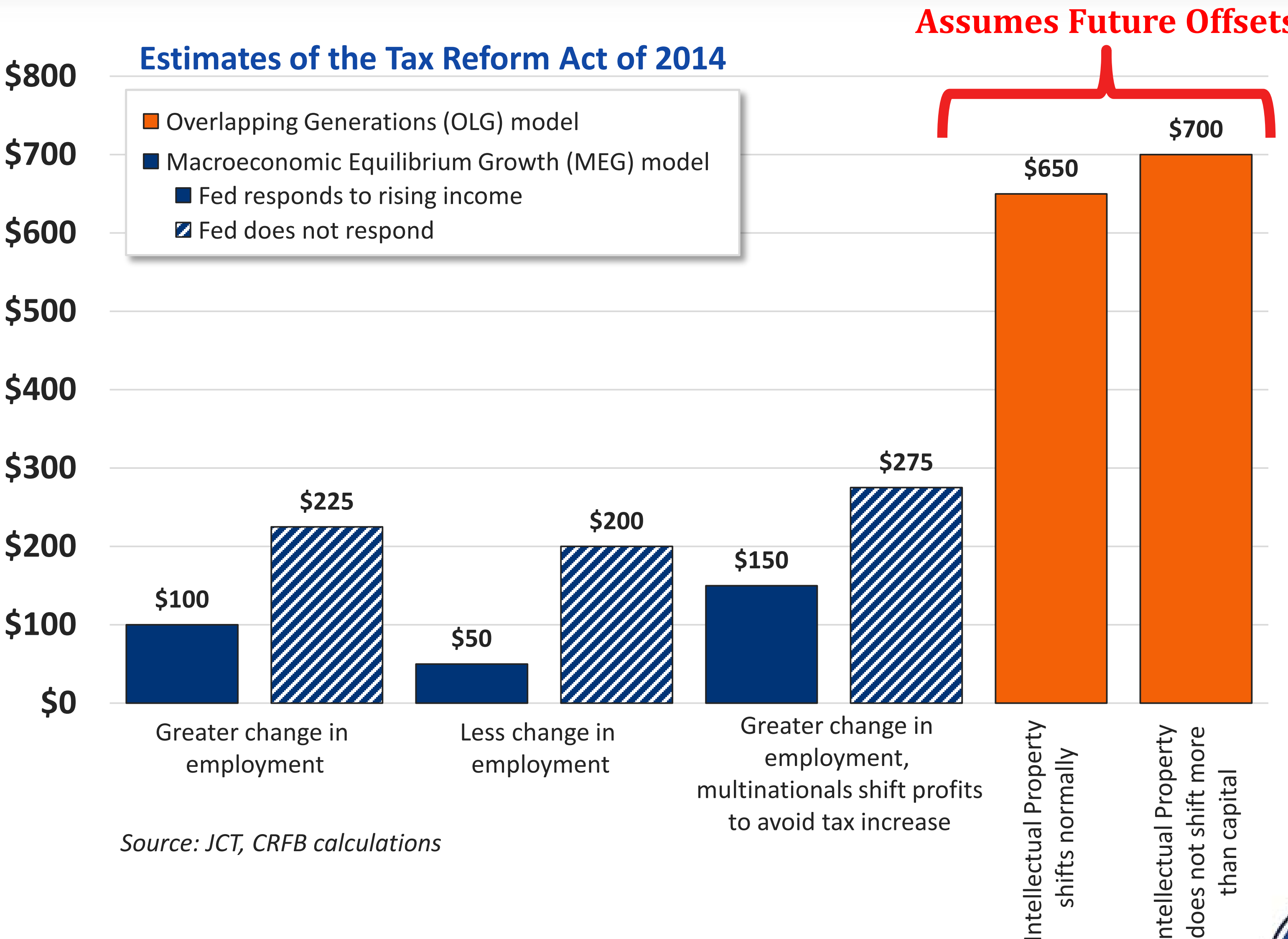
- Both models estimate impact of taxes on decisions of if and how to work and invest, but only OLG assumes foresight

- 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



Source: JCT, CRFB calculations

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Generous Growth Estimates Assume Future Offsets

Table 3.

The Cumulative Impact on the Budget Surplus of a 10 Percent Cut in Federal Income Tax Rates

(Billions of dollars)

	First Five Years	Second Five Years	First 10 Years
Conventional Estimate	-466	-775	-1,241
Additional Debt Service on Conventional Estimate	-56	-261	-317
Total	**-522**	**-1,035**	**-1,557**
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	107	184
Budget stabilized by increases in tax rates after 10 years	82	132	214
Lifetime Foresight—Capital Flows Freely Across Borders			
Budget stabilized by cuts in government spending after 10 years	98	142	240
Budget stabilized by increases in tax rates after 10 years	104	154	258
Unlimited Foresight			
Budget stabilized by cuts in government spending after 10 years	82	158	240
Budget stabilized by increases in tax rates after 10 years	100	245	345
Global Insight's Model	62	n.a.	n.a.
Macroeconomic Advisers' Model	67	n.a.	n.a.

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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

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

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

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

Note: Estimates are rounded and rely on CRFB calculations and multiple sources, including CBO, JCT, Treasury, Tax Policy Center, Tax Foundation, and American Enterprise Institute.
^ = Effect on income tax revenues only.
* = Inconsistent with certain Framework details.