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Reforming the Federal Tax Policy Process

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Executive Summary

When government considers raising or cutting taxes, official scorekeepers estimate changes to federal revenues and the distribution of the tax burden. Those estimates are very important in policy discussions regarding the desirability of proposed tax changes. Therefore, it is crucial that policymakers receive the most accurate and complete assessment of the likely effects of tax proposals.

Unfortunately, policymakers are currently provided with biased and incomplete information. Estimated effects on revenue of proposed tax changes do not take into account most of the economic effects of proposals. In addition, the tax policy process, which is centered in the congressional Joint Committee on Taxation and the Treasury Office of Tax Analysis, is resistant to change and closed to public scrutiny and peer review.

This report proposes seven reforms to increase the accuracy of tax revenue and distribution estimates, three reforms to improve the transparency of the process, and three reforms to restructure federal tax policy organizations to increase accountability.

To improve the accuracy of tax estimates, the JCT and OTA should produce "dynamic" revenue estimates, in addition to the current "static" estimates, which ignore the real world economic effects of tax changes and can generate extremely inaccurate results.

The accuracy of "distributional" analyses, which show the effects of tax changes by income group, can also be improved. Analyses should be presented for longer horizons and should present results by both consumption and income levels. In addition, distributional analyses should utilize alternate incidence assumptions when expert opinions differ.

Accuracy can also be improved by basing "tax expenditure" estimates on a consistent income base rather than the arbitrary measure currently used. Estimated compliance costs of proposed tax legislation should also be provided to policymakers.

To improve the transparency of the tax policy process, the models and methodology used by the JCT and OTA should be publicly disclosed, and data should be generally available to independent researchers.

To help implement the proposed changes, federal tax policy organizations must be overhauled and new tax boards created.

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Introduction

When the federal government considers raising or cutting taxes, official scorekeepers estimate expected changes to revenues and the distribution of the tax burden. Those estimates are very important in policy discussions regarding the desirability of proposed tax changes. For example, tax policy reforms that would be beneficial to the economy can sometimes be held up because of inaccurate estimates of the effects on the federal budget. Therefore, ensuring that Congress and the administration use the most accurate and complete estimates is crucial to the adoption of good tax policy.

The current tax policy process provides policymakers with inaccurate and incomplete information. Estimated revenue effects of proposed tax changes do not take into account most of the economic effects of proposals. In addition, the very large compliance costs of taxes are not incorporated into official information provided to policymakers. Furthermore, the system is closed to public scrutiny and peer review, thus making it highly resistant to constructive reforms. Because it provides such incomplete and inaccurate information, the current process is a major impediment to enacting sound tax policies that would reduce the tax system's inefficiencies and boost U.S. economic growth.

The first section of this report describes the current federal tax policy process and the roles of each relevant organization in the administration and Congress. The main body of the report proposes tax policy reforms in three main categories. First, seven reforms are proposed to increase the accuracy of tax revenue estimates. Next, three reforms are proposed to improve the transparency of the process so that citizens and experts can better understand the effects of proposed tax changes and provide constructive feedback. The final section proposes three reforms to improve oversight of federal tax policy organizations and make them more open to outside input.

Background on the Current Tax Policy Process

House and Senate Tax Committees

The House and Senate tax-writing committees play the most important roles in formulating tax policy. Because the U.S. Constitution requires that revenue bills originate in the House of Representatives, the House Ways and Means Committee is a bit more than an equal partner to the Senate Finance Committee.[1] Moreover, House rules and practices make it much more difficult for legislation reported out of the Ways and Means Committee to be amended on the floor of the House than it is for legislation from the Finance Committee to be amended on the floor of the Senate.

It is in those two committees that the rough and tumble of politics determines the details of tax laws that raise roughly $2 trillion in revenue each year. However, the two committees rely heavily on the Joint Committee on Taxation staff for drafting tax bill language, descriptions of proposals, and revenue estimates and distributional analyses of bills. Therefore, the JCT staff has a very important role in framing the tax policy debate by defining the revenue and distributional effects of proposed legislation.

Joint Committee on Taxation

The JCT is composed of five members of the Senate Finance Committee and five members from the House Ways and Means Committee (three from the majority party and two from the minority party in each case).[2] The JCT analyzes the administration of the tax system, inspects tax returns and statistical data, and holds hearings where it can require the attendance of witnesses.[3]

The Budget Act of 1974 requires the JCT to provide official revenue estimates for all tax legislation considered by either the House or the Senate.[4] As such, the JCT is central to the tax-writing process because revenue estimates often make or break support for legislation. Proposals are often modified

to accommodate the concerns of revenue-estimating staff.

The JCT staff plays an important role in at least three other ways. First, they prepare the analyses of the distributional effects of proposed tax legislation that members of Congress and reporters rely on. Second, JCT attorneys are the primary legal draftsmen of tax legislation reported out of the House and Senate tax-writing committees. Third, JCT staff prepares written summaries of proposed legislation, and the JCT chief of staff verbally explains to members of Congress tax legislation being considered during mark-up. These written and verbal explanations are the primary sources of information used by Congress to understand tax proposals. The JCT also prepares annual tax expenditure estimates and detailed studies on other aspects of the federal tax system.

U.S. Treasury

For major tax policy changes initiated by the administration, the Treasury plays the central role. Under the Treasury secretary, the key figure who formulates tax policy on a continuing basis and provides key analysis is the assistant secretary for tax policy. The assistant secretary has two deputies: the deputy assistant secretary for tax policy and the deputy assistant secretary for tax analysis. The director of the office of tax analysis reports to the latter deputy. The OTA is primarily responsible for the tax economics work performed in the Treasury. Much like the JCT, it provides revenue estimates, distributional analyses, and tax expenditure estimates. The Internal Revenue Service is not a major participant in broad policy matters, but it does have significant input on administrative and regulatory issues.

House and Senate Budget Committees

The House and Senate Budget committees are responsible for reporting out an annual budget resolution that establishes the amount of taxes to be raised each year, the aggregate amount of proposed revenue changes, and the amounts that may be spent in each major area. In accordance with the 1974 Budget Act, Congress is supposed to approve a budget resolution by April 15 of each year. If the budget resolution requires taxes to be increased or reduced from baseline levels, then the tax-writing committees must report out a tax bill that amends the law consistent with the requirements of the resolution. Budget reconciliation occurs later in the annual budget cycle when that tax bill is combined with other proposed changes called for in the resolution and voted on by the House and Senate.[5]

Congressional Budget Office

The Congressional Budget Office provides estimates of proposed federal spending legislation and maintains updated estimates of budget baselines, which show projected spending and revenue amounts assuming no changes in law. To estimate future revenues and spending, CBO forecasts a wide range of macroeconomic aggregates, such as gross domestic product, wages, and interest rates. The CBO Tax Analysis Division occasionally issues detailed economic studies on various aspects of the federal tax system.

Other Congressional Organizations

The General Accounting Office is a congressional agency that conducts numerous studies of the federal tax system, often focusing on tax administration and compliance issues. It also occasionally addresses economic policy matters related to the tax system. The Joint Economic Committee conducts tax analysis and issues reports from time to time on the economic impact of the tax system. The Congressional Research Service also issues various reports for Congress on tax policy matters.

Other Executive Branch Organizations

The Council of Economic Advisers and the National Economic Council are both part of the Executive Office of the President. They provide quasi-independent sources of economic input to the administration's decision-making process on tax and other matters. The

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CEA is generally composed of academic economists, while the NEC generally contains policy-oriented staff. The CEA issues the annual Economic Report of the President, which often addresses tax policy issues.

Reforms to Provide More Accurate Tax Information

Federal policymakers should be provided complete and accurate information from the congressional JCT and the Treasury's OTA as they consider proposed tax legislation. Unfortunately, the information provided by those organizations is far from complete or accurate. Indeed, much information provided to policymakers does not take into account advances in economic science, and much is based on particular views of tax policy not shared by many tax experts. The following seven proposals for reform would modernize and greatly improve the information provided by the JCT and OTA to federal tax policymakers.

Perform Both Static and Dynamic Revenue Estimates

Revenue estimates are 1-year, 5-year, and 10-year projections of expected increases or decreases in federal revenue resulting from proposed tax changes. Current official revenue estimates by the JCT and OTA provide inaccurate and incomplete information. For example, major changes in marginal tax rates substantially affect economic activity and create powerful feedback effects on federal revenues. Yet those real world economic feedback effects are generally ignored by JCT and OTA estimates.

The JCT and OTA should incorporate dynamic feedback effects into revenue estimates of tax changes.

Revenue estimates that assume that tax changes have no impact on economic behavior are called "static" estimates.[6] Revenue estimates that assume tax changes do have an impact on economic behavior are called "dynamic" or "reality-based" estimates. The JCT and OTA should incorporate dynamic feedback effects into revenue estimates of tax changes.

It is true that taking into account the dynamic effects of tax changes requires making estimates and informed judgments about how taxpayers might change their behavior, and such judgments cannot be made with perfect precision. However, it is better to take in account such real world effects so that projected revenues are approximately correct—rather than estimates being precisely wrong, as are current static estimates. Current estimates assume away generally accepted effects of tax changes, and thus provide policymakers with inaccurate information.

The JCT has been criticized for ignoring dynamic effects of tax changes since at least 1978 when Rep. William Steiger (R-Wisc.) proposed a capital gains tax rate cut. Steiger argued that capital gains realizations would increase after a cut, so that tax revenues may actually increase overall or at least not decrease substantially. Steiger's proposal, which reduced the capital gains tax rate from 49 to 28 percent, became law and is generally regarded as having increased federal receipts.

In 1990, Sen. Bob Packwood (R-Ore.) asked the JCT staff to provide an official revenue estimate of a 100 percent tax on incomes over $100,000. The JCT dutifully complied, providing him with an estimate that showed that this confiscatory tax rate would raise two trillion dollars over five years.[7] That estimate, of course, was ludicrous since people would simply stop earning income above $100,000 if it was all to be confiscated by the government. Clearly, purely static revenue estimates do not reflect economic reality.

Since that time, the JCT staff has grudgingly given some ground. With regard to capital gains, the JCT now recognizes that changing the tax rate will affect gain realizations.[8] They have also, from time to time, used concerns about increased sheltering, noncompliance or evasion as reasons to increase the estimate of revenue that will be "lost" by the federal government from tax reduction proposals. The most notable example of this showed up in estimates of the effects of estate tax repeal. The JCT estimated

that repealing the estate tax would reduce federal revenues by almost twice as much as it now produces in annual tax revenue.[9] Yet many other tax proposal estimates do not include any assumed changes in behavior. Thus, the JCT staff uses secret and flexible approaches to considering dynamic behavior effects, which creates suspicions of bias and unfairness.[10]

While the JCT has occasionally incorporated microeconomic dynamic effects, it has never produced estimates that take into account tax effects on macroeconomic variables, such as savings, investment, and output. Note that under House rules, the chairman of the Ways and Means Committee may require that JCT produce a dynamic estimate. Such an estimate, however, would be for advisory purposes only.[11] The Congressional Budget Office has engaged in some selective dynamic estimating of this sort.[12]

The JCT has undertaken some exploratory investigations regarding dynamic revenue estimation. In 1997, the JCT held a symposium that examined the issue.[13] Outside experts were asked to model the economic effects of a broad-based income tax and a broad-based consumption tax. Although there was a wide variance in the magnitudes of the estimated effects of switching from an income to a consumption tax, there was general agreement among the expert modelers that a consumption tax would have a positive impact on GDP, the capital stock, and labor effort. The JCT is currently developing a macroeconomic growth model.[14]

Nonetheless, the JCT takes the position that the uncertainty of the magnitudes of economic effects is reason enough not to implement dynamic scoring.[15] Certainly the quality of the model chosen is of great importance, but almost any of the models is likely to produce more accurate estimates than current static estimates that simply ignore economic effects.[16] The bottom line is that, even given their variance, dynamic models will result in estimates closer to the actual, real world effects of tax changes than will static models.

Importantly, dynamic estimates would also have a pedagogic effect. For example, dynamic estimates would illustrate that not all tax cuts are created equal. Income tax rate cuts, capital gains tax cuts, and capital investment expensing would have a strong positive impact on the economy. Child tax credits, larger personal exemptions, and retroactive tax cuts would not.[17] Dynamic estimates done in accord with sound economic science would reflect those differences and allow policymakers to consider economic effects when making important tax policy decisions.[18] The JCT and OTA should provide policymakers with both static and dynamic tax revenue estimates. With more complete tax and economic analyses, policymakers will be able to make more informed decisions.[19]

Use a Longer Period for Distributional Analyses

The political importance attached to distributional analyses produced by the JCT is, unfortunately, very high. Even worse, the lack of understanding about the meaning and shortcomings of those distributional analyses is also very high.[20]

The methods chosen to conduct distributional analyses have dramatic impacts on the results. Indeed, different methods of distributional analyses can yield directly contradictory results. There is no single "correct" way to measure or analyze the distributional effects of proposed tax legislation. Yet the JCT, and to some extent the OTA, have chosen one particular method—based on one definition of income and one set of incidence assumptions—that is presented to policymakers as if it were definitive. A first step toward reform would be for the JCT and OTA to acknowledge that there are a number of different possible approaches to distributional analyses, each of which may provide valuable information to policymakers.

It is commonplace for certain politicians to complain about income inequalities in society, particularly when tax bills are being debated. Yet a very large share—probably more than half—of the income inequalities in our economy are simply the result of more

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experienced and older workers earning more than their younger counterparts. Most people will experience a gradual increase in their incomes during their career, and then a decline upon retirement. It is misleading to characterize those normal life cycle changes in income as class-based inequality. Yet differences in income are presented in distribution tables for official tax estimates only for a single slice in time.

To understand the distortion this creates, assume there is a society in which everyone earns exactly the same amount when they enter the workforce and receives exactly the same raise every year. Current JCT methodology would make such an utterly egalitarian society appear as if there were severe income inequalities. For another example of the distortion created by distributional analyses based on a single slice in time, consider a very frugal man who consumed little and plowed all earnings back into his business for many years. In the year he sold his business, he would realize a large capital gain and suddenly jump from poor to very rich in official distribution tables.

JCT methodology is particularly problematic when analyzing fundamental tax reform, which would move the system toward a consumption-based tax, such as a national retail sales tax, a Hall-Rabushka flat tax, a consumed income tax, or a business transfer tax.[21] That is because current distributional analyses make those alternative tax systems appear "regressive" or less graduated than any other method. Yet the regressivity or progressivity of a tax system is not an entirely objective measure—it is defined within the context of whether individuals are considered "equal" with regard to a particular measure of income, consumption, or some other parameter. The JCT only presents tables showing tax and income data for a single and quite arbitrary measure of income.

At a minimum, the JCT should adopt a longer time frame for all published distributional tables showing the effects of tax changes. Tables should reflect at least the same 10-year time horizon for which budget analyses are presented. Preferably, a lifetime perspective would be adopted, as has been done in some academic studies.[22] The OTA has adopted a form of 10-year horizon.[23] Note, however, that the concept of distribution is such a subjective and difficult-to-define concept, that its use should be de-emphasized in tax policy analyses.

Explore Effects of Tax Changes on Well-Being

Tax policy is not a zero sum game. Tax changes can improve or hurt overall living standards or the well-being of specific groups.[24] Yet current methods used by policymakers to calculate the effects of tax changes do not reflect that reality. As noted, current estimates are essentially static and do not measure the broader economic effects of tax changes.

Before policymakers make tax policy decisions, it would be very useful for them to examine expert analyses regarding whether tax changes may hurt or help the well-being of individuals and businesses. For example, a policy that improved the after-tax incomes of low-income families would be desirable even if it did not reduce the taxes imposed on those particular families. Currently, policymakers do not have such important information on hand when making decisions.

Suppose a particular tax change would cut taxes for entrepreneurs, but would have the effect of making all families better off. Clearly, that would be a desirable proposal, and would likely garner substantial support. Indeed, most policymakers probably regard the overall economic effects and changes to the general public welfare to be the most pertinent issues with regard to tax changes. Yet such effects are not currently considered by JCT or OTA. Therefore, an important reform would be to present distribution tables showing how tax changes may ultimately affect the after-tax incomes or consumption of different groups. Currently, the JCT does not present such impacts even on a "static" basis, let alone after taking into account changes in real economic variables.[25]

Also note that consumption is probably a better measure of well-being or living standards than income, and thus a better classification variable than the current income measure used. Consumption is less variable than income and reflects an individual's judgment about his or her long-run income-earning potential. The impact of tax changes presented by consumption levels would be very relevant information for policymakers to consider. As such, distributional results should be presented with both income and consumption classifications. That would provide a useful contrast for policymakers because results of the two methods can vary dramatically.[26] Distributions based on wealth would be another reasonable alternative to the current approach.

Use Alternative Incidence Assumptions

Determining the "incidence" of a tax means analyzing which individuals ultimately bear the economic burden of it. The actual economic burden often falls on different individuals from those who write the tax checks to the government. Currently, there is little if any official economic analysis of incidence that is brought to bear on tax proposals being considered by Congress or the administration. Instead, tax distribution analyses either simply assume a particular incidence pattern or do not measure incidence at all. Incidence assumptions are usually not disclosed in distributional tables presented by the JCT or OTA. In 1993, the JCT did issue a report discussing the incidence assumptions and the methods they employed at that time. Table 1 summarizes that information.[27]

The JCT and OTA differ on some of their incidence assumptions. For example, JCT assumes that owners of corporate capital bear the burden of the corporate income tax. However, the OTA assumes that corporate income taxes are borne by all capital owners (corporate and noncorporate).[28] Other public finance experts believe that income taxes (corporate and individual) are embedded in the price of everything we buy.[29] The OTA assumes that broad-based consumption taxes are borne by factor incomes.[30] Still others think that consumption taxes are borne by consumers. The JCT considers them to be borne by wages and old capital. With regard to payroll taxes, the OTA and JCT both adopt the view that payroll taxes are borne by labor, but other experts differ. There is relatively little empirical evidence on these issues and most of the analytical work essentially assumes its conclusion. In sum, there is a wide divergence of opinion about the incidence of various taxes, yet there is almost no recognition of that fact in the official tax information provided to policymakers. Yet, these incidence assumptions drive the results presented in the distributional tables, and thus drive many tax policy debates.

At minimum, the JCT and OTA should be required to fully disclose the incidence assumptions employed in their distributional tables. Better, they should provide detailed discussion and justifications for the assumptions used. Unless there is very strong empirical evidence that a particular incidence assumption is correct, these agencies should be required to present alternative distribution tables using a variety of plausible incidence assumptions. Moreover, these agencies should not simply assume, as they do in some cases, that taxes are not borne by anyone.[31]

As noted, the results of distributional analyses differ dramatically depending on whether they are based on income or consumption groupings, and whether they use annual or lifetime measures. In addition, distributional analyses are greatly affected by the incidence assumptions employed. Yet, policymakers are currently provided with only one perspective on these issues—a static annual analysis based on a particular income concept, with a particular set of rough and debatable incidence assumptions. Given the importance of distributional analyses in political debates and the large variance in outcomes depending on assumptions, the JCT and OTA should not proffer to policymakers a single distributional analysis of tax legislation as if it were carved in stone. If dis-

The JCT and OTA should . . . present alternative distribution tables using a variety of incidence assumptions.

Table 1
Joint Committee on Taxation Incidence Assumptions

Type of Tax	Incidence Assumption—Who Bears the Burden?
Income tax on labor income	Wage or salary earners
Payroll taxes	Wage or salary earners
Targeted tax on labor income	Case-by-case basis
Specific deductions under the individual income tax	Generally the taxpayers whose liabilities are affected
Individual income taxes on capital income	Owners of capital
Corporate income tax	Owners of corporate capital
Broad-based investment incentives	Savers
Taxes on savings	Savers
Broad-based consumption taxes	Converted to equivalent income-based tax and attributed to individuals based on their wages and income from old capital
Narrow-based consumption taxes and specific excise taxes	Converted to equivalent income-based tax and attributed to individuals based on their wages and income from old capital, weighted by the expenditure shares of the taxed goods
Estate tax	Decedent (based on income in the year preceding death)
Gift tax	Generally not distributed
Income of pass-through entities	Distributed as if earned directly by the owners
Provisions affecting tax treatment of pass-through entities themselves	Generally not distributed
Pensions	Case-by-case basis
Nonprofit organizations	Generally not distributed
Non-U.S. persons	Generally not distributed

Source: Joint Committee on Taxation, "Methodology and Issues in Measuring Changes in the Distribution of Tax Burdens," JCS-7-93, June 14, 1993.

The tax expenditure lists are not based on any intellectually coherent measure of income.

tribution tables are to be offered up routinely to policymakers, they should be presented in a number of different ways under different assumptions to provide a range of perspectives.

Base Tax Expenditure Estimates on a Coherent Income Concept

There are a number of competing ideas regarding what properly constitutes "income." Economists have focused on two alternative definitions. The Fisher-Ture conception of income is gross revenue less all expenditures made to earn income. The Haig-Simons conception is the sum of consumption and changes in net wealth.[32] The current income tax system is inconsistent with either concept. Lists of "tax expenditures" (or tax "loopholes") published by Congress and the administration are not currently based on either concept. In fact, the tax expenditure lists are not based on any intellectually coherent measure of income.

The term "tax expenditure" is defined by law as "those revenue losses attributable to provisions of the federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." The term "tax expenditures bud-

get" means "an enumeration of such tax expenditures."[33] Those lists, published by JCT and OTA, are popularly thought of as lists of federal tax loopholes.

Official tax expenditures lists use neither of the two accepted conceptions of income. Instead, they are based on an idiosyncratic idea of a "normal" income tax system that reflects the political biases of the group of economists who developed the lists in the 1970s. Today's tax expenditure lists are often treated as if they were an accurate catalog of loopholes or unjustified tax breaks, yet there really is no consistent basis for many of the items included or excluded.[34]

As an important reform step, the JCT and OTA should present two sets of tax expenditure estimates using consistent, rigorous application of both accepted, intellectually coherent conceptions of income (the Fisher-Ture and the Haig-Simons definitions). The current lists are based on unscientific and politically biased views regarding what constitutes a normal tax system. For example, numerous large items are arbitrarily dropped from tax expenditure lists today, such as personal exemptions and standard deductions, for no reason other than someone in the past deciding that they constituted a part of a "normal" tax system. Tax-exempt organizations represent another large tax expenditure that is not reported on official lists.

Political bias and arbitrariness is evident in the treatment of tax rates as well. For example, when one corporation pays taxes at a lower rate than another corporation, that is listed as a tax expenditure. However, when millions of individuals pay tax at much lower statutory rates than others, it is not reported on JCT and OTA tax expenditure lists.

It is also interesting to note that the tax expenditure lists are only one-sided views of the federal tax system. Tax expenditures reflect an abatement or forgiveness of tax that would otherwise be owed if an income tax were consistently applied. However, there are many cases where individuals are double-taxed under any consistent definition of income. In such cases, items that are double-taxed amount essentially to negative tax expenditures. For example, the double taxation of corporate income is a negative tax expenditure under either accepted definition of income.[35] Thus, the JCT and OTA should be required to report negative tax expenditures in official publications.

The administration, to its credit, has recently acknowledged the need to reform its tax expenditure accounting. The fiscal 2003 federal budget noted that because the tax expenditure list measures variances "relative to an arbitrary base," the "concept of 'tax expenditure' is of questionable analytic value."[36] It also notes that "a highly subjective baseline also may not inform policymakers and the public about those aspects of social or economic policy that are implemented through the tax code."[37] The Treasury is currently reviewing its tax expenditure presentation to determine the standard against which tax expenditures are measured and to explore the possibility of presenting negative tax expenditures.[38]

Include Tax Compliance Costs in Revenue Estimates

The compliance costs of proposed legislation are not currently included in official tax estimates. Tax compliance costs imposed on the private sector, including such costs as record-keeping and tax filing, have been estimated at between $150 to $300 billion per year.[39] Given the magnitude of those costs, their omission from the information about the effects of tax changes provided to policymakers is unacceptable.

For the income tax, there are numerous provisions where the compliance costs approach, equal, or exceed actual revenues raised. For example, compliance costs on small businesses have been estimated to be larger than the income taxes raised from such businesses.[40] Such information would be very valuable to policymakers as they consider alternate tax proposals. For example, a tax proposal that reduced government revenues by $1 million, but saved the private sector $1 million in direct tax costs and a further $1 million in indirect compliance costs, would clearly be beneficial. Note also that proposals for fundamental tax

The compliance costs of proposed legislation are not currently included in official tax estimates.

reform would be judged to be more attractive if proposals were estimated to substantially reduce compliance costs from the high costs imposed by the current system.

An initial attempt was made to more fully incorporate compliance costs into the tax policy process in the IRS Restructuring and Reform Act of 1998.[41] That law requires the IRS to produce an annual study on the sources of complexity in the tax system. Furthermore, the law requires that the JCT, in consultation with the IRS and Treasury, include a "tax complexity analysis" in each report of proposed tax legislation for each provision with "widespread applicability to individuals or small businesses."[42] Tax complexity analyses are supposed to include estimates of the number of taxpayers affected, income levels of affected taxpayers, the extent to which tax forms would require revision, added taxpayer record-keeping requirements, and estimated compliance costs.[43] Unfortunately, the JCT has virtually ignored these requirements, and so far only provided very limited complexity analyses of little value to policymakers. The JCT needs to greatly expand its tax complexity analyses to meet the requirements of the 1998 law.[44]

Estimates of the compliance costs of tax proposals should be routinely provided, along with revenue estimates by the JCT and the OTA.

Estimates of the compliance costs of tax proposals should be routinely provided, along with revenue estimates by the JCT and the OTA. Complexity analyses should be conducted by staff dedicated to such analysis so that expertise can be developed. The JCT has typically evaded its responsibility under the 1998 law by claiming that legislation before it is not of "widespread applicability." The JCT, for example, used this excuse when avoiding a complexity analysis of proposals to repeal the estate tax.[45] Thus, this language should be made more precise by requiring an analysis for any provision that is estimated to change revenues by more than $1 billion annually.

Provide Consistent Presentation of Tax Rates

The stated tax rate of a tax reform proposal can be expressed in two different ways, either by a "tax-inclusive" rate or a "tax-exclusive" rate. To understand the difference, consider a person who earns $100 and spends it all. Now introduce an income tax. Suppose the person pays $20 in income taxes and spends $80 at a store. Alternately, consider a sales tax. Here the person spends $100 at a store and the store would remit $20 to the government. Actual tax payments in both cases are the same. But the tax rates are often expressed differently. In particular, the JCT would state that the income tax rate is 20 percent ($20/$100) based on a tax-inclusive measure. But the sales tax rate would be expressed as 25 percent ($20/$80) based on a tax-exclusive measure.

Sometimes, official government analyses comparing the income tax with various tax reform plans show tax rates inconsistently. To avoid confusion, a consistent method should be used to express tax rates in all tax comparison analyses. This is particularly important for JCT and OTA analyses of fundamental tax reform plans. Generally, it would be best to present analyses of the income tax rate using both a tax-exclusive rate and a tax-inclusive rate.[46]

Reforms to Improve Transparency in Tax Policymaking

Disclose Assumptions behind Estimates

In a democratic society, government operations and policymaking should generally be open to public scrutiny. That should be no less true for the organizations responsible for tax policymaking. Yet the data, assumptions, methodologies, and models employed by those organizations are largely secret despite the high importance of taxation to the general public. This closed process results in inferior analysis being provided to policymakers because the process is not subject to critiques by outside experts. It also leads to a distrust of the process since the foundation of official information is largely unknown. Greater openness would create added peer review of the work of government economists, whose analyses are critical to current fiscal policy outcomes.

Subject to the current protections for personal tax information that are already in law, tax data used by government economists should be disclosed to the public.[47] In addition, the assumptions, methodology, and models employed by the JCT and OTA should be fully disclosed to the public. That would increase confidence in the fairness of the process, and thorough critiques by outside analysts would lead to better information for policymakers.

Full disclosure and open discussion of the methodologies used by the OTA and JCT would generate a lively and constructive debate in academia and the policy community. Such reforms would also result in a higher level of confidence that estimates are based on sound data and theory and do not contain analytical, methodological, or computational errors. The current closed and insular process is not appropriate to something so central to democracy as how we fund our $2 trillion government.

Ensure Public Access to Data Sources

The IRS Statistics of Income (SOI) public use data file is of vital importance to researchers doing serious public finance analyses involving the modeling of tax policy changes. There has been some discussion that the SOI public use file may no longer be made available to outside researchers. Such a change would make it virtually impossible for nongovernmental analysts to undertake serious modeling of the impact of tax policy changes and would further protect JCT and OTA estimates from outside review. The availability of SOI data to private researchers should be legally protected. In addition, the long time lag in the availability of the SOI public use data has been detrimental to timely research. The IRS should increase efforts to make this data file available to researchers as soon as possible after the close of each tax-filing season.

Improve Data and Data Availability

This report has noted that more research and analysis should be completed by the JCT and OTA using consumption and longer-horizon income measures in various official analyses, such as distribution tables. Such alternative analyses may require improved data sets to be created and made available to the public, such as better cross-walks or linkages between Census Bureau consumption data and IRS SOI data. Conducting longer-horizon distributional analyses may require better longitudinal data.

Regarding information on compliance costs, some data is already collected. But better estimates of compliance costs may require fuller data than currently exists. Those additional data sets need to be researched and created.

Reforms to Restructure Tax Policy Institutions

Oversight and accountability are important for any institution. Currently, the OTA and JCT have little effective oversight when it comes to revenue estimates and distributional analysis of tax proposals. The members of Congress who formally comprise the JCT rarely meet, and they do not conduct meaningful investigations into the quality of work performed by JCT staff. Given the demands on the time of members of Congress and their lack of training in taxation or economics, it is not realistic to expect otherwise. A further institutional weakness of the JCT is that the chief of staff has traditionally been an attorney and has not had a good grounding in economic theory.

Neither the OTA nor the JCT are, in practice, accountable for the quality or accuracy of their estimates. Independent analysts are currently barred by practice from receiving sufficient information about how the agencies' analyses are done in order to replicate or critique them.[48] The JCT and OTA staff members are very insular and stay in their positions for extended periods. In these agencies, the same people do business the same way for years, or even decades, and have very little accountability to outside experts or the public. Much good could be done by infusing

The assumptions, methodology, and models employed by the JCT and OTA should be fully disclosed to the public.

Congress should establish an oversight board composed of economists and other experts to review the work of the JCT and OTA.

the staff with new high-ranking personnel to bring fresh and innovative ideas to bear on tax policy estimates.

Establish an Oversight Board for JCT and OTA

To begin fixing some of these institutional problems, Congress should establish an oversight board composed of economists and other experts to review the work of the JCT and OTA. As a sort of peer review, oversight boards would examine the quality of analysts' work and provide direction to ensure that procedures take into account the best economic science. Those boards should be independent of the staff and should be empowered to make a variety of requests for special data and analyses from the staff. The boards would make recommendations to the JCT chief of staff, congressional members of the JCT, and the secretary of the treasury.

Create a Separate Economics Staff in JCT and OTA

Perhaps the best way of incorporating updated economic theory and analysis into the work of the JCT and OTA is to create a separate staff within those agencies dedicated to understanding the economic effects of tax changes. Regular JCT and OTA staff could continue developing "static" revenue estimates and distributional tables, and then submit them to the economics staff, who would provide additional analyses. The new economics staff would adjust the static estimates to produce dynamic estimates by taking into account the estimated economic effects of tax proposals. Referral to the economics staff would be required for all major tax proposals. Major proposals could be defined as those with a static revenue change of more than, perhaps, $1 billion annually. There should also be a requirement that on the request of any member of the JCT, an item would be referred to the economics staff.[49]

Create an Economic Impact Center to Measure Federal Burdens

Current law requires that the estimates of the JCT be regarded as binding for budgetary purposes. Currently, the JCT when sitting as a committee has the authority to accept estimates other than those prepared by the JCT staff. But, in practice, JCT members simply accept JCT staff estimates. To get around that problem, the law should be amended to allow the Ways and Means and Senate Finance committees to use estimates from other sources.

One alternate source of expert analysis could be a new economic impact center (EIC). Such an organization would provide lawmakers with expert analyses of the economic costs or benefits of proposed legislation. Congress should establish an EIC and organize it as an independent federal entity.[50] It would be managed by, and draw on the expertise of, a variety of universities, not-for-profit organizations, and businesses. Its purpose would be to provide independent and better economic information to policymakers.

The EIC would improve the quality of economic information provided to policymakers in a variety of fields, including spending, tax, trade, and regulations. It would take advantage of advances in computing technology and economic science to (1) improve the data sets used by analysts, (2) develop complex multi-variable models consistent with empirical data, and (3) improve analytical practices in the areas of spending, taxes, trade, and regulation.

It would conduct economic analyses in the field of taxation (particularly revenue estimates, distributional analysis, and the macroeconomic effects of tax policies), trade (the economic impact of tariff and non-tariff barriers), regulation (the costs of regulations), and data improvement. There is a strong need to develop best practices in those areas. There is also a strong need for official but independent and objective analyses in those areas. For example, because the agencies that issue regulations analyze their own regulations' costs, those estimates almost always underestimate the true costs of regulations. Current analytical methods are inconsistent with the state of economic science and mislead policymakers about the true impact of proposed policies.

Drawing on experts from throughout the country, the EIC would develop best practices in those fields.

Conclusion

The process by which we make our tax laws must be reformed. The current process is systematically providing inaccurate and incomplete information to policymakers, and it has ignored advances in economic knowledge. Policymakers have undoubtedly made many decisions on tax policy that they would not have made had they been provided with better information. Tax policy has a fundamental impact on the standard of living of all Americans. Yet the ability of policymakers to make fully informed tax policy decisions is impeded by a group of unelected legislative and executive branch officials who stubbornly resist change. Changing the tax policy system so that policymakers are provided with more accurate and complete information will make it easier to enact economically sound tax policies in the years ahead.

Notes

Stephen J. Entin, Lawrence A. Hunter, Dan R. Mastromarco, Daniel J. Mitchell, and Richard W. Rahn provided helpful comments. However, all errors are those of the author.

1 . The House Committee on Ways and Means was established on July 24, 1789, but it was subsequently disbanded. On January 7, 1802, the House agreed to rules that, among other things, provided for standing committees, including Ways and Means. In 1815, the Senate established a temporary Committee on Finance to consider President Madison's proposals for a uniform national currency. On December 10, 1816, the Senate established the Finance Committee as a standing committee.

2. The Joint Committee on Internal Revenue Taxation was established by the Revenue Act of 1926. The act required the committee to occasionally publish for public examination proposed measures and methods for the simplification (!) of internal revenue laws. See Revenue Act of 1926, House Report 1, 69th Cong., 1st Sess. (1925).

3. See Internal Revenue Code §§ 6103, 6405, 8001-8005, 8021-8023. These provisions have not changed markedly since the Revenue Act of 1926.

4. See Section 201(g) of the act, as amended by the Balanced Budget and Emergency Deficit Control Act of 1985 (Gramm-Rudman-Hollings), P.L. 99-177, 99 Stat. 1037. It states that "for the purposes of revenue legislation which is income, estate and gift, excise, and payroll taxes (i.e., Social Security), considered or enacted in any session of Congress, the Congressional Budget Office shall use exclusively during that session of Congress revenue estimates provided to it by the Joint Committee on Taxation. During that session of Congress such revenue estimates shall be transmitted by the Congressional Budget Office to any committee of the House of Representatives or the Senate requesting such estimates, and shall be used by such Committees in determining such estimates. The Budget Committees of the Senate and House shall determine all estimates with respect to scoring points of order and with respect to the execution of the purposes of this Act." 2 USC 601(f). Also see House Rule XIII(3)(h).

5. See James V. Saturno, "The Congressional Budget Process: A Brief Overview," Congressional Research Service, December 1, 2000, for a short summary of the federal budget process. See 2 USC 631 for the budget timetable.

6. They are perhaps more appropriately called tax calculator estimates. Although they make use of sometimes-complex tax calculations, they do not make use of economic understanding about the impact of tax policy on economic behavior. As discussed later in the text, estimators are increasingly willing to take into account certain "behavioral" effects but remain largely unwilling to consider so-called "macroeconomic" effects.

7. Letter from Ronald A. Pearlman to Sen. Bob Packwood, March 21, 1990. The estimate was $2,041.7 billion for fiscal years 1990–94.

8. As far as the author is aware, the JCT staff has never considered any other "behavioral" effect that it believed would reduce the revenue loss estimate from an income tax cut proposal or reduce the revenue increase estimate from an income tax increase proposal.

9. See "Budget Options," Congressional Budget Office, February, 2001. Table 6 shows that the estate and gift tax is estimated to raise $402 billion over the period FY 2002–11 if no changes are made to the law. The CBO estimated that the estate and gift tax would raise $48 billion and $52 billion in FY 2010 and FY 2011, respectively. The JCT estimate of the president's proposal to phase out the estate and gift tax fully by FY 2010 projected that repeal would reduce federal revenues

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by $73 billion and $79 billion in FY 2010 and FY 2011, respectively—nearly twice the projected revenue. See JCT, "Estimated Revenue Effects of the President's FY2002 Budget Proposal," JCX-31-01, May 4, 2001. Their estimate is thought to be based on the supposition that parents would, in the absence of the gift tax, give massive amounts of money to their adult children who would presumably be in lower tax brackets.

10. For example, see testimony of Lindy L. Paull, Joint Committee on Taxation, before the Subcommittee on Oversight, Committee on Ways and Means, May 6, 2002. Paull states that "one of the most significant elements of the Joint Committee staff revenue estimates is the assumed effect of a proposal on taxpayer behavior."

11. Under the rules of the House of Representatives for the 107th Congress adopted January 3, 2001, the chairman of Ways and Means may require the JCT to produce a dynamic estimate. Such an estimate would be advisory only. The static estimate would govern for purposes of the budget resolution. See House Rule XIII(h)(2)-(h)(3).

12. Although CBO does not generally take into account the impact of tax changes on incentives when making macroeconomic estimates, estimates do reflect CBO's view that reducing federal deficits increases savings and investment and reduces interest rates. For example, see CBO, "Description of Economic Models," November 1998.

13. See Joint Committee on Taxation, "Tax Modeling Project and 1997 Tax Symposium Papers," JCS-21-97, November 20, 1997.

14. Testimony of Lindy L. Paull, May 6, 2002.

15. See testimony of Lindy L. Paull, May 6, 2002, for a description of the uncertainties that are of concern to the JCT staff.

16. In the author's view, experience shows that neoclassical models produce more accurate results than Keynesian models, and models based on empirical data produce more accurate results than those that assume full Ricardian equivalence (as CBO macroeconomic models do). Ricardian equivalence models assume that a tax cut that is not accompanied by an equal spending cut will be financed by a future tax increase that is equivalent in present value terms (i.e., as large plus interest) and that taxpayers assume this and adjust their economic behavior on the assumption this future tax increase will take place. Models that assume the U.S. economy is "open" are vastly superior to those that assume it is "closed" since it is a fact that capital and goods flow to and from the U.S. to other countries and those flows are economically important. To assess which models are the most accurate, they should be "back-cast" to see which would have been most accurate in predicting the effects of actual prior policy changes. Models that fail to conform to this reality check should not be used.

17. That is because reducing marginal tax rates increases incentives to work, save, and invest (or in more technical terms, reduces substantially the deadweight losses or excess burdens of the tax system). A child credit does not substantially change the marginal tax on work, savings, or investment and, therefore, does not have a substantial economic effect. Retroactive tax cuts do not affect individual or corporate marginal decisions about whether or not to engage in future economic activity.

18. For a recent discussion by a former JCT staff member making this case, see Martin A. Sullivan, "Injecting More Economics into Revenue Estimates," *Tax Notes*, June 3, 2002, p. 1433.

19. Even under current law, there is no reason why members of the JCT could neither instruct staff to produce dynamic estimates nor adopt another agency's dynamic estimate (e.g., Treasury). The only legal obstacle is House Rule XIII(3)(h)(2), which states that "a dynamic estimate under this paragraph may be used only for information purposes."

20. For example, see Dan R. Mastromarco, "What's So Fair about a Tax on Income?" *Tax Notes*, October 8, 1999.

21. For the flat tax, see Robert Hall and Alvin Rabushka, *The Flat Tax*, 2nd edition (Stanford: Hoover Institution Press, 1995)

22. For example, see Gilbert E. Metcalf, "The National Sales Tax: Who Bears the Burden?" Cato Institute Policy Analysis no. 289, December 8, 1997. See also: Don Fullerton and Diane Lim Rogers, "Distributional Effects on a Lifetime Basis," in *Distributional Analysis of Tax Policy*, ed. David F. Bradford (Washington: American Enterprise Institute, 1995); Laurence J. Kotlikoff, "The Economic Impact of Replacing Federal Income Taxes with a Sales Tax," Cato Institute Policy Analysis no. 193, April 15, 1993; and Laurence J. Kotlikoff, Boston University, testimony before the House Committee on Ways and Means, June 6, 1995.

23. See Julie-Anne Cronin, "U.S. Treasury Distributional Analysis Methodology," OTA Paper No. 85, U.S. Treasury, September 1999, p. 4.

24. Well-being is used in the text in the interest of clarity. Welfare is the word used in the economics literature.

25. OTA analyst Julie-Anne Cronin has written: "the only tax burden measure with some theoretical basis is the percentage change in after-tax income. It alone provides some indication of a family's change in welfare, because after-tax income represents the family's consumption possibilities in either the current or future years." See Julie-Anne Cronin, p. 34. For an example of current JCT methods, see JCT, "Distributional Effects of the Conference Agreement for H.R. 1836," JCS-52-01, May 26, 2001.

26. For a sense of how dramatically different the results can be, see Daniel R. Feenberg, Andrew W. Mitrusi, and James M. Poterba, "Distributional Effects of Adopting a National Retail Sales Tax," in *Tax Policy and the Economy* 11 (Cambridge: National Bureau of Economic Research, 1997).

27. One of the few sources for official information about how the JCT conducts its distributional analyses is JCT, "Methodology and Issues in Measuring Changes in the Distribution of Tax Burdens," JCS-7-93, 1993.

28. See Julie-Anne Cronin. See also James R. Nunns, "Distributional Analysis at the Office of Tax Analysis," in *Distributional Analysis of Tax Policy*, ed. David F. Bradford (Washington: American Enterprise Institute, 1995).

29. For example, see Peter J. Wilcoxen and Dale W. Jorgenson, "The Long-Run Dynamics of Fundamental Tax Reform," *American Economic Review*, May 1997.

30. Julie-Anne Cronin.

31. For example, the JCT and OTA assume that converting to a Roth IRA is "voluntary" and that the resulting tax is not borne by anyone. Similarly, the JCT assumes that a capital gains rate reduction that results in increased tax on greater realizations is not borne by anyone. See Julie-Anne Cronin. Also see JCT, JCS-7-93, 1993. Moreover, it is not clear that corporate taxes are always distributed by the official government estimators.

32. For a more detailed discussion, see David R. Burton, "Tax Policy and the Structure of Production," *Austrian Scholars Conference 8: Proceedings*, March 15-16, 2002, Ludwig von Mises Institute, Auburn, Alabama, www.mises.org/asc/2002/ASC8-Burton.pdf. See also Joshua Hall, "Tax Expenditures: A Review and Analysis," Joint Economic Committee, August 1999.

33. 2 USC 622(3).

34. Stanley S. Surrey's influential book *Pathways to Tax Reform: The Concept of Tax Expenditures* (Cambridge: Harvard University Press, 1973) was largely responsible for the structure of the tax expenditure budget in current law. See Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2002–2006," JCS-1-01, January 17, 2002, for a description of current JCT practice. They note, "the Joint Committee staff has used its judgment in distinguishing between those income tax provisions (and regulations) that can be viewed as part of a normal income tax law and those special provisions that result in tax expenditures." See also U.S. Government, *Budget of the United States Government*, Fiscal Year 2003, Analytical Perspectives, p. 95, for a discussion of how the executive branch produces its tax expenditure list.

35. For example, see Henry C. Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (Chicago: University of Chicago Press, 1938), pp. 185–204.

36. See U.S. Government, Budget of the United States Government, Fiscal Year 2003, "The Need for Change," chapt. 6 in *Analytical Perspectives*, pp. 96–97.

37. Ibid.

38. However, the fact that two of the leading officials within Treasury supporting this review have recently left the department raises questions about whether it will be completed and its outcome.

39. For example, see "Federal Tax Compliance Costs Climb to $225 Billion," Tax Features, Tax Foundation, March 1996. See also, James L. Payne, *Costly Returns, The Burden of the U.S. Tax System* (San Francisco: Institute for Contemporary Studies, 1993). Joel Slemrod of the University of Michigan has made estimates toward the lower end of the range.

40. Arthur Hall, "Compliance Costs of Alternative Tax Systems II," Tax Foundation, March 1996.

41. Public Law No. 105-206.

42. Ibid.

43. Section 4022(b)(2)(B)(iii) requires the compliance cost estimate.

44. In principle, when JCT ignores its duty under the act, the bill could be ruled out of order pursuant to House Rule XIII(h)(1) were a member to raise this point of order.

45. For example, see the JCT's complexity note in House Report 107-37 relating to the Death Tax Elimination Act of 2001 (H.R. 8). It notes that "the staff of the Joint Committee on Taxation has determined that a complexity analysis is not

required under section 4022(b) of the IRS Reform Act because the bill contains no provisions that amend the Internal Revenue Code that have widespread applicability to individuals or small businesses." That indicates a remarkably brazen willingness to evade the requirements of the act.

46. For example, a taxpayer in the 28 percent bracket who pays 15.3 percent of wages in payroll taxes, would have a combined tax inclusive rate of 43.3 percent. The tax exclusive rate would be 76 percent. The taxpayer must earn $176 to spend $100 because he or she must pay $49 in income taxes and $27 in payroll taxes on the $176.

47. See Internal Revenue Code §6103.

48. The recently created "Blue Ribbon Panel" is a step in the right direction.

49. That is because under current methodology, certain items such as capital gains rate reductions may be scored as having a small first order revenue effect but could have a major macroeconomic effect.

50. It could be established as a Federally Funded Research and Development Center managed by the Treasury Department and organized similar to the Argonne National Laboratory, Sandia National Laboratories, Los Alamos National Laboratory, Lawrence Berkeley National Laboratory, Lawrence Livermore National Laboratory, Oak Ridge National Laboratory, Pacific Northwest National Laboratory, National Renewable Energy Laboratory, and the Idaho National Engineering and Environmental Laboratory.

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