Statement of the U.S. Chamber of Commerce

ON: Dynamic Analysis of the Tax Reform Act of 2014

TO: THE SUBCOMMITTEE ON SELECT REVENUE MEASURES COMMITTEE ON WAYS AND MEANS OF THE U.S. HOUSE OF REPRESENTATIVES

BY: J.D. Foster

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**BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS OF
THE U.S. HOUSE OF REPRESENTATIVES**

Hearing on "Dynamic Analysis of the Tax Reform Act of 2014"

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July 30, 2014

Good morning, Chairman Tiberi, Ranking Member Neal, and distinguished members of the Committee. My name is J.D. Foster and I am the Deputy Chief Economist at the U.S. Chamber of Commerce. Thank you for the opportunity to testify today on the dynamic analysis of the Tax Reform Act of 2014.

The Tax Reform Act of 2014 was a landmark event in modern tax policy, as was the companion dynamic analysis released by the Joint Committee on Taxation (JCT). Many lessons regarding tax reform have been drawn from these events. I will, however, limit my remarks here to the lessons regarding dynamic analysis, and I summarize these in five points as follows.

With respect to the modelling exercise:
1) The JTC proved dynamic analysis of tax policy can be done credibly, refuting longstanding assertions to the contrary by some;
2) Dynamic analysis remains roughly equal parts art and science;
3) Thus, it remains important to consider a variety of models under a variety of assumptions with the intent that their respective results bracket a reasonable assessment of the policy's consequences. As they gain experience with the models and the process, analysts should be able to settle on a single, primary model and assumption set, but the tools are not there yet;
4) Consequently it remains important at this stage to give heed to the results from each of the models and under a variety of assumptions, without suggesting that this or that set of results is the right one.

And, with respect to the tax reform process itself, the most important lesson of all:
5) The amount of additional growth required from tax reform should be made explicit at the outset.

Growth as Explicit Objective

Of these five points, the fifth – an explicit growth goal at the outset – is by far the most important for enactment of comprehensive tax reform intended to improve economic performance, though its execution depends in part on continuing progress perfecting dynamic analysis. Comprehensive tax reform offers a unique opportunity to substantially and permanently increase the size of the U.S. economy compared to what it otherwise would be. Perhaps no other policy reform offers such promise. The converse of this statement is recognition of how much damage policy errors in the current tax code do to fundamental processes of economic growth – work, saving, investment, and the pursuit of greater efficiencies – and therefore recognition of the importance of correcting those policy errors through comprehensive tax reform.

The tremendous effort that went into the Camp plan, and the requisite work to get a plan ultimately to a President's desk, underscore the enormous effort and care required to enact comprehensive tax reform. It would engage the nation in a rare, robust, and wide-ranging debate over national priorities, and it would consume prodigious amounts of congressional calendar and presidential political capital. If the primary goal is, as it should be, to make good on the promise of a stronger economy, then the expected results should justify the effort.

Proponents of a stronger economy through comprehensive tax reform have long been handicapped at the outset, but in a manner perhaps only now truly apparent. Comprehensive tax reform is typically required to meet a variety of ex ante precisely quantified or identified design criteria. However, the most important criterion of all – a stronger economy – has been left generic and vague, and thus repeatedly suffered at the expense of the other criteria. This is a problem. Fortunately, having defined the problem, an effective solution is relatively easy to adopt. Going forward, comprehensive tax reform should be guided by an explicit and quantified goal for increasing economic output and income.

Economic Growth – First Among Equals

Comprehensive tax reform raises a panoply of constraining requirements contesting with the growth objective. Unlike just about any other policy Congress might consider, most Americans are directly and personally touched by the tax system in one fashion or another. This makes tax reform a uniquely personal political endeavor. Common requirements imposed on tax reform are largely dictated by political considerations specifically to inoculate against certain political concerns.

Revenue neutrality, for example, isolates the question of how to tax from the question of how much to tax in the aggregate. Conservatives then need not fear tax reform becoming an excuse for a tax hike, while liberals need not fear tax reform being hijacked for a tax cut. Tax reform is difficult enough without these suspicions, yet barring tax reform from reducing the overall tax burden tends to limit the extent of economic gain tax reform can achieve.

A second, politically dictated requirement often imposed on comprehensive tax reform is distributional neutrality – holding constant the average tax rate levied on low-, middle-, and upper-income individuals and families. Simply put, liberals generally fear a shift of tax liability onto low-income citizens, while conservatives pushing for stronger economic growth oppose hiking taxes on capital income and gains typically earned by upper-income taxpayers.

Distributional neutrality largely inoculates tax reform from these burden shifting concerns. Yet distributional neutrality, like revenue neutrality, can also impose significant limitations on how tax reform could improve economic performance, such as through lower tax rates of workers, small businesses, and corporations, and such as lower tax rates on capital income and capital gains, and through expensing of capital purchases, and by adopting a territorial tax system.

In addition to revenue and distributional neutrality, other considerations cum requirements demand attention. Many popular tax provisions of little or no overall economic consequence are threatened by comprehensive tax reform; likely some would be preserved in tax reform, reducing the extent of other changes that would be expected to benefit the overall economy.

Giving Growth a Fair Chance

As Chairman Camp has emphasized, tax reform's chief objective is a stronger economy. The Chairman worked diligently to release the first comprehensive tax reform plan in many years, a plan intended to meet the chief objective. According to the body of analyses available to date, an honest appraisal must conclude this plan shows a fairly modest improvement in economic performance, likely much less than intended. How did this come about? What constrained the effort so that it was unable to produce the kind of game changing economic gain intended and which should be expected?

Part of the answer may be that the models used for dynamic analysis are yet too rudimentary to capture properly the full magnitude of growth effects from tax reform. Only future work to improve the models will show whether this is true.

Much of the answer is certainly that while a significantly stronger economy was the goal, the size of the necessary improvement in the economy was not specified. As has been common in the past, whatever additional growth was anticipated to result was implicitly accepted as the best one could do even if it meant the best was not very much.

In contrast, major design criteria such as revenue and distributional neutrality, along with certain other presumed policies like preserving the Earned Income Tax Credit and the exclusion for employer-sponsored health insurance were met with fair precision. *Put simply, in the contest of competing requirements, this was not a fair fight; substantially stronger growth never had a chance.*

Fortunately, the problem being clear the solution is equally clear – tax reform should proceed with a definite, specific, realistic, and quantified goal for a stronger economy.

Setting a Goal

Deciding tax reform's goal for economic improvement is a debate unto itself and cannot be settled here. However, it is possible to advance the discussion. The most obvious goal is for tax reform to produce the greatest improvement in economic performance possible. Once the best available models are found by JTC, they could be used to calculate this figure and then perhaps this figure should then guide for tax reform thereafter.

Embracing the greatest possible economic improvement is as obviously impractical as it is obvious. Even after tax reform, the tax code will be called upon to accomplish a variety of economic and social policies, the most obvious of which is the revenue goal.

While much federal spending is clearly supportive of economic growth, much is also dedicated to a variety of humanitarian and social policy goals with at best tangential economic benefits. This is not the occasion to debate the propriety of these goals or the policies implemented to achieve them, but from a purely economic standpoint it follows that if the federal government through these non-economic policies requires 18 percent to 20 percent of Gross Domestic Product in taxes as per the historical norm, then the economy will be substantially smaller than it could be under a lower revenue requirement, all else held equal. Thus a reasonable alternative might be that tax reform must capture at least half the additional growth that would be possible under an ideal tax system collecting the requisite amount of revenue.

An ideal tax would minimize the amount of economic loss given the revenue goal, whereas the current tax system results in far more loss. How much more loss is yet to be determined, but suppose the JTC's models indicated the maximum achievable economic improvement through tax reform given the current revenue requirements is 14 percent. One possibility for sake of debate would be that comprehensive tax reform should at least raise output by 7 percent once a transition period concludes.

Under this approach, all other industrial and social policy goals demanded of the tax code would be implicitly budgeted to cost in terms of lost economic output and income no more than half of what is possible to achieve through tax reform. Tax policy uses tax expenditures to indicate the revenues foregone for non-tax purposes due to individual tax provisions. The approach suggested here sets a maximum economic expenditure to indicate the aggregate income and output foregone through the tax code in toto.

Establishing the explicit goal for improvement in economic performance arising from comprehensive tax reform is a debate unto itself. It is a good debate to have. Then, once a targeted economic gain is established at the outset, this economic goal can then go toe to toe in a fair match in the ensuing debates with the goals of revenue neutrality, distributional neutrality, and all the other legitimate concerns raised by tax reform. If the resulting product achieves anything less than the stated goal, then the crafters would be sent back to the drawing board to try again.

Explicit Growth Goals Requires Credible Models

For comprehensive tax reform to produce substantial gains in economic performance, the legislative process must be guided by an explicit and stated measure of improvement. For those involved in the process to accept an explicit and stated goal, analysts supporting policymakers in the endeavor must have tools of sufficient credibility, reliability, and facility to provide reasonable judgments as to whether the growth goals would be met or not.

The JTC's analysis of the Camp tax reform plan represents a remarkable advance in this regard. Indeed, without JTC's progress toward a functional dynamic analysis capability, and as well the parallel progress by the Congressional Budget Office (CBO), it would be impossible to have a testable economic gain objective and consequently successful comprehensive tax reform would continue to be sorely handicapped.

In part, the JTC's achievement is remarkable because so many have argued for so long that producing a credible dynamic analysis of comprehensive tax reform was simply too difficult. While still climbing the learning curve, the JTC has dispelled this myth.

The JTC's analysis also demonstrated the acceptance of certain basic propositions regarding modelling. For example, not long ago some analysts continued to argue the models should pretend the United States economy is alone in the universe, rather than acknowledge there's a great big global economy out there – the closed versus open economy debate. Often, those pressing the closed economy case would raise all manner of extraneous considerations, such as the difficulty of modelling exchange rates. While modelling exchange rates reliably is very difficult even for models designed specifically for the purpose, it turns out also not to be all that important to dynamic analysis of tax policy. And so, sensible models now acknowledge in their essentials that the U.S. is part of a global economy, capable of importing and exporting saving along with goods and services.

Another advance in dynamic analysis has been the coalescence of analysts' views regarding certain key parameter values for these models. In almost all cases, these parameters, most especially for the responsiveness of the supply of labor and saving, are estimated in other contexts by entirely different kinds of models. Only time and additional analysis will tell whether these currently assumed parameter ranges at least bracket the "correct" values for the dynamic analysis models, but broad census about these matters at least permits us to move on to more structural questions while refining the parameter estimates.

It is also clear, however, that the learning process has far to go with respect to broader questions of model design. The JTC, for example, used two models – the Macroeconomic Equilibrium Growth Model and an Overlapping Generations (OLG) Model. Each is a fine model, yet each was originally designed for other purposes and was adapted by the JTC for its dynamic analysis. This then requires extra care to prevent the respective models' design idiosyncrasies from entangling the results in extraneous issues.

It is curious the JTC did not include in its analysis a model designed specifically to examine tax policy's effects on growth, though the OLG model is a close cousin. The advantages of such a model become apparent if one considers the three-step essentials of how the CBO, Administration forecasters, and others doing medium-run economic forecasts proceed.

The obvious first step is to gauge the current state of the economy and its immediate trajectory. In many respects, this is one of the most difficult tasks even for current forecasting. Stage two is to develop a measure and forecast of the economy's potential output, such as the potential output forecast developed by CBO. This forecast of potential output anchors the overall forecasting exercise.

History and theory agree that if an economy is underperforming as the U.S. economy is today, then over time and usually in fairly short order markets will heal and the economy will eventually return to full employment, achieving its potential output. (This, of course, assumes no major unforeseen shocks and no adverse future policies.) Forecasters then describe the economy's recovery path from its current state to its full employment state at some future date, which means above normal growth rates in the economy over the duration of the recovery period.

Now bring dynamic analysis into the picture. Tax reform's goal is to raise the future level of economic output. Fundamentally, this means estimating the extent of increase in the level of potential output once all adjustments have taken place. This is the most critical step in dynamic analysis.

Once a new trajectory for potential output is established, what remains is to determine how the economy's actual path will differ, and hopefully increase, given the shift from the old to the new trajectory of potential output. The analyst or the model will alter the economy's actual path starting from its current state, either by accelerating near-term growth or extending the period of above-normal growth rates until the new, higher trajectory of potential output is attained.

Determining the extent of increase in potential output in the economy arising from a change in policy is the central result in dynamic analysis. Thus it is curious the JTC does not include among the models it uses a model with the trajectory of potential output as its central focus, and instead uses models with many other features, many of which are at best tangential to dynamic analysis.

A Caveat, and a Recommendation for Further Progress

The JTC's analysis showed that this work can be done credibly, but it also showed there is much left to learn. For this reason, it remains important for dynamic analysis of policies to be performed using a variety of models under a variety of parameter assumptions. The hope and expectation is for the results to bracket the correct answers, and offer some sense of the range of uncertainty about those answers.

This uncertainty, in turn, suggests the importance in considering the results of giving weight to each set of results. The natural temptation if one supports a policy is to emphasize the stronger results and if one opposes a policy to emphasize the weaker. Such emphasis however suggests one has greater confidence in one model or set of parameters than another, and such confidence appears as yet unwarranted.

I would like to conclude with a recommendation for the Committee's consideration. In January, 1997, the JTC with the urging of then Chairman Bill Archer sponsored a symposium on dynamic analysis. Participants included most of the leading researchers in the field and the symposium is widely regarded as a landmark event and part of the intellectual foundation that led almost two decades later to the JCT's recent dynamic analysis of Chairman Camp's plan.

My recommendation is for the JCT to hold a second such symposium using as part of its focus the analysis it did of the Chairman's proposal. The symposium would once again bring together the leading thinkers on economic modelling of policy changes, and would have as its dual focus a discussion on the state of dynamic analysis and next steps, and an examination of the most pro-growth tax reform policies in light of the current state of dynamic modelling.