An hourglass-shaped graphic with a globe in the top bulb and another globe in the bottom bulb. The hourglass is light blue and has a dark blue top and bottom. The globe in the top bulb is dark blue, and the globe in the bottom bulb is light blue. The text is centered within the hourglass.

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Would Tax Reform Alter the Economy's Growth?

Marc Labonte, Government and Finance Division

April 21, 2006

Abstract. An argument frequently made by proponents of tax reform is that it would boost economic growth. The term "tax reform" means different things to different people. This report uses the recent recommendations of the President's Panel on Tax Reform as a launching point. Although the Panel proposes making many small changes to the tax system, its recommendations incorporate a few broad concepts that are evaluated in this report.

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Would Tax Reform Alter the Economy's Growth?

Marc Labonte
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Summary

An argument frequently made by proponents of tax reform is that it would boost economic growth. "Tax reform" means different things to different people. This report uses the recent recommendations of the President's Panel on Tax Reform as a launching point. (Tax reform may have important effects on the efficiency, equity, and simplicity of the tax system, but these issues are not addressed in this report.)

The Panel's proposal is meant to be revenue neutral over 10 years compared with a baseline that assumes that the 2001 and 2003 tax cuts are not allowed to expire as scheduled and the other tax proposals in the President's budget are enacted. This means that the Panel's proposal raises less revenue than a current law baseline, such as the CBO baseline, which assumes that expiring tax provisions are allowed to expire. The proposal would raise, on average, about as much revenue as a share of GDP annually as the government currently collects. Thus, the proposal would not be expected to have a stimulative or contractionary effect on aggregate spending in the economy in the short run. Because budget deficits reduce national saving, it would be expected to cause about the same degree of crowding out of private investment as is occurring today (and more crowding out than would occur under a current law baseline).

Because the Panel's proposal is revenue neutral, it is made up of revenue raisers and revenue reducers that cancel each other out overall. The largest revenue reducer is the repeal of the alternative minimum tax (AMT). This revenue loss is so large that the Panel is not left with much scope to significantly reduce marginal income taxes and remain revenue neutral. Most of the other tax reductions in the proposal are focused on taxes on capital (or saving). (To remain revenue neutral over 10 years and cut taxes on saving, the Panel proposes the expansion and conversion of "back-loaded" tax-preferred saving accounts that raise revenue in the short run but lose revenue in the long run.) Although many economists have criticized the AMT, it has marginal rates that are similar to the regular income tax for most affected taxpayers, so repealing it does not influence incentives to work or save in most cases.

The overall effect on economic growth is likely to be negligible. Any effects on labor supply would be small and ambiguous because some workers would face higher marginal tax rates, and others would face lower tax rates. The proposal could potentially have a larger effect on saving, but the theoretical and empirical evidence is mixed. Since 1980, tax preferred saving accounts have been expanded and taxes on capital gains and dividends have been reduced; these changes have not stopped the personal saving rate from declining from over 10% of disposable income to zero in that time. This suggests that saving may not be very responsive to further tax reductions.

The Panel proposes reducing or eliminating many of the tax expenditures in the current system. Although these changes may increase economic efficiency (by reducing distortions in market outcomes), they are unlikely to have more than negligible effects on economic growth, which depends on increases in labor, capital, and productivity. This report will be updated as events warrant.

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Introduction

An argument frequently made by proponents of tax reform is that it would boost economic growth. The term “tax reform” means different things to different people. This report uses the recent recommendations of the President’s Panel on Tax Reform¹ as a launching point. Although the Panel proposes making many small changes to the tax system, its recommendations incorporate a few broad concepts that will be evaluated:

- Elimination of the alternative minimum tax (AMT). This would reduce revenues by \$1.2 trillion over 10 years.² This lost revenue is offset by other provisions in the proposal that raise revenue.
- Reduction in certain tax expenditures, such as the mortgage interest deduction and the deductibility of health insurance, and elimination of other tax expenditures, such as the education credits and deductibility of state and local taxes.
- Reduction in the number of marginal income tax brackets from six to three or four.
- Replacement of the standard deduction and personal exemptions with a family credit.
- Reduction in the taxation of capital through higher contribution limits on tax-preferred saving accounts, reduced taxation of dividends and capital gains, a lower corporate income tax rate, and more favorable rules for writing off capital investment.

Overall, the Panel stated that its proposed tax system would generate revenue equal to a baseline under which the 2001 and 2003 tax cuts were extended. It would generate less revenue than a current law baseline (such as the Congressional Budget Office’s) under which those tax cuts expire as scheduled.

The Panel proposed two separate plans: the Simplified Income Tax (SIT) Plan and the Growth and Investment Tax (GIT) Plan. Both plans incorporate all of these broad concepts and differ mostly on the corporate side (the GIT plan would more fundamentally alter the structure of the corporate tax system). If the Administration adopts a proposal based on the Panel’s recommendations, the proposal will be presented to Congress. This report will evaluate how each of these concepts could potentially influence the growth rate of the economy. Tax reform may also have important effects on the efficiency, equity, and simplicity of the tax system, but these issues are not addressed in this report.

¹ President’s Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America’s Tax System*, Nov. 2005.

² U.S. Department of the Treasury, *Fact Sheet: The Toll of Two Taxes: The Regular Income Tax and the AMT*, Mar. 2, 2005. See also CRS Report RS22100, *The Alternative Minimum Tax for Individuals: Legislative Initiatives in the 109th Congress*, by Gregg A. Esenwein. General information on the AMT can be found in CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, by Steven Maguire. The panel did not provide official revenue estimates of its proposals.

Economic Growth: Short Run vs. Long Run

Economic growth refers to an increase in gross domestic product (GDP), the goods and services currently produced by the economy. Economists distinguish between short run and long run sources of growth. In the long run, production is determined solely by inputs of labor and capital, and how productively those inputs are used. Thus, in the long run, economic growth is determined by how quickly inputs of labor and capital are increased and how quickly productivity grows. Most of this report will analyze how various provisions of the tax reform proposal would affect long-run growth, but first it will briefly analyze the proposal's overall effect in the short run.

Total Revenues and Fiscal Policy

Although growth in labor, capital, and productivity determines the economy's average growth rate over time, most economists believe that it cannot explain the short-term fluctuations (recessions and expansions) of the business cycle. In the short run, these fluctuations in growth are caused by changes in aggregate spending (demand) in the economy. Recessions occur when spending—whether it be consumer, investment, net export, or government spending—falls below the economy's productive capacity. As a result, labor becomes unemployed and physical capital lies idle. When spending exceeds the economy's productive capacity, price inflation occurs. Any mismatch between spending and production is strictly temporary: over time, the economy automatically adjusts to bring the two back in line. Since World War II, recessions have lasted on average for 10 months.

The government has two tools at its disposal to alter aggregate spending: monetary policy and fiscal policy. Fiscal policy alters aggregate spending through changes in the budget deficit. When the government borrows more from the private sector to increase government spending or reduce taxes, it increases aggregate spending. When the government borrows less, aggregate spending falls. After its initial expansionary effects, a constant budget deficit over time neither expands nor contracts aggregate spending. Any potential changes in the aggregate spending caused by changes in deficit resulting from tax reform could presumably be offset by changes in monetary policy since the path of deficits would be preannounced in advance.

Fiscal policy influences aggregate spending in the short-term, but it also has long-term effects on growth. A larger deficit, whether it be caused by tax cuts or higher government spending, must be financed out of the finite pool of private saving. Private capital investment must be financed out of the same pool, so deficits are said to “crowd out” capital investment spending by bidding up interest rates to secure those finite resources. With higher interest rates, there are fewer profitable investment opportunities. Crowding out could be avoided by borrowing abroad, but then the additions to the capital stock would be foreign owned, and the future income it produced would not flow to Americans. Because capital investment increases the productive capacity of the economy, crowding out leads to a smaller economy than would otherwise have been over the longer run.³

³ See CRS Report RL31775, *Do Budget Deficits Push Up Interest Rates and Is This the Relevant Question?*, by Marc Labonte.

Should the Panel's proposal be considered revenue neutral? It depends what one considers to be the baseline to which it is compared: current law (in which current tax cuts and AMT relief expire) or the President's budget proposal. The CBO baseline uses the current law concept. The Panel provides no revenue estimates, but over the next 10 years, it has stated that its proposal would keep revenues on average at the level the Administration proposed in its budget. The Administration's budget assumes that the 2001 and 2003 tax cuts will be extended and the Administration's other tax proposals (including expanded tax-preferred saving accounts) will be adopted.⁴ This budget reduces revenues by \$1.3 trillion (of which, extending the tax cuts accounts for \$1.1 trillion) over 10 years compared with current law. In the Administration's budget, revenues would rise from 16.9% to 17.7% of GDP over five years. The Administration's budget does not project overall revenues after five years, but CBO data indicate that revenues would continue to slowly rise because of real bracket creep and the increase in the number of taxpayers subject to the AMT. If the Tax Panel's recommendations maintain revenues at roughly current levels on average, then there would be little effect on aggregate spending now or in the future, assuming outlays stay constant as a share of GDP. (By contrast, under a baseline based on current law, such as the CBO baseline, revenues would rise by about 1.5% of GDP after 2011 because of the expiration of the 2001 and 2003 tax cuts.) In other words, the tax reform proposals would lead to the same degree of crowding out compared with current law as the President's budget.

The Panel's proposal would result in greater revenue loss in the long run because of its expansion of tax preferred saving accounts (discussed below). Similar to Roth IRAs, these accounts (and defined contribution pension plans under the GIT plan) would tax contributions to the account deposited today but would allow tax free withdrawals of earnings and principal withdrawn in the future. That means the accounts, sometimes referred to as "back-loaded" accounts, would raise revenue in the short run but lose revenue when saving is withdrawn, mostly outside the 10-year budget window. Although there is no estimate of this proposal's long-run cost, Burman, Gale, and Orszag estimated that an earlier Administration proposal to expand tax preferred saving accounts (by less than the Panel proposed) could lead to an annual long-term revenue loss of 0.5% of GDP.⁵

"Supply Side" Effects and Long-Term Growth

In contrast to the short-term effects of fiscal policy on aggregate demand (spending), a change in tax policy can also affect economic growth over the longer run by affecting the growth rate of labor, the capital stock, and productivity (often referred to as the "supply side" of the economy). Capital is financed out of national saving, so the capital stock can be increased in the long run only if saving is increased. Changes in the growth rate of labor or saving will depend on how much tax reform changes the incentive to work or save and how responsive labor and saving are to changes in incentives.⁶

⁴ No detailed revenue estimates have been released, so it is not known if the Panel's recommendations would alter revenues from their current path on an annual basis.

⁵ Leonard Burman, William Gale, and Peter Orszag, "The Administration's Savings Proposals: Preliminary Analysis," *Tax Notes*, March 3, 2003, p. 1423. The Administration's proposals may have had a larger revenue loss, however, because there were no restrictions on withdrawals so the participation rates would have likely been higher. See also CRS Report RL32228, *Proposed Savings Accounts: Economic and Budgetary Effects*, by Jane G. Gravelle and Maxim Shvedov.

⁶ Theoretically, lower marginal income taxes could cause workers to save and work more or less. They could save and (continued...)

This is not the end of the story, however. Current fiscal policy is unsustainable over the long run. Tax revenue is insufficient to finance spending at present, and spending under current policy is projected to increase dramatically because of an aging population and rising medical costs.⁷ Therefore, neither current tax rates nor the tax rates proposed by the Panel to be revenue neutral can be considered permanent. Any effects of lower taxes today will be more than offset by higher taxes in the future because the future revenue needs of the government will rise due to current borrowing. Since many dynamic models of behavioral responses to a change in taxes require an assumption of fiscal sustainability, the economic effects of current policy cannot be estimated in these models without an explicit assumption of higher taxes or lower spending in the future.

Over long periods of time, labor and capital inputs per capita cannot be continually increased.⁸ Therefore, technological change is the main determinant of increases in income per capita over long periods of time. Because there has not been any established connection between the U.S. tax system and the rate of technological change, any change in tax regimes will make a small contribution to economic output, limited to the cumulative effects of the initial changes in labor and capital inputs.

Effects on Labor Supply

To keep the proposal revenue neutral and compensate for the large revenue loss caused by eliminating the AMT, the Tax Reform Panel had little scope for significant reductions in marginal tax rates. Marginal tax rates on labor income for most taxpayers under tax reform would be roughly similar to the current system. The Panel recommends reducing the total number of marginal tax brackets by shifting some taxpayers into higher brackets and some into lower brackets.

Some taxpayers would face a slightly lower marginal income tax rate under tax reform: for example, the elimination of the 35% bracket means the highest income taxpayers will have their marginal rates reduced by two percentage points to 33% under the SIT plan and by five percentage points under the GIT plan. However, very few taxpayers would be affected by this proposal—only 0.4% of all taxpayers, accounting for 7.5% of total earnings, fell under the 35% statutory rate in 2005.⁹ Some taxpayers would also face slightly lower marginal rates under tax reform because the phaseout of deductions and personal exemptions at high income levels under the current system raises the effective marginal tax rate; under tax reform, the family credit does not phase out.

On the other hand, some taxpayers would face slightly higher marginal tax rates under tax reform, particularly under the GIT plan. For example, the elimination of the 10% bracket, which 22% of

(...continued)

work more since saving and work are now more rewarding on a take-home basis (called a “substitution effect.”) But they could also save and work less since less pre-tax income is needed to equal previous standards of living (called an “income effect.”) Thus, theory does not hold that tax cuts unambiguously raise economic growth.

⁷ See CRS Report RL32747, *Social Security and Medicare: The Economic Implications of Current Policy*, by Marc Labonte.

⁸ In the neoclassical growth model, increases in saving/capital have only a temporary effect on growth because of diminishing returns to capital. Eventually, the capital stock becomes large enough that any further additions have no effect on output.

⁹ Congressional Budget Office, *Effective Marginal Tax Rates on Labor Income*, Nov. 2005, p. 21.

taxpayers fell under in 2005, means some of these taxpayers will now face a 15% marginal rate. For many taxpayers filing as head of household, marginal rates will be somewhat higher because that category will be eliminated. Other individuals face slightly higher rates because the proposed income thresholds for some brackets are higher under tax reform.

The elimination of the AMT means some taxpayers that faced the AMT's marginal rates will now face the regular system's rates instead. For most affected taxpayers in 2006, this would move them from a statutory marginal rate of 26% or 28% under the AMT to a statutory marginal rate of 25%, 30%, or 33% under the regular tax system (with the Panel's new marginal rates). Thus, for most affected taxpayers in 2006, elimination of the AMT would mean a slightly lower or higher marginal tax rate, and therefore would have little effect on incentives. For some taxpayers with large families, however, elimination of the AMT would move them from the AMT rates to the 15% tax bracket; the effect on incentives could be significant for this group. Because the AMT is not indexed for inflation and does not allow personal exemptions, more and more taxpayers with children in the 15% bracket would fall under it as time went by.

This analysis is based on a comparison to the AMT in its current form, according to current law. In the past few years, Congress has repeatedly "fixed" the AMT temporarily, so that it has never affected more than a relatively few individuals in the 15% or 25% bracket under the regular income tax. The latest fix to the AMT expired at the beginning of 2006, and will be renewed if the tax reconciliation bill (H.R. 4297) that is currently in conference becomes law. If Congress continues to extend AMT reform one year at a time (as it does in the reconciliation bill), relatively few taxpayers would fall under the AMT and see a significant drop in their marginal rates under tax reform.

Thus, the recommendations would have an ambiguous effect on labor supply—some workers would face slightly higher marginal taxes on labor, others would face slightly lower. In any case, given how little labor supply has changed over the past decade and a half, as seen in **Figure 1**, there is little reason to think that there would be any significant change in labor supply in response to these small changes. Despite many changes in tax policy, including major tax increases in 1990 and 1993 and major tax cuts in 2001 and 2003, the hours worked and employment-population ratio of men and women have hardly changed at all over that time. The little variation that is found in the employment-population ratio corresponds to the effects of recessions in 1990-1991 and 2001, and is therefore unlikely to be related to changes in incentives.¹⁰

¹⁰ For a review of the empirical literature, see CRS Report RL31949, *Issues in Dynamic Revenue Estimating*, by Jane G. Gravelle.

Figure I. Labor Supply from 1990-2005



Source: Bureau of Labor Statistics

Note: "Employ-pop (employment-population) ratio" is measured by dividing the number of employed individuals 16 years and older by the total population 16 years and older. "Weekly hours worked" is measured as the annual average weekly hours worked of workers in all industries. There are no data on hours worked available for 2005.

Effects on Saving¹¹

The Tax Reform Panel proposes to reduce the taxation of saving and capital investment for both individuals and corporations. On the individual side, the Panel proposes expanding tax-preferred saving accounts so that every taxpayer could, in effect, save up to \$20,000 per year tax deferred outside of their pension. This compares with a current limit on individual retirement accounts of \$4,000, although that can be supplemented in the current system by the various other accounts available. The Panel proposed that the new accounts replace various existing retirement, health, and medical saving accounts, but because the proposed accounts have fewer restrictions on their use than existing accounts (e.g., annual withdrawals up to \$1,000 could be made penalty free from one type of account), individuals may find them more attractive.

If tax reform were to increase national saving, it would have a positive effect on capital investment and economic growth. To determine whether expanding tax preferred vehicles would raise saving, it is useful to look at the evidence on existing vehicles. Evidence on whether existing

¹¹ See also CRS Report RS22367, *Federal Tax Reform and Its Potential Effects on Saving*, by Gregg A. Esenwein.

tax-preferred accounts boost private saving is mixed.¹² Although there is no doubt that significant sums are saved in these accounts, the issue is whether saving in the accounts represents new saving that would otherwise have not taken place or existing saving that was shifted out of nontax-favored vehicles. Account holders have higher saving rates than others, but this is not evidence that the accounts boost saving because the account holders may be inherently higher savers in the first place. About half of IRA-holders currently contribute the full legal limit;¹³ this suggests that these account holders were probably already saving more than the contribution limit, and the account holdings represent the shifting of existing saving. If this is the case, tax preferred saving offers an incentive to save less (called an “income effect”) because less saving is needed to generate future income because of the tax break, and additional saving cannot take advantage of the tax preference.

If contribution limits were expanded, would saving rise? It could only potentially rise for those whose total saving is above the current limit but below the proposed limit. For those saving above the current legal limit, Auerbach points out that an increase of the contribution limit, which allows existing saving to be transferred to enlarged tax-preferred accounts, represents a windfall gain to existing saving (because capital gains are not taxed until realized) that costs the government money without generating new saving.¹⁴ For those who are not currently saving at the legal limit, expanding saving accounts would not increase the incentive to save since it offers no new incentive for these savers to take advantage of. If income limits were removed, as the Panel proposes, saving could only potentially rise for those newly eligible individuals currently saving less than the proposed contribution limit. Those saving above the proposed limit would have an incentive to save less, since they would now earn a higher rate of return on existing saving, but be unable to earn a higher rate of return on new saving.

Some economists argue that tax-preferred saving accounts raise the saving rate, in part, because withdrawal restrictions prevent people from being “tempted” into drawing down their saving, as they might in a normal saving vehicle. If this argument is correct, then the Panel’s proposal to allow up to \$1,000 to be withdrawn annually without penalty would reduce the positive effect on saving from this factor.

Furthermore, private investment depends on national saving, not just private saving, and the proposal affects both. The proposed “back-loaded” saving accounts (in which contributions are taxed and subsequent investment earnings are not) reduce tax revenue in the long run, so even if private saving rose, that would be offset by a decline in public saving. (The overall tax reform package is intended to be revenue neutral over 10 years, but the cost of the back-loaded saving accounts would be substantially lower in the first 10 years than in the long run.)

On the corporate side, tax reform would reduce the taxation of business investment, which would raise the after-tax profitability of investment. Whether this would raise overall investment levels in the long run depends, again, on how responsive private saving is to higher rates of return. The level of investment is determined by the equilibrium between the demand for investment

¹² See CRS Report RL30255, *Individual Retirement Accounts (IRAs): Issues and Proposed Expansion*, by Thomas L. Hungerford and Jane G. Gravelle.

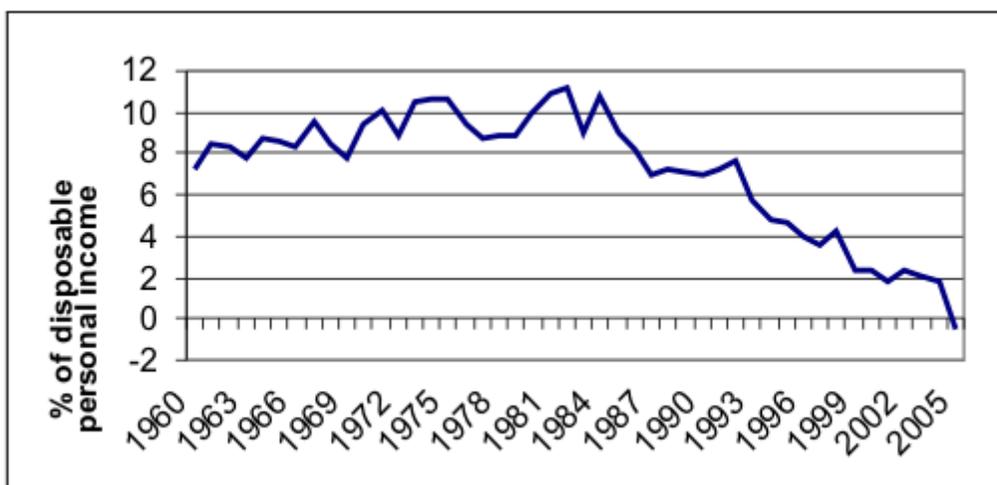
¹³ Sarah Holden, et al, “The Individual Retirement Account at Age 30: A Retrospective,” *Investment Company Institute Perspective*, vol. 11, no. 1, Feb. 2005. This estimate is for traditional IRAs in 2003.

¹⁴ Alan Auerbach, “The Tax Reform Panel’s Report: Mission Accomplished?” *Economists’ Voice*, BE Press, Dec. 2005.

spending and the supply of saving. Reducing taxes on business investment pushes up the demand for investment, but, in the extreme example, if saving stayed constant there would be no change in investment levels and the after-tax rate of return would remain the same (because the before-tax rate of return would fall through higher borrowing costs until equilibrium was restored). Profit-maximizing businesses may desire to save more when rates of return rise, but ultimately, profits accrue to individuals and they could potentially reduce household saving in response to higher corporate saving. It is possible that investment could rise, even if national saving did not rise in response to the higher after-tax rates of return on capital, as a result of a greater inflow of foreign capital. By identity, this would lead to a larger trade deficit, however, which could be problematic since the trade deficit is already unprecedentedly large.

Measuring the responsiveness of saving to a change in the rate of return empirically is difficult because saving represents a decision to postpone consumption from the present to the future. Thus, the decision will be based not only on today's saving rate but also future saving rates. For that reason, the responsiveness of saving to rate of return is usually not be measured directly but instead estimated with highly complex, stylized models. However, these models often use assumptions that many economists have argued are unrealistic (see the next section), and these assumptions are important to their predictions. Thus, predictions vary widely from model to model. Using direct evidence instead is also problematic because many factors besides rate of return determine saving, including demographics and the state of the economy, and it is difficult to properly control for all of these variables. Moreover, as a practical matter, there is no single "rate of return" in the economy that can be observed and compared with saving.

Figure 2. Household Saving, 1960-2005



Source: Bureau of Economic Analysis

As simple evidence of the responsiveness of saving to capital income taxation, the household saving rate can be looked at over time. As **Figure 2** shows, household saving has been declining continuously since the 1980s, despite the steady expansion in tax preferred saving vehicles and reduction in tax rates on capital income. Although this is not conclusive evidence that tax reform would not raise the household saving rate (taken literally, the figure suggests it would lower the saving rate), it certainly does not suggest that tax is the primary determinant of household saving behavior.

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Even if tax reform did not change the overall level of capital investment, it could potentially lead to greater efficiency within the allocation of capital investment across different classes of assets. For example, it might reduce the wedge between the taxation of nonhousing and housing assets or between the taxation of debt and equity. Although this would increase economic efficiency, it would probably have little effect on economic growth. To the extent that tax reform would shift investment into more productive types of capital assets, this might lead to a one-time boost to growth, but the boost would presumably be small since the increased investment in certain assets would be offset by less investment in other assets.

The Tax Reform Panel's Quantitative Estimates of Their Proposals' Effect on Growth

The Panel briefly states that the SIT plan could raise economic output by up to 0.5% in 10 years and 1.2% in the long run based on simulations using three different theoretical macroeconomic models. For the GIT plans, the simulations predict higher output of up to 2.4% in 10 years and 4.8% of GDP in the long run. These estimates are relatively modest: for example, if the economy were assumed to grow 3% annually as a baseline, then the economy would have grown 34% over 10 years under current policy anyway. Because the panel offers no elaboration on how these figures were reached besides identifying the models used (they are the neoclassical growth model, the overlapping generations (OLG) model and the Ramsey model), it is difficult to offer an evaluation that goes into specifics. However, some general tentative observations can be offered. It is likely that larger effects were found in the OLG and Ramsey models than in the neoclassical model, so the following observations will focus on the former two.¹⁵

These models are highly theoretical and have not been proven to perform well empirically. The models are favored by some economists because they are logically consistent and tractable, not because they have proven to be realistic; professional forecasters use a completely different type of model. Some of the assumptions made in the models have been criticized for being extremely unrealistic. For example, they require individuals to be able to make highly complex decisions today that span their entire lifetime (successfully making accurate forecasts of economic variables in order to do so), they assume individuals act systematically and rationally (and do not, say, under-save), and they assume that labor supply changes when interest rates change. Further, the Ramsey model assumes that people have infinite life spans, or at least all treat their descendants' well-being as equivalent to their own.

The growth response in these models comes from assumptions made by the user about how sensitive labor and saving are to a change in taxes. As was discussed earlier, the tax reform proposals reduce the marginal tax rate on labor by only small amounts, so the growth response presumably comes primarily from the reduction in marginal tax rates on saving and capital. Presumably, the simulation assumes that saving is relatively responsive to changes in tax rates, although the dramatic decline in saving as tax rates have fallen since 1980 suggests otherwise. Although the Panel does not provide enough detail to be certain, their results may be reached by modeling tax reform as a shift to a consumption tax. This would be misleading because a consumption tax places a one-time tax on existing saving, and the Panel's recommendation does not. By placing a one-time tax on existing saving, which is a lump-sum tax without negative incentive effects, consumption taxes are able to reduce other tax rates and have larger effects on

¹⁵ For more details, see CRS Report RL31949, *Issues in Dynamic Revenue Estimating*, by Jane G. Gravelle.

economic growth. If the changes were modeled as a shift to a consumption tax, they might also assume that some growth would derive from a shift to a perfectly clean, broad tax base, whereas the proposals actually move only part of the way in that direction. For these reasons and others, Burman and Gale claim that the Panel's estimates are too high compared with the results found in other research on the economic effects of a shift to a consumption tax.¹⁶

The Ramsey and OLG models also contain, to varying degrees, the assumption that people save more when the government runs a budget deficit in anticipation of higher taxes or lower spending in the future (because deficits must be reversed in the future). This means that the models cannot be solved unless the modeler specifies how taxes will be raised or spending reduced to balance the budget in the future (the Panel does identify the assumption it uses). Therefore, part of the increase in growth in the models comes from an assumption that individuals will work and save more now, when taxes are low, so that they can work and save less in the future, when taxes are high. As noted above, if the tax reform proposal is compared with current law (which assumes that the 2001 and 2003 tax cuts will expire as scheduled), then the proposal would cause the "crowding out" of private investment and reduce growth because it increases the budget deficit. The estimates made by the Panel presumably do not take this effect into account because they are made compared with a baseline in which the deficit has already been increased by an assumption that the tax cuts were made permanent.

Tax Expenditures

The Panel's reform proposal makes many changes to the tax expenditures currently found in the income tax. Tax expenditures are defined as "revenues 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 liability."¹⁷ One of the Panel's primary stated goals was to promote simplicity in the tax system, and they single out reform of tax expenditures as a way to achieve that goal. In most cases, they propose simplification or reduction of tax expenditures, although in some cases, such as the state and local tax deduction, they propose elimination.

Economists generally dislike tax expenditures because they distort economic activity. For example, allowing mortgage interest to be deducted leads to greater mortgage borrowing, at the expense of other types of borrowing and saving. If markets are functioning properly, these distortions reduce economic efficiency. Only if there are market failures present can the distortion caused by a tax expenditure increase economic efficiency. Furthermore, holding government spending constant, the revenue loss from tax expenditures leads to another set of distortions because it must be replaced by revenue that is raised through higher marginal taxes on labor or capital income, which distort the decision to work or save. For example, the Treasury Office of Tax Analysis estimated that if all tax expenditures were eliminated (so that only the standard deduction and personal exemptions remained), marginal tax rates could be lowered by one-third and still raise the same amount of revenue as the current system.¹⁸

¹⁶ Leonard Burman and William Gale, "A Preliminary Evaluation of the Tax Reform Panel's Report," *Tax Notes*, Dec. 5, 2005, p. 1349.

¹⁷ Congressional Budget Act of 1974, P.L. 93-344.

¹⁸ President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*, Nov. 2005, p. 52.

If the reduction in tax expenditures were coupled with marginal rate reductions, then they would reduce the distortions to work and save, which could potentially raise economic growth depending on how individuals responded. However, as noted above, the Panel's proposal on a whole does not reduce everyone's marginal rates. The revenue raised by reducing or eliminating expenditures is instead used primarily to compensate for the revenue lost by eliminating the AMT. Although many economists see the elimination of the AMT as desirable, it was not a tax with high marginal rates compared with the regular income tax. Therefore, the Panel's proposals regarding tax expenditures appear to have little scope for influencing economic growth.

Efficiency vs. Growth

As opposed to its popular usage, economic efficiency does not involve economic growth, wealth, or productivity. In fact, evidence shows that efficiency is at loggerheads with these goals.¹⁹ Generally, an outcome is economically efficient if the marginal cost of producing one more unit of a good is equivalent to the marginal benefit of consuming one more unit of the good. When markets function perfectly—which is defined as a market with many buyers and sellers, no barriers to entry, perfect information, and the costs and benefits of the transaction are completely borne by the buyer and seller—an economically efficient outcome will occur and government intervention can only reduce efficiency. A market failure is said to exist when these criteria are not present.²⁰ Unless a market failure is present, tax expenditures reduce efficiency by inducing economic activity related to the expenditure at greater levels than would otherwise occur. A tax expenditure reduces economic growth only if it discourages work, saving, or productivity. Therefore, the Reform Panel's proposal to reduce or eliminate many tax expenditures may enhance economic efficiency without having much impact on economic growth.

Conclusion

Changes to the tax system have the potential to affect economic growth in three ways. First, changes in overall revenues that are not offset elsewhere change the budget balance, temporarily affecting aggregate spending in the economy. However, these changes also affect national saving, which in turn raises or lowers interest rates and private investment. Second, changes in the taxation of labor can influence incentives to work. Third, changes in the taxation of capital and saving can influence the saving rate.

The President's Tax Reform Panel has proposed to keep revenues equal to the levels proposed in the President's budget, which includes an extension of the 2001 and 2003 tax cuts and some smaller new provisions. As a share of GDP, this proposal would keep revenue close to its current levels. This implies little change in aggregate spending from current policy, and a similar amount of crowding out of private investment as found under current policy, and more crowding out than a current law baseline under which the tax cuts expire as scheduled. Therefore, fiscal policy would continue to have a negative effect on economic growth because of the crowding out effects of the budget deficit.

¹⁹ For example, insurance markets may increase efficiency but reduce precautionary saving, thereby reducing growth.

²⁰ For more information, see CRS Report RL32162, *The Size and Role of Government: Economic Issues*, by Marc Labonte.

The Panel has proposed to make modest changes in marginal tax rates on labor, with some taxpayers facing lower rates and others facing higher rates. This implies an ambiguous and—given the relatively steady pattern of labor supply over time—probably insignificant effect on labor supply.

The Panel has proposed to make larger reductions in the taxation of capital and saving, through changes to both the corporate and individual tax systems. If saving were sensitive to changes in after-tax rates of return, then saving could rise as a result. But empirical evidence is not clear on how sensitive it is, and the sharp and steady decline in private saving since the 1980s—despite the reduction in the taxation of capital and expansion of tax-preferred saving vehicles over that time—offers prima facie evidence that private saving would be unlikely to rise significantly as a result of tax reform.

The reason that the Panel proposes relatively modest changes in marginal tax rates on labor and capital overall is because of the need for revenue raisers to offset the Panel's proposal to eliminate the alternative minimum tax (AMT). This proposal results in large revenue losses because the number of taxpayers under the AMT is projected to increase rapidly in the next few years. Although many economists have criticized the AMT, it has marginal rates that are similar to the regular income tax for most affected taxpayers, so repealing it does not significantly influence incentives to work or save in most cases.

Over long periods of time, technological change is the major determinant of income growth per capita, and there is no established link between the U.S. tax system and the rate of technological change.

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