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The Economic Freedom Act:
Economic and Fiscal Effects

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THE ECONOMIC FREEDOM ACT: ECONOMIC AND FISCAL EFFECTS

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Abstract: *The Economic Freedom Act, proposed by Representative Jim Jordan, would terminate the ineffective Troubled Assets Relief Program (TARP), and substitute a proven way to stimulate the economy: tax relief—from permanent repeal of the capital gains and death taxes to significant reductions in payroll taxes and the top corporate tax rate. Analysts at The Heritage Foundation's Center for Data Analysis (CDA) conducted static and dynamic analyses of the act (H.R. 5029), finding that over the long term, dynamic economic effects would offset much of the cost of the tax relief. In the short term, the act would increase the deficit if it was not coupled with reductions in spending. This means a specific plan for spending cuts is imperative. The CDA analysts detail the economic and fiscal effects of the Economic Freedom Act's spending and tax cuts.*

The Economic Freedom Act (H.R. 5029), introduced by Representative Jim Jordan (R–OH), would terminate the Troubled Assets Relief Program (TARP) and repeal the remaining stimulus spending, reducing a number of taxes as economic stimulus instead. These tax reductions would include: permanent repeal of the individual and corporate capital gains tax; reduction of payroll taxes for employers and employees by half for 2010; repeal of the estate tax; and a reduction of the top corporate tax rate from 35 percent to 12.5 percent.

A static and dynamic analysis of the Economic Freedom Act performed by analysts in the Heritage Foundation's Center for Data Analysis shows that the relief and stimulus would be significant, and the dynamic economic effects would offset much of the cost of the reduction in tax rates over the longer term. Over the 10-year window (2011–2020), however, the act would increase the deficit because the

act's reduction in spending (such as the repeal of TARP) does not offset the cost of the reduction in tax rates. However, Congressman Jordan also supports the FY 2011 Republican Study Committee (RSC) budget plan, which proposes spending cuts designed to eliminate the deficit in 10 years. Coupled with such a plan, the Economic Freedom Act would be much more affordable.

MICROECONOMIC AND DEMOGRAPHIC EFFECTS

H.R. 5029 would be costly during its first year, tax year 2010. On the personal income tax side, the act would cost the U.S. Treasury about $280 billion, reflecting the cost of the reduction in payroll taxes as well as the cost of the elimination of tax on capital gains.[1] A static simulation of the personal income tax portion thereafter, reflecting only the elimination of the capital gains tax, projects revenue losses

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1. Estimates of the cost of changes to capital gains tax rates necessarily depend on projections of capital gains and losses in the economy. The effect of the 2007–2008 recession on gains and losses reported in the Tax Model is based on Congressional Budget Office revenue projections; however, actual revenue loss will be very sensitive both to changes in stock market valuation and to behavioral effects of relative tax rates.

of about $80 billion per year (starting closer to $75 billion in 2011, and steadily increasing).

These provisions would offer significant tax relief to households at all income levels. In particular, in 2010, the average household would see a tax break of almost $3,000. While tax credits target specific demographic groups, such as those with children, H.R. 5029 would provide relief for all demographics and all income levels. In 2010, seniors, single filers with no dependents, single parents, and joint-filing households with two or more dependents would all see relief, either through the reduction in payroll taxes or through the elimination of capital gains taxes, or both. (See Table 1.)

Those currently receiving more in credits than they have paid out in regular income taxes would still see relief, so long as they work and therefore are subject to payroll taxes. However, those paying net income taxes would see greater relief proportionally to how much they currently owe. This kind of tax relief is superior to tax credits for specific items such as home loans or automobiles, which may inflate or sustain bubbles in a certain economic sector or prop up inefficient businesses.[2] Targeted tax credits have a history of failure, and putting money back into the taxpayers' pockets through broad tax relief such as the reduction of payroll taxes and the elimination of investment taxes is superior.[3]

DYNAMIC RESULTS: POSITIVE AND NEGATIVE

A dynamic analysis of Representative Jordan's proposal for a combination of tax cuts, stimulus repeal, and TARP repeal shows that it would sup-

Economic Freedom Act Would Provide Tax Relief for All Income Groups

	2010 Income Tax Paid, Including FICA Taxes			
	Current Law	Under H.R. 5029	Difference	
0 dependents	$20,356	$18,354	–$2,002	–9.8%
1 dependent	20,490	17,497	–2,993	–14.6%
2 dependents	21,518	18,506	–3,013	–14.0%
3 or more dependents	23,338	20,436	–2,902	–12.4%
Senior	7,991	7,193	–799	–10.0%
Single parent	8,308	5,938	–2,370	–28.5%
Single, no exemptions	8,131	6,478	–1,653	–20.3%
Income less than $25,000	–2,896	–3,318	–422	–14.6%
Income $25,000–$49,999	0	–1,152	–1,152	–
Income $50,000–$74,999	6,567	4,494	–2,074	–31.6%
Income $75,000–$99,999	11,207	8,263	–2,944	–26.3%
Income $100,000–$499,999	33,949	28,847	–5,103	–15.0%
Income $500,000–$999,999	162,471	157,003	–5,468	–3.4%
Income $1 million and more	707,915	701,487	–6,428	–0.9%
Average	**21,564**	**18,574**	**–2,991**	**–13.9%**

Note: Income figures are adusted gross income.

Sources: Heritage Foundation calculations based on the Center for Data Analysis Individual Income Tax Model.

Table 1 • CDA 10-06 ☎ heritage.org

port growth of the U.S. economy both by increasing its potential and reducing deadweight costs of government, which in itself would allow the economy to move closer to its potential. Additional economic growth occurs as currently underused labor and capital resources are hired to produce goods and services.

The analysis shows that the "stimulus" effect of tax cuts, even when combined with potentially contractionary spending cuts, does produce sustainable growth over the longer term. Employment rises immediately by 300,000 and averages 1.2 million jobs per year between 2011 and 2020,

2. Ronald D. Utt, "Rethink the Housing Tax Credit: Stimulus Plans Should Think Past the Needs of Special Interest," Heritage Foundation *WebMemo* No. 2680, November 4, 2009, at *http://www.heritage.org/Research/Reports/2009/11/ Rethink%20the%20Housing%20Tax%20Credit%20Stimulus%20Plans%20Should%20Think%20Past%20the%20Needs%20of%20 Special%20Interest.*

3. See, for example, Karen A. Campbell and Guinevere Nell, "Sustainable Economic Stimulus: Repeal Capital Gains and Dividend Taxes," *WebMemo* No. 2263, February 3, 2009, at *http://www.heritage.org/Research/Reports/2009/02/ Sustainable-Economic-Stimulus-Repeal-Capital-Gains-and-Dividend-Taxes.*

mostly in the private sector.[4] GDP is also higher each year and averages $273 billion more per year (in 2010 dollars).

Under the Jordan proposal, household and business incomes (and likely the number of businesses) are able to increase more than they would have under the baseline, which means that both the corporate and personal tax bases are higher. This growth results in the following revenue effects:

- Although corporate tax collections are lower than the baseline, individual tax collections are above the baseline;

- Over the 10-year window, total federal revenues are below the baseline. But the revenue losses shrink continuously as the tax base remains above the baseline and begins to rise. The federal tax base is 9.8 percent higher by the end of 2020; and

- This will help state tax budgets. State and local personal tax receipts are about 15 percent higher by the end of 2020. If state and local finances are stronger (that is, spending increases by less than the increase in revenues), the states can reduce their supply of municipal bonds and decrease some of the upward pressure placed on interest rates by federal borrowing needs.

However, the analysis also reveals that the spending reductions from repealing stimulus and TARP are not enough to offset lost revenues from decreases in tax rates. The large short-term deficit impacts dig the debt hole deeper such that the positive dynamic effects of higher employment, incomes, savings and investments are unable to overcome the negative impact on the deficit in the 10-year window.

Because debt-to-GDP ratios are already projected to rise to unsustainable levels, the positive growth effects from the proposal may be more dampened than usual by the crowd-out effects of federal debt.

Thus while the tax cuts, particularly the repeal of the estate tax, encourages saving and wealth creation, higher debt levels direct some of that saving to purchasing of government bonds rather than investment in new productive technology.

In particular, the large revenue losses in the initial years, especially from cutting the payroll tax in half before the dynamic benefits of higher investment can grow the tax base, create large deficits that must be financed by increased borrowing. This raises the interest payments the federal government must pay (even without an increase in interest rates). This interest expense further inflates the deficit that must be overcome by future tax increases or reduced spending.[5]

Federal payroll tax revenue losses in 2010 are dynamically less than the static estimate due to positive employment incentives. The positive economic growth feedback (from higher employment and higher incomes) causes payroll tax collections to be higher over the entire remaining 10-year window (2011–2020). However, higher employment and income creates greater Medicare and Social Security benefit liabilities as well, due to the structure of the entitlement programs. Without entitlement reform, the Social Security and Medicare programs will continue to put increasing pressure on deficits and burden the future taxpayers with the rising national debt.

THE DYNAMIC ECONOMY

The temporary decrease in the payroll tax provides a boost to economic activity mostly along the intensive margin. This is the margin along which currently employed individuals will choose to change the number of hours they work.[6] With only a temporary reduction in the tax, current employees and employers will increase work hours in 2010 to take advantage of the lower labor costs. This allows

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4. As described later, initial job gains probably consist of more hours worked in existing jobs rather than new jobs, due to the incentive effects of the temporary payroll tax reduction. Also, due to the deepness of the recession and sluggish recovery, there is much underused capacity. Because the model is starting in a recession trough, policy shocks are currently having dramatic impacts due to the dynamics of the model. There is still much uncertainty regarding the trajectory out of this recession and minimal historical data to gauge the path out of recovery. Therefore, while the qualitative results are correct, the longer term quantitative trajectories and averages are more indicative of policy impact than any immediate one year quantitative impact.

5. Although total tax revenues under the Economic Freedom Act simulation grow each year and begin closing the gap with the baseline, they do not rise above the baseline in the 10-year window. This leads to substantially more debt held by the public at the end of 2020 than would otherwise be the case.

6. This can be done, for example, by working a longer work day, going from part-time to full-time, or taking less unpaid vacation time during the year.

individuals to earn higher disposable incomes both from higher gross wages (more work hours) and lower taxes. Dynamically, this can spur an increase in consumption and saving, which could drive further economic growth. But the temporary nature of the tax reduction is unlikely to create many new jobs because businesses are forward-looking and expect employment costs to return to their higher level. Furthermore, due to the already elevated federal debt levels, a temporary tax cut is more likely to be saved in less-risky (and more liquid) assets in anticipation of future higher taxes.[7]

Capital gains taxes are a tax on new value created in the economy. One of the greatest sources of value creation is the activity of entrepreneurs. A tax on capital gains raises the cost of financing entrepreneurship and therefore poses a disincentive. Removing this disincentive allows more potentially value-creating projects to be undertaken.[8]

It also removes an incentive to invest in loss-creating (or highly risky) investments. Well-diversified investors often offset their capital gains by taking capital losses and investing in riskier projects. For the undiversified individual entrepreneur, this asymmetric treatment taxes success, and due to loss limitations may not allow the unsuccessful entrepreneur to offset all losses, which can discourage entrepreneurial risk-taking.[9] So the capital gains tax both encourages risky secondary investment decisions (of traders on Wall Street, for example) and discourages the small entrepreneur's willingness to undertake personal risk. Without a tax on capital gains, the decision to invest will be made solely on the expected value creation of the project (economic reasons) rather than choosing a different decision purely for tax purposes.

Lowering the corporate income tax allows U.S.-based businesses to compete in the global economy.

A lower corporate rate frees more corporate profits to be reinvested in the company or paid to stockholders to reinvest. A lower corporate tax rate also has indirect effects on capital, by reducing the present value of the depreciation allowance and the value of interest expense deductions.

There are many subtle ways this can affect investment behavior. In particular, it alters the value of the existing capital stock and changes expectations of the value of the future capital stock. While adjustment costs and liquidity (cash flow factors) can complicate the timing and pattern of investment, in general a lower corporate tax rate can spur investment spending since a lower tax rate raises the expected user cost of capital.[10] Further, because a lower tax reduces the value of the interest rate deduction, debt-financing becomes relatively less attractive, while lower taxes on corporate profits and elimination of the capital gains tax makes equity-financing more attractive. A lower supply of corporate bonds puts downward pressure on interest rates and can increase the value of equity. While debt-financing can increase the profits of an organization, it can also magnify losses. To the extent that a lower tax rate allows investors to make the trade-off between risk and return based on fundamental economic conditions rather than for tax purposes, the overall allocation of investment capital will be more efficient and increase real GDP.

A lower corporate tax rate also increases both the corporate tax base and personal tax base. The lower rate attracts more businesses to form in the U.S. and encourages more investment that increases the profits of existing firms and raises the wages of employees, as well as creating new employment opportunities that expand the personal tax base. Some of the lost revenue from the lower rate, is therefore dynamically offset by these expansions in

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7.   Rather than invested in new entrepreneurial ventures that would create jobs. The anticipation of higher future taxes is arguably creating a greater than usual demand for liquidity, especially among high-income earners in anticipation of 2011 tax increases. This increase in demand for liquidity causes what might otherwise seem very loose monetary policy to be tight. If the Fed does not adequately accommodate the greater demand for liquidity, this can slow the recovery as individuals rationally try to get to their desired level of liquidity by getting rid of or not investing in longer-term, risky (but potentially more productive) investments.

8.   See, for example, Christian Keuschnigg and Soren Bo Nielsen. "Start-Ups, Venture Capitalists, and the Capital Gains Tax," *Journal of Public Economics*, Vol. 88, No. 5 (April 2004), pp. 1011–1042.

9.   William M. Gentry, "Capital Gains Taxation and Entrepreneurship," Williams College, Working Paper, January 2010 at *http://www.law.northwestern.edu/colloquium/tax/documents/CapGainsEntre.pdf* (July 27, 2010).

10.   Alan J. Auerbach. "Taxation and Capital Spending," Academic Consultants Meeting of the Board of Governors of the Federal Reserve System, October, 7, 2005.

the tax base. The corporate tax code, however, has many complicating deductions and credits such that the effective rate that corporations pay is typically lower than the statutory corporate tax rate. Congressman Jordan's tax proposal does not call for any changes to these corporate tax offsets and therefore the amount of revenue received from a 12.5 percent statutory rate is less than might be expected and not fully dynamically offset in the 10-year window (although the trajectory points to positive revenues past the 10-year window).

Finally, permanently repealing the estate tax removes an inefficient way of creating a progressive tax structure. It is a tax on the wealth that has been generated throughout a person's lifetime. While estate taxes can encourage more charitable giving, the American culture (individual preferences and values) already provides a strong incentive. Whereas other economies may have a situation where wealth is "old money" that creates class systems that are a hindrance to economic mobility, in the U.S. economy the prospect and ability of building wealth can drive economic mobility. Repealing the estate tax removes a disincentive to create wealth and redirects many resources, currently used to avoid the tax, to productive, value-creating investments. In a capitalist system, this new value created not only is distributed to investors but spills over to workers, shareholders and government institutions.

CONCLUSION

A static analysis of the Economic Freedom Act shows that the relief and stimulus would be significant for individual tax filers. Dynamic analysis shows that the economic effects of the bill would stimulate investment and lead to higher incomes over the medium and long term. Although these dynamic effects would offset much of the cost over the long term, over the short term the reduction in spending in the act does not offset the cost of the reduction in tax rates. Without further spending cuts, such as those in the FY 2011 RSC budget plan, the increase in the federal debt would somewhat dampen the positive economic growth effects of the bill.

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APPENDIX 1:
MICROECONOMIC METHODOLOGY

The portions of H.R. 5029 that affect the individual income tax code were simulated using the Center for Data Analysis (CDA) Individual Income Tax Model in order to estimate the effect of the bill on tax revenue and the distribution of the resulting tax burden and to compare these effects to current-law estimates.

The CDA tax model simulates the effect of tax-law changes on a representative sample of taxpayers, based on IRS Statistics of Income (SOI) taxpayer microdata. Data for these taxpayers are extrapolated or "aged" to reflect detailed taxpayer characteristics through 2016. The data are aged for consistency with the Congressional Budget Office (CBO) baseline forecast in order to produce effective and marginal tax-rate estimates with which to forecast dynamic effects of the changes in tax burden.

The personal income tax provisions of H.R. 5029 that were simulated were the reduction of payroll taxes in 2010 and the elimination of the capital gains tax. Immediate expensing for small businesses through Schedule C was not modeled. These policy changes were run together as a single simulation to allow interactions between them. This simulation was then compared with a simulation of current law. Both simulations included recent tax changes such as:

- The new Making Work Pay credit;
- Scheduled "patches" and changes in the alternative minimum tax (AMT) and education credits (the Hope, Lifetime Learning, and American Opportunity tax credits); and
- Tax increases that accompany the recently passed health care bill. The Medicare Hospital Insurance tax is increased by 0.9 percentage point and applied to capital gains income for those with incomes $250,000 and above (joint filers) or $200,000 and above (all others), and itemized deductions for out-of-pocket medical expenses are limited to expenses above 10 percent of adjusted gross income (AGI); the current threshold is 7.5 percent.

For each simulation, average effective tax rates including FICA income and revenue were calculated for use in the macroeconomic model. Tax burdens for various demographic groups were also determined.

Economic Freedom Act: Key Economic Indicators

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Average 2011–2020
Gross Domestic Product											
Forecast	14,093.1	14,389.5	14,795.8	15,235.7	15,690.0	16,158.0	16,571.2	16,997.1	17,443.1	17,893.8	15,926.7
Baseline	13,809.1	14,230.2	14,626.8	15,041.3	15,462.8	15,898.6	16,309.1	16,717.5	17,147.5	17,583.3	15,682.6
Difference	284.0	159.3	169.0	194.3	227.3	259.3	262.1	279.6	295.6	310.5	244.1
Real GDP Growth Rate											
Forecast	4.1	2.1	2.8	3.0	3.0	3.0	2.6	2.6	2.6	2.6	2.8
Baseline	2.8	3.0	2.8	2.8	2.8	2.8	2.6	2.5	2.6	2.5	2.7
Difference	1.3	–0.9	0.0	0.1	0.2	0.2	0.0	0.1	0.1	0.0	0.1
Total Employment											
Forecast	134,817.3	137,988.3	140,540.8	142,505.8	144,192.8	145,788.8	147,030.5	148,029.8	149,001.0	150,027.0	143,992.2
Baseline	132,941.7	136,340.3	139,269.0	141,355.0	143,045.5	144,601.6	145,968.0	147,103.0	148,173.9	149,284.4	142,808.2
Difference	1,875.6	1,648.0	1,271.8	1,150.8	1,147.3	1,187.2	1,062.6	926.8	827.1	742.6	1,184.0
Private Employment											
Forecast	112,519.6	115,396.6	117,729.5	119,451.0	120,904.4	122,325.0	123,387.8	124,267.9	125,116.6	125,857.4	120,695.6
Baseline	110,758.8	114,035.5	116,695.6	118,502.0	119,922.6	121,284.8	122,450.6	123,420.6	124,342.1	125,162.6	119,657.5
Difference	1,760.8	1,361.1	1,033.9	949.1	981.8	1,040.3	937.1	847.3	774.5	694.8	1,038.1
Unemployment Rate											
Forecast	8.2	7.8	7.3	6.9	6.5	6.0	5.7	5.5	5.2	4.9	6.4
Baseline	9.2	8.4	7.7	7.3	6.8	6.4	6.0	5.7	5.4	5.1	6.8
Difference	–0.9	–0.6	–0.4	–0.4	–0.4	–0.4	–0.3	–0.3	–0.2	–0.2	–0.4
Disposable Personal Income											
Forecast	10,639.2	10,749.1	10,911.5	11,373.5	11,835.4	12,261.8	12,596.2	12,928.0	13,282.1	13,665.7	12,024.3
Baseline	10,395.8	10,587.6	10,738.5	11,166.3	11,559.3	11,956.7	12,296.4	12,615.9	12,968.5	13,348.6	11,763.3
Difference	243.4	161.5	173.1	207.3	276.1	305.1	299.8	312.1	313.6	317.1	260.9
Disposable Income per Capita											
Forecast	33,897.3	33,919.1	34,101.7	35,204.9	36,284.3	37,233.0	37,885.1	38,515.3	39,198.3	39,953.3	36,619.2
Baseline	33,121.8	33,409.5	33,560.8	34,563.3	35,437.9	36,306.5	36,983.4	37,585.5	38,272.8	39,026.2	35,826.8
Difference per Person	775.4	509.6	540.9	641.6	846.5	926.5	901.7	929.8	925.5	927.1	792.5
Difference for Family of Four	3,101.8	2,038.4	2,163.6	2,566.4	3,385.9	3,706.1	3,606.8	3,719.2	3,701.9	3,708.4	3,177.4
Personal Consumption Expenditures											
Forecast	10,062.7	10,183.5	10,311.8	10,557.2	10,868.9	11,174.9	11,414.9	11,656.4	11,916.0	12,201.3	11,034.8
Baseline	9,764.2	10,000.9	10,156.3	10,390.0	10,678.9	10,963.1	11,210.5	11,451.0	11,711.9	11,999.2	10,832.6
Difference	298.5	182.7	155.5	167.2	190.0	211.8	204.4	205.4	204.1	202.0	202.2
Personal Savings											
Forecast	232.7	215.3	233.4	428.4	554.3	653.7	735.9	817.2	902.0	989.9	576.3
Baseline	303.1	245.6	219.9	390.7	469.6	560.8	638.2	706.1	786.1	866.3	518.6
Difference	–70.4	–30.3	13.5	37.7	84.6	92.9	97.7	111.1	115.9	123.5	57.6
Personal Savings Rate											
Forecast	2.2	2.0	2.1	3.8	4.7	5.3	5.8	6.3	6.7	7.2	4.6
Baseline	2.9	2.3	2.0	3.5	4.0	4.7	5.2	5.6	6.0	6.4	4.3
Difference	–0.7	–0.3	0.1	0.3	0.6	0.6	0.6	0.7	0.7	0.7	0.3
Gross Private Domestic Investment											
Forecast	2,078.1	2,229.1	2,461.7	2,594.6	2,697.5	2,815.8	2,888.6	2,976.6	3,076.3	3,172.3	2,699.1
Baseline	1,947.8	2,187.6	2,383.2	2,487.8	2,568.2	2,667.6	2,739.7	2,817.0	2,905.1	2,991.1	2,569.5
Difference	130.3	41.5	78.5	106.8	129.3	148.2	148.9	159.6	171.2	181.2	129.5

(continued on next page)

Economic Freedom Act: Key Economic Indicators (continued)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Average 2011–2020
Non-Residential Fixed Investment											
Forecast	1,516.6	1,647.8	1,805.5	1,931.7	2,024.1	2,106.6	2,186.1	2,270.3	2,366.3	2,461.4	2,031.6
Baseline	1,436.1	1,580.4	1,734.1	1,837.6	1,907.8	1,973.5	2,046.3	2,121.9	2,205.2	2,288.6	1,913.1
Difference	80.5	67.3	71.3	94.0	116.3	133.1	139.8	148.4	161.1	172.8	118.5
Residential Fixed Investment											
Forecast	470.7	570.7	613.0	624.8	637.6	657.7	663.8	667.8	673.0	678.3	625.7
Baseline	455.3	563.4	606.2	617.5	627.5	645.5	652.0	656.7	663.1	669.1	615.6
Difference	15.4	7.3	6.8	7.3	10.1	12.2	11.8	11.1	9.9	9.2	10.1
Change in the Stock of Business Inventories											
Forecast	93.6	20.2	51.8	48.3	47.0	62.8	51.8	53.5	54.4	52.8	53.6
Baseline	61.0	50.8	50.9	42.3	43.2	58.9	53.1	51.9	52.2	51.2	51.5
Difference	32.6	−30.6	0.9	6.0	3.8	4.0	−1.2	1.6	2.1	1.5	2.1
Full-Employment Capital Stock											
Forecast	14,929.2	15,370.7	15,899.5	16,493.4	17,090.7	17,672.0	18,257.2	18,847.9	19,458.3	20,089.4	17,410.8
Baseline	14,821.4	15,153.2	15,605.6	16,111.7	16,616.9	17,106.0	17,607.5	18,125.2	18,662.9	19,219.6	16,903.0
Difference	107.8	217.5	293.9	381.7	473.8	566.0	649.7	722.7	795.4	869.8	507.8
Consumer Price Index											
Forecast	1.8	2.8	2.5	2.6	2.7	2.7	2.6	2.7	2.7	2.6	2.6
Baseline	1.6	2.1	2.2	2.2	2.1	2.1	2.1	2.1	2.0	1.9	2.0
Difference	0.2	0.7	0.3	0.4	0.5	0.6	0.6	0.6	0.7	0.7	0.5
Treasury Bill, 3-Month											
Forecast	1.3	3.1	3.6	4.6	4.7	4.7	4.7	4.7	4.7	4.7	4.1
Baseline	1.3	3.1	3.6	4.6	4.6	4.6	4.6	4.6	4.6	4.6	4.0
Difference	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.0
Treasury Bond, 10-Year											
Forecast	3.7	4.5	4.8	5.6	5.7	5.7	5.7	5.7	5.7	5.7	5.3
Baseline	3.7	4.5	4.8	5.6	5.7	5.7	5.7	5.7	5.7	5.7	5.3
Difference	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Unified Federal Tax Revenue											Total
Forecast	2,226.0	2,458.4	2,776.0	2,926.6	3,093.3	3,291.0	3,533.4	3,785.0	4,067.1	4,401.8	32,558.7
Baseline	2,510.1	2,704.1	3,042.5	3,188.9	3,384.6	3,565.1	3,766.6	4,005.3	4,249.9	4,538.4	34,955.5
Difference	−284.0	−245.6	−266.4	−262.3	−291.3	−274.1	−233.3	−220.3	−182.7	−136.6	−2,396.8
Unified Federal Spending											
Forecast	3,485.5	3,540.9	3,714.9	4,004.5	4,308.1	4,620.3	4,912.2	5,261.9	5,652.9	6,098.8	45,599.9
Baseline	3,549.8	3,556.2	3,691.5	3,944.2	4,203.1	4,465.7	4,709.0	5,003.3	5,330.0	5,698.4	44,151.1
Difference	−64.3	−15.3	23.4	60.4	105.0	154.6	203.3	258.6	322.9	400.3	1,448.9
Unified Federal Surplus/Deficit											
Forecast	−1,259.5	−1,082.5	−938.9	−1,077.9	−1,214.8	−1,329.3	−1,378.9	−1,476.8	−1,585.7	−1,696.9	−13,041.2
Baseline	−1,039.8	−852.2	−649.0	−755.2	−818.4	−900.6	−942.3	−998.0	−1,080.1	−1,160.0	−9,195.6
Difference	−219.7	−230.3	−289.8	−322.7	−396.4	−428.7	−436.5	−478.9	−505.6	−537.0	−3,845.6
Federal On-Budget Surplus/Deficit											
Forecast	−1,010.2	−865.4	−716.6	−828.1	−952.6	−1,018.2	−1,011.7	−1,045.8	−1,081.8	−1,132.0	−9,662.3
Baseline	−853.5	−707.9	−511.0	−589.4	−641.9	−680.3	−669.1	−664.8	−678.5	−703.0	−6,699.5
Difference	−156.7	−157.5	−205.5	−238.7	−310.6	−337.8	−342.6	−381.0	−403.3	−429.0	−2,962.8
Difference	2.7	4.1	5.1	6.1	7.1	8.2	9.2	10.2	11.0	11.8	7.5

(continued on next page)

Economic Freedom Act: Key Economic Indicators (continued)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Average 2011–2020
Privately Held Federal Debt											
Forecast	10,558.0	11,671.1	12,653.6	13,650.1	14,805.2	16,086.5	17,435.0	18,866.9	20,402.7	22,059.2	15,818.8
Baseline	9,983.0	10,870.8	11,586.1	12,273.2	13,063.0	13,920.3	14,839.2	15,807.2	16,845.9	17,976.4	13,716.5
Difference	575.0	800.3	1,067.4	1,376.9	1,742.2	2,166.2	2,595.8	3,059.7	3,556.8	4,082.8	2,102.3
Privately Held Federal Debt Share											
Forecast	67.0	70.9	73.1	74.8	76.8	79.1	81.6	83.9	86.2	88.6	78.2
Baseline	64.3	66.8	68.0	68.7	69.7	70.9	72.3	73.7	75.2	76.8	70.6
Difference	2.7	4.1	5.1	6.1	7.1	8.2	9.2	10.2	11.0	11.8	7.5
Federal Net Interest Payments											Total
Forecast	299.0	378.2	461.0	542.2	617.8	665.5	714.3	805.5	921.0	1,060.5	6,465.1
Baseline	282.7	353.7	425.3	491.2	548.5	576.5	607.1	679.1	771.4	879.2	5,614.7
Difference	16.3	24.5	35.7	51.0	69.3	89.0	107.2	126.4	149.6	181.3	850.4
Federal Corporate Tax Base											
Forecast	1,515.6	1,468.5	1,532.6	1,558.1	1,552.3	1,573.6	1,570.1	1,634.5	1,755.4	1,877.1	16,037.9
Baseline	1,455.4	1,468.1	1,507.3	1,516.5	1,506.8	1,512.7	1,515.5	1,560.2	1,656.4	1,747.1	15,446.1
Difference	60.2	0.4	25.3	41.7	45.5	60.9	54.6	74.3	99.0	129.9	591.8
Federal Corporate Tax Collections											
Forecast	115.1	78.6	90.8	87.3	98.1	102.1	108.0	113.2	123.9	133.5	1,050.6
Baseline	424.6	395.2	412.4	410.7	417.6	422.7	428.9	446.3	476.3	503.6	4,338.3
Difference	−309.5	−316.6	−321.6	−323.4	−319.5	−320.6	−321.0	−333.1	−352.4	−370.0	−3,287.7
Federal Personal Tax Base											
Forecast	6,707.5	7,171.1	7,750.4	8,040.5	8,154.7	8,508.6	8,958.2	9,372.2	9,908.9	10,485.9	85,058.1
Baseline	6,180.6	6,568.6	7,177.1	7,424.0	7,684.7	8,001.7	8,353.3	8,725.6	9,126.4	9,553.2	78,795.3
Difference	526.9	602.5	573.2	616.5	470.0	506.9	604.9	646.5	782.5	932.7	6,262.8 7.9
Federal Personal Tax Collections											
Forecast	1,095.6	1,318.1	1,523.6	1,596.4	1,640.8	1,753.9	1,899.9	2,041.6	2,221.1	2,418.0	17,509.0
Baseline	982.4	1,155.2	1,378.9	1,456.3	1,546.9	1,654.8	1,773.8	1,906.3	2,047.5	2,200.9	16,103.1
Difference	113.2	162.9	144.6	140.1	93.9	99.1	126.1	135.2	173.6	217.0	1,405.9
Federal Payroll Tax Receipts											
Forecast	1,050.6	1,117.0	1,210.1	1,266.0	1,364.3	1,440.6	1,526.1	1,611.0	1,699.5	1,792.6	14,077.7
Baseline	1,027.6	1,093.5	1,182.9	1,231.2	1,316.4	1,379.6	1,452.3	1,523.0	1,595.1	1,670.2	13,471.7
Difference	23.0	23.6	27.1	34.7	47.9	61.0	73.7	88.0	104.4	122.5	606.0
Federal Social Security and Medicare Payments											
Forecast	1,253.6	1,331.5	1,431.4	1,533.7	1,648.6	1,775.0	1,911.0	2,058.3	2,217.3	2,387.5	17,547.9
Baseline	1,259.9	1,336.5	1,428.3	1,525.3	1,631.7	1,745.3	1,866.4	1,996.6	2,135.5	2,282.2	17,207.6
Difference	−6.3	−5.0	3.2	8.5	16.9	29.7	44.5	61.7	81.8	105.3	340.3

Appendix Table 1 • CDA 10-06 ☎ heritage.org

APPENDIX 2:
MACROECONOMIC METHODOLOGY

CDA analysts used the IHS Global Insight June 2010 short-term model of the U.S. economy to estimate the overall net economic effects of H.R. 5029, a tax reform proposal from Representative Jim Jordan.[11] The baseline represents the most likely path of the U.S. economy over the next 10 years. The relationships in the model are calibrated by historical U.S. data and mainstream economic theory. The model is a tool that provides insight into likely magnitudes and the direction of economic variables due to policy changes. A dynamic analysis is important because in an ever-changing and market-based economy, the indirect and feedback effects need to be taken into account to get a true estimate of the likely overall economic impact.

Direct effects happen, for example, when many individuals make small changes in their labor and leisure trade-off decisions. These changes, in turn, change capital-labor trade-offs made by businesses. The macroeconomic model estimates these changes in relative prices dynamically such that these changes affect investment and output levels. Tax-rate changes also affect disposable income and demand variables. These have further feedback effects with supply variables as well as interaction with the fiscal revenues and spending variables. The feedback effects further increase or decrease the longer-term impact of the policy, providing a quantitative picture of whether the economy would tend to be stronger or weaker if the proposal were implemented versus the baseline.

The simulation made changes to the variables that would be directly affected by the proposal. Each part of the proposal was solved separately first so that the indirect effects from that policy could be isolated and compared with empirical research to be sure that the model was correctly estimating the policy effect.

Then the entire simulation was run such that the different policies could interact with one another in order to estimate the overall net effect of the policy. For example, repealing the death tax puts downward pressure on interest rates and increases the value of assets. The elimination of capital gains taxes increases the incentive to invest and also increases asset values, but tax revenue losses can increase the deficit and crowd out private-sector investment.

The changes for each piece of the simulation were as follows:

Repeal of the Death Tax. This tax is part of the unified budget revenues but is not counted in the National Income and Product Account (NIPA) for government receipts. Therefore, an adjustment variable in the model reconciles the two government revenue variables. The amount added to the NIPA accounts for estate tax revenue in the baseline was obtained from IHS Global Insight ($32–33 billion per year). This amount was then subtracted from the adjustment variable.

The model does not "know" that this revenue reduction is due to elimination of the death tax. In order to have the model estimate the indirect effects correctly, the direct effect on corporate interest rates was also changed for the simulation. MIT economist James M. Poterba estimated in a 2000 study that eliminating wealth-transfer taxes would reduce the required yield on investment by at least 1.3 percent.[12]

Elimination of the Capital Gains Tax. The capital gains tax-rate variable was set to zero for each quarter of the simulation. This variable affects the value of equity and hence the cost of equity and the capital financed by it.[13]

This variable only indirectly affects government tax receipts; therefore another adjustment needs to be made in order to correctly estimate the revenue effects. This is done using the static lost-revenue estimates. Since the proposal calls for a complete elimination of the tax, dynamic revenue from capi-

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11. The IHS Global Insight model is used by private-sector and government economists to estimate how changes in the economy and public policy are likely to affect major economic indicators. The methodologies, assumptions, conclusions, and opinions presented here are entirely the work of analysts at The Heritage Foundation's Center for Data Analysis. They have not been endorsed by and do not necessarily reflect the views of the owners of the IHS Global Insight model. See "Description of the Global Insight Short-Term U.S. Macroeconomic Model," at *http://www.heritage.org/About/Staff/Departments/Center-for-Data-Analysis/~/media/CDA/CDA_models_data/globalinsightmodel.ashx*.

12. James M. Poterba, "Estate Tax and After-Tax Investment Returns," in Joel M. Slemrod, ed., *Does Atlas Shrug?* (Cambridge, Mass.: Harvard University Press, 2000).

tal gains would not affect government receipts from capital gains.[14] (To the extent that capital gains represent increased productivity and growth, government revenue will be indirectly positively affected.)

After the capital gains and payroll tax changes were made, the static microsimulation estimate of the amount of lost revenue (that is, with no changes in income or individual behavior; e.g., no changes in labor supply decisions) was compared to the dynamic macro-simulation of the federal government revenue estimate. Because of the temporary nature of the payroll tax policy, one would expect to see an immediate dynamic effect in terms of a higher level of average hours worked per week and overall hours worked; therefore dynamic revenue losses would not be as great even in the short term. However, because it takes time for individuals to make full behavior changes, the first year estimates of static and dynamic revenue losses should be fairly close. The static model estimated an initial revenue loss of about 15 percent, while the dynamic model estimated an initial revenue loss of about 11 percent.[15]

Temporary Reduction of the Payroll Tax. The federal payroll tax-rate variable's value was reduced by half for each of the remaining quarters (Q2–Q4) of 2010.

Reduction in the Corporate Tax Rate. The statutory corporate income tax-rate variable's value was changed from 35 percent to 12.5 percent for each of the quarters in the simulation.

Repeal of the Remaining Stimulus Spending. The amounts of stimulus spending (other than from tax cuts or unemployment insurance benefits) added to variables in the baseline forecast were obtained from IHS Global Insight. This amount was then subtracted from those variables to simulate the repeal.

Repeal of TARP. The CBO estimates the present value of the long-term cost of the TARP program to be $109 billion.[16] The budgeting rules require the present value of the expected cost to affect the deficit in the year enacted with subsequent debits or credits to the outlay projection for any changes in projected costs. Since this amount would be an expenditure of the unified budget, but not accounted for in the NIPA accounts, the reconciliation between the NIPA expenditures and budget expenditures variable was decreased by this amount. Repealing TARP eliminated the present-value overall cost of the program, thereby reducing the projected deficit in year 2010.

13. There is some debate about whether capital gains taxes affect share prices. Empirical evidence seems to indicate that equity prices do capitalize the capital gains tax. Thus, dividend yields and stock market valuations move in opposite directions. A reduction in capital gains taxes increases the market value of assets. Mark H. Lang and Douglas A. Shackelford, "Capitalization of Capital Gains Taxes: Evidence from Stock Price Reactions to the 1997 Rate Reduction," *Journal of Public Economics*, Vol. 76, No. 1 (April 2000), pp. 69–85. The IHS Global insight model reflects this view.

14. Since the tax is completely eliminated, the static revenue losses represent the opportunity cost to the government under current law. There would be a dynamic increase in capital gains from the proposal, but since these gains would not be realized under current law, they are not in the current baseline and therefore do not create a greater budget loss than the static expected losses. (If the tax were reduced but not eliminated then another adjustment would need to be made to account for the dynamic increase in the capital gains tax base.)

15. Because the forecast horizon in the dynamic model begins in the second quarter of 2010, a full year's impact for 2010 could not be estimated and therefore some of the 2010 effect is pushed into 2011. The average of the 2010 and 2011 effect produced the reported estimate that is in line with the static estimate.

16. Congressional Budget Office, "An Analysis of the President's Budgetary Proposals for Fiscal Year 2011," March 2010, at *http://www.cbo.gov/ftpdocs/112xx/doc11280/03-24-APB.pdf* (July 27, 2010).

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This *Report* of the Center for Data Analysis began as a requested analysis from Congressman Jim Jordan (OH-4). Congressman Jordon asked for this study of H.R. 5029 on April 23, 2010. A copy of his request is available and can be obtained by writing the Director of the Center for Data Analysis at The Heritage Foundation.