

# ISSUE BRIEF

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## Chairman Camp's Tax Reform Plan a Milestone for Dynamic Analysis

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House Ways and Means Committee chairman Dave Camp (R-MI) released a plan for comprehensive tax reform. Setting aside its merits, Camp's proposal is noteworthy on two accounts: (1) It presents the most comprehensive tax reform proposal in decades, and (2) it includes a dynamic estimate from the Joint Committee on Taxation (JCT).

The latter is a long overdue and welcome change to how tax policy is discussed at the federal level. The Camp bill will remain a hallmark piece of legislation and fundamentally change how tax legislation is evaluated by JCT in the future.

**Static vs. Dynamic Scoring.** Despite universal agreement among economists that taxes influence behavior and therefore affect economic growth, conventional government scores of tax policy have historically excluded the effects of behavioral changes on macroeconomic growth. This is known as "static scoring."

For instance, when JCT scores how much revenue would be raised by eliminating the tax deduction for 401(k) contributions, it acknowledges that individuals will contribute less to 401(k)s, but fails to account for the macroeconomic effects of lower contributions through reduced national savings and investment.

In "dynamic scoring," however, individual responses do not occur in a vacuum, nor are they equally offset by other responses. Rather, the changes that individuals and businesses make in response to tax policy can have a very significant impact on economic growth.

**Benefits of Dynamic Scoring.** Particularly as it relates to comprehensive tax reform, dynamic scoring is paramount to developing and implementing a more pro-growth tax code that will ultimately generate higher incomes for all individuals and businesses. Without dynamic scoring, it is easy for policymakers to implement economically damaging tax policy.

For example, virtually all economists agree that gasoline taxes are less harmful to economic growth than capital gains taxes. Yet static scoring would show that raising either of those taxes by equal amounts would have equally nonexistent impacts on the economy, and because gasoline taxes tend to fall more heavily on low- and middle-income taxpayers than capital gains taxes, policymakers may be more easily persuaded toward bad tax policy such as increasing capital gains taxes.

Nonpartisan tax experts have applauded dynamic scoring. Tax analyst Martin Sullivan has argued:

Gradually, lawmakers, the press and the public would be far better acquainted with the following important and powerful economic ideas... Marginal rate reductions are more economically beneficial than infra-marginal tax giveaways. Inefficient taxation of residential investment reduces economic growth. Overtaxation of corporate capital hinders economic growth.<sup>1</sup>

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The use of dynamic scoring appropriately places the emphasis of tax policy on efficiency, leaving other aspects (such as fairness) to be addressed outside the tax code where they more appropriately belong.

Outside the federal government, dynamic scoring is already in play. Ten state governments—including Texas, California, and New York—use some form of dynamic scoring in their budget forecasts. Similarly, in the private sector, many businesses have incorporated dynamic forecasts into their strategic planning.

**A Huge Step Forward.** The inclusion of a dynamic estimate, although still not the official score, is a huge step forward toward fundamental tax reform. The discussion of JCT using dynamic scoring has been an ongoing debate for decades. Previous chairs of the Ways and Means Committee, such as Bill Thomas (R-CA) and Bill Archer (R-TX), were instrumental in pushing the JCT to include dynamic analysis.

Since 1995, JCT has begun to address the shortcomings of its tax analysis. This has included convening panels of experts to discuss dynamic scoring and working on models that can provide quantitative dynamic estimates. The director of the JCT argued in 1995 against using dynamic scoring. In 2003, the House of Representatives required JCT to provide macroeconomic analysis of revisions to the tax code. Now JCT is on record with a dynamic economic estimate of a fundamental tax reform bill.

The significance of JCT's economic estimate cannot be underestimated, and Camp is to be commended for this accomplishment. The daily tax publication *Tax Notes* quotes a source saying, "Once we start down this road, it is going to be very hard to go back to a world where we only look at estimates where [gross domestic product] is fixed."<sup>2</sup>

**The Camp Proposal.** In its analysis of Camp's tax proposal, JCT provided both its conventional score and two versions of dynamic estimates. Camp's proposal is revenue/deficit neutral under JCT's conventional score but results in increased economic growth and additional tax revenues under both dynamic models.

As requested by Camp, JCT applied the additional tax revenues projected by the dynamic models

to further reduce the corporate tax rate. Depending on the model and assumptions (such as Federal Reserve policy and labor supply elasticity), JCT estimated that the positive growth effects of the proposal would allow the corporate tax rate to decline to between 18.9 percent and 24.2 percent. This is between 3 percent and 24 percent lower than the static score as a result of the positive feedback effects on economic growth.

**Making Assumptions.** The assumptions used in dynamic models are fundamental to the models' results. As such, the use of assumptions is also a main criticism against dynamic scoring because the creator or user of the model has a high degree of control over the model's projected outcome. However, economic literature provides ranges of appropriate modeling assumptions, and providing full disclosure of model assumptions would help eliminate unconventional or erroneous assumptions.

Further, static revenue estimates are subject to the same criticism on the use of assumptions. The difference between dynamic and static assumptions, however, is primarily that static revenue estimates rely on a single, universally rejected assumption that taxes have no effect on individuals' and businesses' behaviors. While dynamic scoring involves significantly more assumptions, it at least attempts to predict a more accurate outcome.

Relying upon static scoring is a bit like forgoing an annual physical exam under the assumption that, despite having gained 30 pounds since last year, one's overall health has not changed. Ignorance may be bliss, but it is not reality.

**Incomplete Without It.** JCT's dynamic models, like any models, may be subject to criticism for their assumptions and methodology. However, it is better to be approximately correct than precisely wrong. As the use of dynamic analysis becomes more common, JCT will hopefully refine and strengthen its models to more accurately predict the actual path of the economy in response to tax changes. As this modeling effort improves, the dynamic analysis that includes revenue feedback from economic growth or decline should become as important as the traditional static revenue score.

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1. Martin A. Sullivan, "Practical Aspects of Dynamic Revenue Estimation," in Dan R. Mastromarco, David R. Burton, and William W. Beach, *The Secret Chamber or the Public Square* (Washington, DC: The Heritage Foundation, 2005).

2. Luca Gattoni-Celli, "Pivotal Macroeconomic Analysis of Camp's Reform Tests JCT," *Tax Notes*, February 26, 2014.

Camp's comprehensive tax reform proposal and JCT's inclusion of dynamic scoring have opened the doors for fundamental, pro-growth tax reform that will be critical to confronting and overcoming the nation's unsustainable fiscal and economic outlook. Camp's legacy as a champion of tax reform is cemented with the JCT's dynamic estimate. Future JCT analysis of tax reform plans will be incomplete without it.

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