

Cost Benefit Analysis of Tax Regulations

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Cost benefit analysis of tax regulations

- The traditional A-4 framework does not provide useful guidance in the evaluation of tax regulations
- A new framework for tax regulations would unavoidably implicate deeply political questions
- Transparency is achievable, but a definitive, apolitical answer as to whether a proposed regulation passes a cost benefit test likely is not
- Focus of quantitative analysis should be revenues, avoidance and evasion behavior, compliance costs, and distributive impacts

CBA is a decision-making aid

- EO 12291: “Regulatory action shall not be undertaken unless the potential benefits to society for the regulation outweigh the potential costs to society;”
- EO 12866: “Each agency shall...propose or adopt a regulation only upon a reasoned determination that the benefits of the intended regulation justify its costs.”
- EO 13563: “...each agency must...propose or adopt a regulation only upon a reasoned determination that its benefits justify its costs.”
- EO 12866: “...in choosing among alternative regulatory approaches, agencies should select those approaches that maximize net benefits...”

A-4 does not provide useful guidance for tax regs

- “...the revenue collected through a...tax is a transfer payment.”
- “You should not include transfers in the estimates of the benefits and costs of a regulation. Instead, address them in a separate discussion of the regulation’s distributional effects.”
- In the tax policy context, a key question is whether a potential regulation achieves compliance and other goals at reasonable cost
- A major economic benefit of compliance is revenues, but A-4 instructs agencies to ignore revenues in computing benefits

A-4 ignores the government budget constraint

- Typical use of A-4 assumes that revenues change independent of tax and spending policies. True in the short run; false in the long run.
- If true in the long run, there would be no reason to have income taxes, payroll taxes, or excise taxes – only corrective taxes could be justified
- EO 12866 instructs agencies to select the regulatory approach that maximizes net benefits (unless a statute requires another approach), but under A-4 definitions that means repealing all non-corrective taxes
- Treasury/IRS lack the authority to repeal taxes, but the implicit objective reflects the problem that A-4 (as written) does not provide useful guidance in evaluating tax regulations

The root of the problem

- Analysis of regulations that affect deficits is fundamentally incomplete
 - Most formal economic modeling assumes that the government budget constraint holds with equality
 - Any change in revenues/deficits resulting from a change in tax policy must be offset with corresponding changes in spending and taxes
- Ignoring transfers between the public and the government in CBA amounts to an assumption that the government budget balances via lump-sum taxes/transfers
- For non-tax regulations, this can often be a reasonable approach, but for tax regulations it undermines the exercise

A further problem

- A primary goal of tax regulation is ensuring that the rules of the tax system are coherent and clearly stated so that the tax system treats all taxpayers equitably
- Inherently distributive question
- Quantification requires estimates of inconsistencies in treatment (hard, requires knowledge of the distribution of entity-specific compliance choices) and a normative view on the harms of dispersion across people
- Key to understanding the merits of regulating in general, though may provides less guidance on which regulatory alternative to adopt

A partial framework for tax regulations (I)

- A partial framework for quantifying the impact of tax regulations immediately raises political questions
- Net benefits of a “marginal” “increase” in regulation (Keen and Slemrod 2017 with some liberties in interpretation)

$$\lambda \times \left[\left(\begin{array}{c} \text{revenue} \\ \text{gain from} \\ \text{regulation} \end{array} \right) - \left(\begin{array}{c} \text{administrative} \\ \text{costs of} \\ \text{regulation} \end{array} \right) \right] - \left(\begin{array}{c} \text{compliance} \\ \text{costs of} \\ \text{regulation} \end{array} \right)$$

- Fails to capture benefits of ensuring that the rules of the tax system are coherent or that it treats taxpayers equitably when those benefits do not directly impact revenues or administrative/compliance costs
- Excludes distributive impacts

A partial framework for tax regulations (II)

$$\lambda \times \left[\left(\begin{array}{c} \text{revenue} \\ \text{gain from} \\ \text{regulation} \end{array} \right) - \left(\begin{array}{c} \text{administrative} \\ \text{costs of} \\ \text{regulation} \end{array} \right) \right] - \left(\begin{array}{c} \text{compliance} \\ \text{costs of} \\ \text{regulation} \end{array} \right)$$

- What is lambda?
 - Spending approach: the marginal social benefits of increased spending
 - Motivating question: does the social value of the marginal public spending financed by an increase in regulation exceed the compliance costs?
 - Requires an assumption about what the marginal public spending is, as well as an estimate of its social value
 - Tax approach: the marginal cost of public funds
 - Motivating question: does the social value of the marginal reduction in taxes financed by an increase in regulation exceed the compliance costs?
 - Requires an assumption about which taxes are cut, as well as an estimate of the tax cuts' social value
 - Selecting $\lambda = 1$ yields A-4-like results, but with a different interpretation
 - Selecting $\lambda \leq 1$ generates a strong presumption against enforcement

A framework for evaluating tax regulations (III)

- The specification of the hypothetical use of funds is inherently controversial – yet it determines the answer to whether a potential regulation has net benefits
 - “Conservative” perspective: λ is low under the spending approach and high under the tax approach
 - “Liberal” perspective: λ is high under the spending approach and low under the tax approach
- Justifications for ignoring distribution in CBA often lean on the assumption of a redistributive tax system in the background; logically can't lean on the same assumption when evaluating tax regulations
 - Further issues in interpreting the resulting estimate

A framework for evaluating tax regulations (IV)

- Adopting either approach implies an objective for Treasury/IRS that calls for a radical rewrite of the tax system (though they do not have the authority to do so) – not the traditional understanding of what the Treasury/IRS regulatory objective is
- Don't recommend this approach, but if chosen, would:
 - Adopt the tax approach: keeps analysis within core expertise of Treasury/IRS
 - Use marginal cost of funds that varies by tax (income, payroll, excise): avoids setting an objective that implicitly calls for replacing one tax with another
 - Quantify impacts on distributional objectives as benefit/cost using weights based on existing tax system: avoids setting a new distributive objective
- But a more useful approach focuses on transparency, and does not make political judgments in an attempt to provide a definitive answer to whether a proposed regulation has net social benefits

Apolitical quantitative CBA for tax regulations

- Produces the components of net benefits but does not take a stance on lambda
- Does not take a stance on gross benefits and costs or on net benefits

$$\lambda \times \left[\left(\begin{array}{c} \text{revenue} \\ \text{gain from} \\ \text{regulation} \end{array} \right) - \left(\begin{array}{c} \text{administrative} \\ \text{costs of} \\ \text{regulation} \end{array} \right) \right] - \left(\begin{array}{c} \text{compliance} \\ \text{costs of} \\ \text{regulation} \end{array} \right)$$

- If simplify and assume Treasury/IRS spending is fixed, administrative costs are unaffected (incipient cost impacts manifest in revenues/compliance costs)
- Focus on revenue impacts and compliance costs, plus distributive impacts
 - There is a lot of complexity under the hood
 - Revenue gain often will not be the quantity of interest, but will require a modified calculation to the extent it exceeds the cost of avoidance/evasion
 - There can be (gross) costs embedded in the (net) revenue estimate
 - There can be (gross) benefits embedded in the (net) compliance cost estimate, especially in the case of implementing regulations

Revenue gain from regulation (I)

- Combines two conceptually distinct quantities
 - Measure of change in socially productive and unproductive behavior
 - Relaxation of the government budget constraint
- Why is it a measure of socially productive/wasteful behavior?
 - Private cost of avoidance/evasion behavior is equal to the tax rate
 - Change in avoidance/evasion resulting from a “marginal” regulation is costless to taxpayer (envelope theorem)
 - Can approximate social benefits of reduced avoidance/evasion as tax rate multiplied by increase in the tax base resulting from reduced avoidance/evasion multiplied by λ
 - Requires adjustments if private cost \neq social cost
 - Same logic in reverse for productive activity

Revenue gain from regulation (II)

- The motivating equation relies on an assumption that the regulation is “marginal” under which this approximation is exact
- Requires adjustment in the case of many potential tax regulations
 - Private cost of last dollar of avoidance/evasion is equal to the tax rate; first dollar generally avoided at lower cost
 - Approximation relies on the assumption that the difference between the two is small enough that they can be treated as the same
 - If regulation allows or prohibits a broad class of strategies or behavior, assumption that private cost of avoidance is constant could be invalid
 - Then want a direct estimate of the social cost of avoidance/evasion, almost never have in practice
 - Weight reduction in social costs of avoidance/evasion by λ and static revenue impact in excess of social costs by λ minus one (implicitly assuming envelope theorem applies to all other behavior)
 - Related to Weisbach, Hemel, Nou (2018) behavioral revenue concept

Useful quantitative estimates in this framework

- Four quantitative estimates of interest:
 - Revenue estimate including behavioral responses
 - Static revenue estimate and direct estimate of the change in the social cost of avoidance/evasion if available/necessary
 - Direct estimate of the private-sector compliance costs
 - Distribution table

Interpreting the quantitative estimates

- Evaluates a subset of costs and benefits of tax regulations
 - Replaces a compliance motivation for tax regulations with a cost-benefit paradigm
 - Ignores value of enforcing compliance for its own sake (separate from positive spillovers in voluntary compliance)
- Many regulations intended to achieve horizontal equity or coherence aims, or to clarify the rules of the road, especially in the case of initial implementing regulations

Application to 199A guidance

- Question: Whether/how to allow businesses to aggregate wages from different legal entities for purposes of computing the W-2 limitation?
- Net benefits from CBA perspective relative to no-guidance baseline:
 - Reduction in compliance costs from clarity in rules
 - Reduction in horizontal inequities from clarity in rules
 - (Potentially) revenue gains including (potentially) reduction in planning
- Challenge
 - First two apply to essentially any choice about how to aggregate
 - Last one is the one implicated in consideration of alternatives
- Question: Should the aggregation rules be designed primarily to limit the scope of 199A because 199A is itself a planning opportunity? Not traditional perspective on tax regulation but is implicit in CBA paradigm.

Application to SALT credits

- Allow states to provide 80-100% tax credits for contributions to entities specified by state/local governments?
- Traditional A-4 perspective:
 - Elegant solution to minimizing planning incentives (and thus costs) created by asymmetric tax treatment of charitable contributions and state/local taxes, which often fund similar activities
 - Reduces effective tax rates, potentially spurring some additional productive activity
 - Reduces cross-state disparities in tax rates
 - Ignore revenue loss
 - Allowing credits likely delivers large net benefits
- Alternative perspective:
 - Disparities in treatment of different taxpayers, undermines integrity of tax system
 - Substantial revenue loss is cost if $\lambda > 1$, benefit if $\lambda < 1$
 - Seemingly contrary to distributive intent of Congress
 - For values of λ above 1, shutting down credit arrangements likely delivers large net benefits at expense of potentially shifting people into more costly, less effective workarounds
- Alternative perspective with $\lambda > 1$ yields more reasonable conclusions and highlights a key economic consideration in developing tax regulations

Recap

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Aside: Defining the baseline

- A pre-statutory baseline will rarely be useful in the case of major tax legislation
 - Major tax legislation is often strongly redistributive (upward or downward)
 - Major tax legislation often increases or decreases revenues and deficits
- In the case of initial implementation, it may be most useful to take as the baseline expectations of taxpayer behavior in the absence of specific guidance
- In the case of regulations outside the context of specific or recent legislation, a no-action baseline may be appropriate
- Selection of the baseline will have implications for distributional impacts of regulation, again an issue if hypothetical transfers are the justification for ignoring distribution in typical CBA

Aside: the purpose of tax regulation

- Application of a CBA framework to tax regulations reflects a substantial departure in the implied purpose of tax regulations
 - Encourages Treasury/IRS to design regulations to “improve” the tax system rather than implement the tax system Congress enacts
 - Moves away from a perspective built around coherence, compliance, and administrability
 - Contrast purpose of tax regulations with regulations attended to address environmental externalities, market failures, or public health
- Bottom-line question of what cost is worth paying for a given compliance objective is always tied into questions about what the tax system should be