WRITTEN TESTIMONY
OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION
REGARDING THE REVENUE ESTIMATING PROCESS

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PRESENTED
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I. INTRODUCTION

My name is Ken Kies. I am the Chief of Staff of the Joint Committee on Taxation. It is my pleasure to present the testimony of the Joint Committee on Taxation at this joint hearing of the House Committee on the Budget and the Senate Committee on the Budget concerning the revenue estimating process and how that process might be improved.

At the outset, let me make one observation concerning the overall philosophy of the Joint Committee estimating function. This philosophy has three guiding principles. First, the objective of the estimating process is to consistently produce accurate estimates that can be reasonably relied upon by Members of Congress in making legislative decisions. Second, the Joint Committee on Taxation staff ("Joint Committee staff") is dedicated to continually improving its estimating methodology to enhance the accuracy of its work product. Third, the Joint Committee staff is highly sensitive to the need that the estimating process be viewed as fair and impartial. In that spirit, we believe this hearing offers a welcome opportunity to explain and discuss the estimating process.

The Joint Committee staff plays an integral role in virtually every stage of the tax legislative process. One aspect of this role involves estimating the effects of proposed tax legislation on fiscal year budget receipts, typically referred to as the revenue effects. Although this portion of the Joint Committee staff's work utilizes significant amounts of staff resources and is highly visible, it by no means constitutes the sole work of the staff.

To provide a more complete understanding of the role of the Joint Committee staff in the tax legislative process, this testimony includes as Appendix I a discussion summarizing the history of the Joint Committee, the work of the Joint Committee staff, and the role of the Joint Committee staff in the tax legislative process.

This testimony will focus on the issue that has attracted significant attention to the work of the Joint Committee staff in recent years -- the methodology employed by the staff when estimating the effects on Federal budget receipts of tax legislation considered by the Congress. First, the testimony will discuss the estimating methodology currently utilized by the Joint Committee staff. Second, it will discuss a few of the revenue estimates prepared by the Joint Committee staff in recent years that have generated both some controversy and confusion concerning the current estimating methodology. Third, it will discuss some of the issues that arise in considering whether to modify the existing methodology to take into account macroeconomic effects, if any, that might occur from tax

legislative proposals. This portion of the testimony will also discuss possible approaches for improving the current estimating process.

II. REVENUE ESTIMATING METHODOLOGY

A. Overview of The Joint Committee Staff's Current Revenue Estimating Methodology

1. The Basic Calculation of All Revenue Estimates

Revenue estimates measure the anticipated changes in Federal receipts that result from proposed legislative changes to the Internal Revenue Code or related statutes. The following discussion outlines the major elements involved in revenue estimating methodology currently employed by the Joint Committee staff.

Requests for revenue estimates range from those affecting broad groups of taxpayers (e.g., proposals to exclude all interest and dividends from gross income or to adopt a value-added tax) to those affecting a narrow class of taxpayers (e.g., a proposal applicable only to the banking industry). Each proposal is estimated using essentially the same methodology. In simple terms, two calculations are required. First, one must determine the revenue projected to be collected under present law. Second, one must estimate the revenue yield that will result from the tax law after it is modified. The difference between these two amounts is the revenue estimate.

2. The Revenue Baseline and Macroeconomic Forecasts

The reference point for a revenue estimate prepared by the Joint Committee staff is the Congressional Budget Office ("CBO") five-year projection of Federal receipts, referred to as the revenue baseline.[1] The revenue baseline serves as the benchmark for measuring the effects of proposed tax law changes. The baseline assumes that present law remains unchanged during the five-year budget period. Thus, the revenue baseline is an estimate of the Federal revenues that will be collected over the next five years in the absence of statutory changes.

The revenue baseline is based upon CBO forecasts of macroeconomic variables such as the annual rate of growth of

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[1] The revenue baseline is a component of the budget baseline prepared by CBO, which includes expenditures as well as receipts.

nominal gross domestic product ("GDP"), inflation rates, interest rates, and employment levels. For modeling purposes, a number of elements of the CBO forecast are disaggregated to match specific tax-related variables. For example, the aggregate forecast of wages and salaries paid is statistically matched to various types of taxpayers, e.g., by income class.

In contrast, the reference point for revenue estimates prepared by the Treasury Office of Tax Analysis ("OTA") is an alternative set of economic forecasts generated by the Administration. Differences in resulting revenue estimates prepared by the Joint Committee staff and by the OTA staff often can be traced to differences between the economic forecasts of CBO and the Administration.

As mandated by the Congressional Budget Act, revenue estimates published by the Joint Committee staff generally provide a fiscal year budget impact for the period ending five years following the current fiscal year (total of six fiscal years).

B. Econometric and Statistical Simulation Tax Models

1. Models Based on Statistics of Income Data

For most income tax revenue estimates, the Joint Committee staff relies on large computerized models of the Federal income tax system and the economy. These models have been developed by economists on the Treasury OTA staff, the Joint Committee staff, and in private economic consulting organizations. In simple terms, these models contain two components: (1) a calculator, which computes taxes paid under present law and under the proposal for which a revenue estimate is prepared and (2) tax return or other data. The primary data source for most models is the tax returns filed by individuals, corporations, and fiduciaries with the Internal Revenue Service ("IRS") and provided to the Joint Committee by the IRS Statistics of Income Division ("SOI"). The models combine the most recently available taxpayer information with forecasts of the aggregate level of national income provided by CBO.

The largest microsimulation model employed by the Joint Committee staff is the individual income tax model, which contains a random sample of approximately 200,000 individual income tax returns. This data is also matched with data from the Current Population Survey to account for individuals who do not file income tax returns. Once this match is complete, the file sample contains approximately 250,000 records. This sample is then statistically weighted to represent the entire filing and nonfiling population.

To estimate the revenue effects of most proposed changes in the individual income tax, the Joint Committee staff first uses the individual income tax model to calculate the tax liability for each of the sample returns in the model on the basis of present law. The model then recalculates the tax for each of the returns incorporating the parameters contained in the proposed legislation. In so doing, the model accounts for the interaction of all variable components of a taxpayer's return. For example, a 10-percent increase in the personal exemption does not necessarily increase the revenue loss associated with the personal exemption by 10 percent. Some returns will become nontaxable as a result of the increase, while other returns will shift to a different marginal rate bracket. The model will take these changes into account. After statistically weighting the present-law and proposed-law tax payments to adjust the results to reflect outcomes for the more than 110 million U.S. individual tax returns, the model calculates the difference in total revenues between present law and the proposal. This result obtained from the model is often only the first step in estimating the revenue effect associated with a proposal. For example, as discussed below, the Joint Committee staff often must make further adjustments to account for changes in taxpayer behavior, to reflect interaction among a package of proposals, or to reflect fiscal year budget reporting.[2]

In addition to the individual tax model, microsimulation models based on SOI data developed by the Joint Committee staff and the OTA staff include a corporate tax model, a partnership model, and an estate and gift tax model.

2. Other Models

In addition to the large microsimulation models based upon large samples of tax returns, the Joint Committee staff has developed a variety of econometric models to estimate the revenue impact of changes in tax laws relating to business investment and depreciation, natural resources and energy, employee benefits and other issues. The information needed to calculate the revenue effects of a proposal may not be available from tax return data

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[2] To be useful tools in budget analyses, estimates must be presented in a form consistent with the Federal government's cash-flow accounting system. Under this system, amounts received by the Treasury are accounted for at the time of receipt and disbursements are accounted for during the period when paid out.

To be consistent with the cash-flow measure of budget receipts, revenue estimates are shown in a format that corresponds to fiscal-year receipts of the Treasury Department. Because taxes are most often calculated on a calendar-year basis, the translation of changes in calendar-year tax liabilities into changes in the fiscal-year receipt of taxes is necessary.

or may be available only for a limited number of potentially affected taxpayers. In these instances, the Joint Committee staff must look beyond the SOI data files and construct a model that relies on such alternative sources of data.

Frequently, data may be available from other government agencies, such as the Department of Commerce, the Department of Transportation, the Department of Labor, the Department of Health and Human Services, the Social Security Administration, and the Federal Reserve Board. For example, the Current Population Survey conducted by the Bureau of the Census of the Department of Commerce provides useful and otherwise unavailable data relating to pension plan participation by income class.

In the absence of Federal or State government data sources, Joint Committee staff must locate other reliable sources, such as that available from leading economists, CBO, the General Accounting Office ("GAO"), private consulting or research organizations, or affected taxpayers.

C. Key Factors Impacting the Preparation of Revenue Estimates

After a microsimulation model produces a preliminary estimate of the revenue effect of a proposal, the Joint Committee staff often must make further adjustments to address issues that cannot be answered by directly applying the simulation models. These adjustments may be necessary to account for such things as changes in taxpayer behavior (in addition to taxpayer behavioral effects calculated directly from the model), the interaction of various proposals, and issues relating to taxpayer compliance.

1. Anticipated Behavioral Responses

One of the most significant elements of Joint Committee staff revenue estimates is the assumed effect of taxpayer behavior. Although the microsimulation models used by the Joint Committee staff account for certain taxpayer behavior, additional adjustments are often necessary. In general, a revenue estimate prepared for any proposal that increases or reduces the deductibility or excludability of an item of expense or income, or that changes the rate of tax on certain types of income or consumption, will incorporate an analysis of potential behavioral responses. Thus, revenue estimates prepared by the Joint Committee staff are not static, as has been frequently suggested. The Joint Committee staff's estimates are dynamic to the extent they take account of the direct behavioral responses that can be expected from proposed changes in the tax laws.

In many cases, empirical research can offer guidance as to how taxpayers will respond to a proposed change in tax law. If adequate historical data exists (e.g., if a similar proposal was

once included in the tax law), taxpayer response may be estimated statistically. For example, sufficient data is available to permit revenue estimates for proposals to change the excise tax on cigarettes to account for the expected change in demand for cigarettes.

Occasionally, reliable data will not be available to predict how taxpayers will respond to a proposed change. In such cases, the Joint Committee staff makes an informed judgment, relying on relevant economic theory and other relevant sources, to assess possible behavioral responses.

The following examples demonstrate the ways in which the Joint Committee staff accounts for possible taxpayer behavior in preparing revenue estimates:

- When Congress limited the ability of taxpayers to deduct passive losses, the Joint Committee staff estimating methodology assumed that investment patterns would change and corporations would claim a portion of the losses no longer freely available to individuals. Thus, the Joint Committee staff estimated that the limitation on passive losses of individuals included in the Tax Reform Act of 1986 would raise $36 billion from individuals for the period 1987 to 1991, but would lose $12.6 billion from corporations during the same period.

- When the Tax Reform Act of 1986 made it less attractive for property and casualty insurance companies to invest in tax-exempt bonds, the Joint Committee staff assumed that these companies would shift partially from investments in tax-exempt bonds to higher yielding taxable investments and that other corporations and individuals would acquire the tax-exempt bond holdings that insurance companies previously held. This phenomenon of investment shifting is an example of what are collectively referred to as "portfolio effects."

- Changes in excise taxes are expected to have an effect on the quantity of the taxed items purchased. For example, the estimate of revenues to be gained from imposing the so-called "luxury tax" on boats, cars, airplanes, furs and jewelry assumed reductions in purchases of these items.

- Changes in the taxation of capital gains are assumed to affect how rapidly capital assets are sold. A proposed decrease in capital gains taxation will speed up the sale of capital assets, which moves some revenue into the budget window. Some of the speed up is assumed to be permanent; that is, it is assumed that some capital assets that might otherwise have been held until the

death of the owner, thereby avoiding capital gains taxation entirely, are sold within the budget window as a result of a capital gains tax decrease. These changes result in increases in revenue, which offset much of the decrease from the tax cut.

- Other changes in the taxation of capital to provide specific incentives to acquire certain types of assets, such as targeted investment tax credits and accelerated depreciation, are also generally expected to affect investment decisions. These incentives are expected to speed up and, for some proposals, increase investment in the types of capital benefiting from the incentives. Investment in assets not entitled to the incentives is assumed to decline.

- Changes in individual income tax rates are assumed to affect portfolio management decisions of individuals. For example, an increase in the top individual income tax rate is assumed to result in increased holdings of tax-exempt bonds and reduced holdings of taxable investment instruments. To the extent that increasing the rate of tax on ordinary income reduces the taxation of capital gains relative to such ordinary income, it is assumed that individuals will shift portfolios so that they receive less current income as dividends and more as capital gains. Both of these assumptions reduce the estimated revenue gain from an increase in the top individual income tax rate.

- Changes in the deductibility of various expenses, such as home mortgage interest payments, business meals, or contributions to tax-deferred savings plans, are assumed to affect the rate at which such expenses occur. A decrease in the deductibility of business meals, for example, is assumed to reduce the total amount spent on business meals.

- Finally, for changes in tax law that may be difficult to enforce or administer, some efforts by taxpayers to avoid taxation are assumed. One such example is the provision included in the Energy Policy Act of 1992 to include in income the value of employer-provided parking to the extent that it is greater than $155 per month. The Joint Committee staff estimate assumed that there would be a tendency for taxpayers to take steps to reduce or underestimate the value of employer-provided parking so as to avoid income inclusion under this provision.

2. <u>Interaction</u>

When one proposal would modify two or more provisions within the Internal Revenue Code, the result of the combination of changes often produces a greater or lesser revenue effect than the sum of the revenue effects of each proposal if enacted separately. If this interaction is ignored, the analysis is incomplete; if the interaction is assigned to any one element of a proposal, the revenue estimate for that proposal may be misleading.

The proper interpretation of the revenues attributed to specific proposals and the accompanying interaction are determined by the "stacking order" of the analysis. There are two principal methods of presenting these results in line-by-line revenue tables, and it is important to note that the numbers in each type of presentation may appropriately answer different questions but reflect the same estimated revenue effect.

The first of these methods provides a revenue estimate for each proposal in isolation against present law, assuming none of the other proposals is adopted. A separate line on the revenue table displays interactions among proposals. This procedure is usually the most efficient when only a few proposed changes are involved. Under this method, deleting a proposal from the package may have a greater or lesser revenue effect than the effect shown on the specific line for that proposal.

A second method requires that each proposal be estimated as if all other proposals have already been enacted with a separate line again used to display interactions among proposals. The Joint Committee staff utilized this second method to analyze the Tax Reform Act of 1986. This method showed the revenue impact of adding or deleting specific proposals from the total tax reform package (rather than the revenue impact relative to present law of that single change without making any of the other changes contained in the package).

3. Compliance and Enforcement

Implicit in all Joint Committee staff revenue estimates are assumptions concerning compliance and enforcement. The revenue yield of any provision is dependent on the extent of compliance by taxpayers from both voluntary behavior and enforcement (including penalties assessed by the IRS). In general, levels of enforcement are assumed to remain unchanged as a result of most legislative proposals. However, many estimates do take into account changes in taxpayer compliance. This represents another aspect of taking into account behavioral effects.

Certain changes in tax law are specifically designed to improve compliance and also have the potential to affect enforcement. An example is the extension of information reporting to previously uncovered income sources. Information

reporting generates compliance revenue by changing taxpayer perceptions of the risks of noncompliance and by assisting them in identifying the income they have received. In addition, the information reporting document could be of use to the IRS in the generation of enforcement revenues, either in the matching or audit process.

Revenue estimates of so-called "compliance" provisions do not always recognize both compliance and enforcement effects. The realization of compliance revenues in the example above requires only that the proposed change of law be expected to change taxpayer behavior. Thus, compliance revenues are included in the estimate. Downstream enforcement revenues, however, are dependent upon specific actions by the IRS, which may or may not occur depending on resource allocation decisions. Using the assumption of a constant baseline level of enforcement, such revenues would be "counted" only in the event of specific resource allocations and not merely because of a change in law. Thus, in the above example, only the compliance revenue attributable to taxpayer behavior would be counted unless there were adequate resource allocations to justify counting the enforcement revenues.

D. Behavioral Effects and Macroeconomic Aggregates

1. Overview

The extent to which behavioral effects are taken into account in calculating the revenue effects of proposed tax legislation seems to cause the greatest confusion concerning the current estimating process. As discussed above, the Joint Committee staff does take many behavioral responses into account in preparing revenue estimates.

Revenue estimates often mistakenly are referred to as "static" because traditional estimating conventions utilized by the OTA staff and the Joint Committee staff assume no overall effect on economic aggregates such as gross domestic product, i.e., the forecast of total employment, investment, and other economic aggregates are assumed to remain unaffected by tax proposals. However, economists preparing revenue estimates assume that the components of these variables may change among sectors or industries, depending on the nature of the legislative proposal. For example, when the deduction for business meals was reduced, the revenue estimating methodology assumed some job displacement in the restaurant industry. However, it was assumed that this displacement was generally absorbed in other industries.

Ordinarily the growth of the following economic variables,

as supplied by CBO, is assumed to be unchanged by proposed tax law changes for revenue-estimating purposes:

--Gross Domestic Product
--Aggregate investment
--Interest rates
--Overall price index
--Total level of State and local taxes

Although these aggregate levels are fixed in the CBO baseline, the composition of the variables underlying these aggregates may be assumed to vary as a result of legislative proposal. Examples of elements of economic forecasts that may be reallocated include the following:

--Shifts between corporate and noncorporate income
--The mix of employee compensation between cash and nontaxable fringe benefits
--Relative prices

2. Behavioral Effects Not Generally Included in Revenue Estimates

The Joint Committee staff generally does not attempt to estimate the possible effects of a tax change on the baseline forecasted growth of GDP. Use of a fixed revenue baseline means that, in developing revenue estimates, the Joint Committee staff does not take into account macroeconomic or "feedback" effects, if any.

Thus, for example, with respect to tax changes that are likely to affect the return to capital, such as capital gains relief, investment tax credits, and accelerated depreciation, the fixed GDP forecast assumption means that the Joint Committee staff does not attempt to estimate growth in income resulting from the increased productivity, if any, caused by increases in investment. It also means the Joint Committee estimate does not account for any net increase in entrepreneurial activity generated by the incentives.

Similarly, the Joint Committee staff does not attempt to forecast changes in labor supply resulting from changes in income tax or payroll tax rates. At some income levels, the reduced disposable income resulting from an increase in tax rates could lead to an increase in labor supply by individuals seeking to maintain consumption levels. At other income levels, increases in tax rates may reduce labor supply as the marginal value of extra hours worked decreases. Hence, consideration of labor supply effects could increase or decrease the revenues to be anticipated from a tax increase, depending on whom the tax increase is affecting.

Some tax changes may affect the demand for labor. For example, excise tax increases that reduce demand for a product may result in layoffs in the affected industry. To the extent

that the affected industry comprises a significant portion of a regional economy, such as tobacco in North Carolina, Virginia and Kentucky or luxury boats in New England, the reduced demand for labor could result in a locally situated economic downturn. The resulting increased unemployment could generate additional Federal expense in the form of increased payments of unemployment compensation, food stamps, and other transfer payments. Joint Committee staff estimates do not reflect these effects.

Similarly, some tax incentives, such as empowerment zones and targeted jobs tax credits, target specific segments of the population likely to be receiving transfer payments from the Federal government. The budgetary effects of the revenue loss from these proposals may be offset by a reduction in Federal transfer payments, as well as by increased income and payroll taxes on any additional earned income. The Joint Committee staff does not attempt to account for these outlay effects in estimating such proposals.

The Joint Committee would not, in any case, attempt to measure such increases or decreases in transfer payments because they affect outlays for which CBO provides estimates.

III. ESTIMATING METHODOLOGY RELATING TO CERTAIN PROPOSALS WHICH HAVE GENERATED CONTROVERSY OR CONFUSION

A. Overview

A few revenue proposals for which the Joint Committee staff has provided revenue estimates in recent years have generated both some controversy and confusion concerning the current estimating methodology.

In an effort to further understanding of the complex issues involved in revenue estimating and to dispel popular misconceptions regarding certain of the Joint Committee staff's estimates, the estimating methodology and issues relating to the following proposals are discussed below:

(1) Proposals to reduce the rate of tax on capital gains.

(2) The 10-percent luxury excise tax on boats, airplanes, jewelry, and fur enacted in 1990 and repealed in 1993.

(3) Proposals to increase the top rate of tax on individuals.

B. Discussion of Specific Estimates

1. Proposals to Reduce the Rate of Tax on Capital Gains

Of the revenue estimates prepared by the Joint Committee staff in recent years, none has attracted more attention than the estimates of proposals to reduce the rate of tax on capital gains. During the 1990 Budget Summit, significant attention was devoted to the differences in estimates of capital gains proposals prepared by the Joint Committee staff and the Treasury OTA staff.

A general overview of the methodology the Joint Committee staff utilizes to estimate capital gains proposals is presented below. In particular, there is a discussion of the two most significant issues to be considered when estimating capital gains proposals: (1) the extent to which enactment of a reduction in the rate of tax on capital gains will induce taxpayers to realize capital gains (the "unlocking effect"); and (2) the fact that current estimating methodologies fail to account for any possible macroeconomic effects of a proposed capital gains tax rate reduction.

The first step in estimating the revenue effects of a proposal to reduce the rate of tax on capital gains is to calculate the decrease in tax liability that would result from lowering the tax rate for baseline gains (i.e., those capital gains that would be realized even in the absence of a change in rates), measured without taking taxpayer behavior into account. This amount is calculated directly from the individual income tax model described above. In doing this calculation, the Joint Committee staff relies upon the forecast of capital gains realizations incorporated in the CBO baseline.

The second step takes into account induced realizations expected from the proposed rate change. Induced realizations represent the additional gains taxpayers are expected to realize as a result of a proposed lower tax rate on capital gains. These "induced realizations" are calculated by combining two factors: (a) the Joint Committee estimate of taxpayers' behavioral response to the proposed rate reduction (i.e., the assumed elasticity); and (b) the gain realizations reflected in the CBO revenue baseline. For many capital gains proposals, in the first few years after a capital gains tax rate reduction takes effect, the Joint Committee staff estimates that induced realizations will be more than sufficient to offset the revenue loss resulting from the lower rates, so that net Federal tax revenues are increased. However, the Joint Committee staff's estimates assume that this initial surge in realizations is a temporary phenomenon. Thus, the Joint Committee staff generally estimates that, after an adjustment period, in most cases taxpayers will settle into a more permanent level of realizations that will be lower than the initial surge, but higher than would be expected

in the absence of a rate reduction.[3]

The Joint Committee staff has long recognized that a change in the rate of tax on capital gains will affect the level of capital gains realizations by taxpayers.[4] Economists use the term "elasticity" to describe the relative change in taxpayers' decisions to realize capital gains that can be expected in response to changes in the capital gains tax rate. Mathematically, the realization elasticity is the percentage change in realizations divided by the percentage change in tax rates.[5]

The Joint Committee staff estimate of the elasticity of taxpayer response to a reduced capital gains tax rate was developed after careful review of the major empirical and theoretical studies by experts in government and the academic community. The elasticities ultimately used, however, are not those reported in any single study; nor are they derived by a mechanical averaging of any group of studies. Rather, they reflect the staff's independent evaluation of the results of the various studies, analyzed in the context of the historical record.

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[3] The current methodology of the Joint Committee staff in preparing distributional analysis of tax proposals, including capital gains tax rate cut proposals, includes increased tax revenue from the proposed changes for each of the five years of the budget period. This would include the tax from induced realizations in the case of a capital gains rate reduction.

[4] For example, in the General Explanation of the Revenue Act of 1978 (P.L. 95-600), the revenue table included a separate line item reflecting the increased revenues from induced capital gains realizations.

[5] For example, if a 10-percent reduction in the capital gains tax rate were expected to result in a 10-percent increase in realizations, the realization elasticity would be -1 (10 percent/-10 percent). An elasticity of -1.0 would mean that if the capital gains tax rate were lowered, the percentage increase in realizations would exactly offset the revenue loss from the reduction in the rate, resulting in no net revenue effect. An elasticity of -1.1 would mean that, if the capital gains tax rate were lowered, the increase in realizations would produce more revenues than the revenue loss occurring as a result of the lower tax rate. Similarly, an elasticity of -0.9 would mean that the increase in realizations from a reduction in the capital gains tax rate would be less than the loss of revenues from the lower rate.

Consistent with current estimating methodology, the Joint Committee staff does not take into account the possible effects of a capital gains tax cut on GDP (i.e., the macroeconomic or so-called "feedback" effects) in preparing revenue estimates of capital gains tax cut proposals. With respect to the effects of a capital gains tax cut, feedback effects on GDP, if any, would be expected to come from increases in productivity resulting from changes in the capital stock. Such productivity growth would occur slowly at first, with most of the effects outside the budget window. In theory, increased entrepreneurial activity utilizing otherwise unemployed labor could generate short-run increases in GDP.

2. Estimates of the Luxury Excise Tax

The luxury excise tax enacted as part of the Omnibus Budget Reconciliation Act of 1990 imposed a 10-percent excise tax on the value of automobiles in excess of $30,000, the value of boats in excess of $100,000, the value of personal-use aircraft[6] in excess of $250,000, and the value of furs and jewelry in excess of $10,000. The tax was effective for sales occurring on or after January 1, 1991. As part of the Omnibus Budget Reconciliation Act of 1993, the tax on boats, personal-use aircraft, furs, and jewelry was repealed. The repeal was effective for purchases of boats, jewelry, furs, and personal-use aircraft occurring on or after January 1, 1993. The 10-percent tax on automobiles was indexed periodically for inflation such that, in 1994, the tax applied only to the value of automobiles in excess of $32,000.

The methodology used to estimate excise tax proposals generally involves several steps. Once the initial tax base is determined, the base is adjusted to account for changes in consumption patterns (elasticities of demand and supply) that result from the imposition of the tax. The base is also adjusted to account for any significant compliance problems in the administration of the proposed tax. The tax rate is then applied to the adjusted tax base to yield the expected gross revenues from the tax.

One of the most fundamental components of any revenue estimate is the construction of the tax base. Estimation of the luxury excise tax proposal required information on units of each item sold at a given price. Because no single data source contained all the information necessary for the estimates, several data sets were used to derive the revenue estimates of the tax.

At the time of the legislative consideration of the luxury

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[6] Aircraft for which 80 percent of use was for nonpersonal activities were excluded from the tax.

tax in 1990, little information was available from academic literature or from the affected industries on the elasticity of demand for cars, boats, jewelry and furs, and personal-use aircraft with values in excess of the proposed excise tax thresholds. Based on the available information, the Joint Committee assumed that demand for these items was highly elastic. Thus, the Joint Committee staff revenue estimate assumed a significant change in consumption patterns stemming from the implementation of the tax, i.e., it assumed a significant decline in purchases of the taxed items. Furthermore, the Joint Committee staff estimate assumed that some purchases of luxury goods which were otherwise planned to occur after the implementation of the tax were accelerated to avoid the tax. The Joint Committee estimate also assumed an initial period of lower than usual tax collections based upon an anticipated low level of compliance with the tax in its initial years.

A comparison of estimates shown in the table below demonstrates that the luxury excise tax in fact produced more revenue than was expected in its first two years. This was due to the unexpectedly large receipts from the tax on automobiles. In addition, the tax on boats and jewelry produced more than the anticipated revenues in the first two years of the tax. The tax on furs generated the expected revenues for the 1991-1992 tax period, while the tax on personal-use aircraft generated less revenue than was anticipated. The table below compares the original Joint Committee gross revenue estimates from 1990 for the luxury excise tax with the actual tax receipts collected by the IRS.

IRS LUXURY EXCISE TAX RECEIPTS
COMPARED TO JCT ESTIMATES[7]
Fiscal Years
[Millions of Dollars]

Items	1991(a)	1992
Airplanes over $250,000:		
IRS Actual Receipts	0.1	0.4
JCT Estimate	1.0	4.0
Shortfall	-0.9	-3.6
Boats over $100,000:		
IRS Actual Receipts	7.3	12.4
JCT Estimate	4.0	9.0
Excess	3.3	3.4
Automobiles over $30,000:		
IRS Actual Receipts	151.5	296.5
JCT Estimate	27.0	69.0
Excess	124.5	227.5
Furs over $10,000:		
IRS Actual Receipts	0.3	0.7
JCT Estimate	(*)	1.0
Shortfall	0.0	-0.3
Jewelry over $10,000:		
IRS Actual Receipts	9.2	15.8
JCT Estimate	1.0	3.0
Excess	8.2	12.8
Total:		
IRS Actual Receipts	168.4	325.8
JCT Estimate	33.0	87.0
Total Excess	**135.4**	**238.8**

(a) Year contains only 9 months of receipts.
(*) Gain of less than $1 million.

Since the enactment of the luxury excise tax, there has been much debate about its effect on the boating industry. Data from

[7] The Joint Committee staff estimates provided in this table are the original estimates used in the Omnibus Budget Reconciliation Act of 1990 presented on a gross basis. IRS tax collection data represents gross fiscal-year excise tax collections. The net revenue estimates usually produced by the Joint Committee staff must be shown on a gross basis to produce any meaningful comparison.

the National Marine Manufacturers Association shows that the boating industry was in a recession two years prior to the enactment of the luxury tax. Beginning in 1989, the boating industry began to experience a significant decline in sales for both luxury and nonluxury boats. Between 1988 and 1990, sales of luxury and nonluxury boats declined by about one-third.[8] This decline continued through 1993. It has been asserted that several factors contributed to the decline in sales. Several sources cited the lack of consumer confidence due to the oncoming recession, the luxury tax, State sales taxes, and a large used boat market from which lower priced substitutes were available, as reasons for the decline in boat sales between 1988 and 1993. In 1993, anticipated repeal of the luxury excise tax caused a delay in the planned purchases of boats until the 1994 season. The imposition of a luxury excise tax on boats logically would be expected to result in a reduction of luxury boat sales. The Joint Committee estimate of the luxury excise tax on boats took account of such a reduction in sales on top of an already declining industry.

3. Proposals to Increase the Top Individual Income Tax Rate

a. 100-Percent Rate on Income Above Certain Levels

Considerable attention has recently been directed to reports of Joint Committee revenue estimates of a 100-percent marginal tax rate applied to income over $100,000 or $200,000. For many years, Senator Bob Packwood (R-OR) has asked the Joint Committee staff to prepare an analysis of the theoretical revenue that would be generated under such a hypothetical rate. Senator Packwood's purpose in requesting this analysis has not been to determine the precise revenue consequences if such a proposal were actually enacted. Rather, his purpose was to illustrate that a confiscatory tax rate would not produce the levels of tax that some have mistakenly asserted. The responses that have been provided to Senator Packwood have been used incorrectly as evidence of the flaws in the Joint Committee staff's revenue estimating methodology. For example, in a recent article that appeared in the *Wall Street Journal*, incorrectly asserting that Joint Committee estimating methodology does not take into account behavioral changes, it was asserted:

> "Thus, when Sen. Bob Packwood (R. Ore.), incoming chairman of the Finance Committee, asked the JCT to calculate the revenue effects of raising the top tax rate to 100% on everyone making more than $200,000 in 1989, he was told that this tax change would raise $204 billion in 1990, rising to

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[8] GAO Report - Tax Policy and Administration: Luxury excise tax issues and estimated effects, February 1992; GAO/GGD-92-9.

> $299 billion by 1993! Such a result is obviously ridiculous, yet is totally consistent with established JCT procedures."[9]

In fact, the information that has been provided to Senator Packwood represents a simple mathematical calculation derived from the Joint Committee's individual income tax model of the amount of taxable income above $100,000 (or $200,000) reduced by the current Federal income tax attributable to such income. Thus, the response shows the amount of tax that could be raised by such a change if there were no behavioral responses to the 100-percent tax rate.

However, the Joint Committee has consistently stated to Senator Packwood that it is impossible to provide a complete analysis of a proposal to impose a 100-percent marginal tax rate on income above certain levels. In a letter to Senator Packwood dated October 12, 1994, the Joint Committee on Taxation staff stated as follows:

> "...[w]e are unable to provide a complete analysis of the proposal outlined. Our estimating models and methodology incorporate behavioral effects based on available empirical evidence to produce reliable estimates of the effects of tax changes in general. Even when tax rate changes are relatively small, our analyses include significant changes in behavior to account for portfolio shifts and the timing of income realizations. At a proposed tax rate of 100 percent, however, we lack historical experience on which to base an estimate of the significant behavioral effects. One may speculate that these effects would be extraordinary. If the 100-percent tax rate were to be in effect for a substantial period of time, so that taxpayers would have no rational hope of avoiding or evading the 100-percent tax in the out years by deferring income to lower rate years or using other tax avoidance or deferral plans, then in our judgment there would be a substantial reduction in income-producing activity in the economy and, thus, a significant reduction in tax receipts to the Federal government."

Copies of a number of letters to Senator Packwood on this issue are included in Appendix II. All contain similar caveats.

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[9] Bruce Bartlett, "Static Scoring Gets It Wrong", *Wall Street Journal* (December 14, 1992).

b. Taxpayer Response to Increases in the Top Individual Tax Rate

As part of the Omnibus Reconciliation Act of 1993, two new individual income tax brackets of 36 percent and 39.6 percent were added. In addition, new alternative minimum tax rates were imposed and the limitation of itemized deductions and the personal exemption phaseout were made permanent.

The estimation of the above described changes began with the use of the individual income tax simulation model, described previously, to calculate the change in tax liability resulting from the proposed changes with no assumed behavioral change. The model provides the forecast distribution of income which is essential to the calculation and accounts for interactions between the provisions.

The model output was then adjusted after considering certain behavioral responses on the part of affected individuals. This adjustment was particularly critical in this case because the provisions affected high-income individuals who are generally assumed to have greater access to information and greater ability to rearrange their affairs to minimize the impact of the tax.

The types of taxpayer behavior taken into account include the shifting from investments which yield interest and dividend income taxed at the new higher rates into investments that provide capital appreciation, which is taxed at unchanged lower rates. Also considered were shifts from taxable to tax-exempt assets, conversion to C corporation business form, conversion of wage income into tax-deferred or tax-exempt fringe benefits, and increased noncompliance and avoidance.

In making the determination of how much behavioral response to include, the Joint Committee staff reviewed available studies and consulted with the OTA staff. The final result was a reduction in the estimate of increased fiscal year receipts of $8.5 billion or a reduction of approximately 7 percent, for the five-year period.

Because all revenue estimates assume fixed levels of macroeconomic aggregates, the behavioral responses considered do not include actions which would affect the overall output of the economy such as a change in the supply of labor. While macroeconomic effects were not included in the estimate, it is not clear that they would have a significant impact on the magnitude of the tax change. In the case of changes in the top individual income tax rate, one would expect that the most probable macroeconomic effect would be a change in the labor supply of affected individuals.

IV. ISSUES RELATING TO ESTIMATING THE MACROECONOMIC EFFECTS OF PROPOSED LEGISLATION

A. In General

As indicated earlier in this testimony, under current revenue estimating methodology, a revenue estimate predicts how Federal receipts will increase or decrease relative to the baseline projections if a proposed change in the tax law is enacted. However, although a revenue estimate under current estimating methodology may incorporate anticipated behavioral responses to a proposed change in the tax law, the estimate does not take into account the potential effect, if any, the proposal may have on aggregate economic growth, interest rates, or other macroeconomic variables. Thus, a current methodology revenue estimate does not predict the positive or negative effects, if any, a proposal might have on the overall economy.

It has been suggested that in making revenue estimates of a tax proposal the Joint Committee staff should take into account the projected macroeconomic effects that would result from that particular tax proposal.

B. Issues to be Considered Concerning the Possibility of Incorporating Macroeconomic Effects in Revenue Estimates

There are a number of important issues which need to be analyzed in considering whether to modify the current estimating methodology applicable to proposed tax policy changes. Many of these are discussed in the document released last week by the Congressional Budget Office entitled "Budget Estimates: Current Practices and Alternative Approaches." While we will not repeat a discussion of each of those considerations, we would highlight the following:

- Inclusion of macroeconomic effects in estimates of revenue proposals but not spending proposals could create a serious inconsistency in overall budget analysis.

- Most revenue proposals are likely to have little or no macroeconomic consequences.

- Because of the complexity and lack of consensus as to the measurement of such macroeconomic effects, attempting to take macroeconomic consequences into account could undermine the credibility of the

estimating process and render estimates less reliable. The uncertainty of monetary policy further contributes to this problem.

- Given the fact that most of the discussion associated with proposals to take macroeconomic effects into account has focused on proposals which are viewed, at least by some, as having the potential for positive macroeconomic effects, taking such effects into account could reduce the pressure to further reduce the deficit. Moreover, to the extent that an estimate overstates the positive macroeconomic effects of a proposed change, the result could be an increase in the deficit.

V. CONCLUSION

There are difficult practical and theoretical hurdles to overcome prior to including macroeconomic effects in Joint Committee staff revenue estimates. That does not mean that it is not appropriate to improve the revenue estimating process and, at the same time, to begin the steps necessary to overcome these hurdles.

As a first step, it is clear that the Joint Committee staff must act to rectify the perceived inadequacies with the existing revenue estimating process. The Joint Committee staff can do this by (1) continuing to improve the methodology employed in preparing revenue estimates and (2) doing a better job of informing the Congress about the revenue estimates it prepares.

Much of the confusion surrounding revenue estimates could be alleviated through increased disclosure of the underlying assumptions used by the Joint Committee staff in deriving these estimates. Thus, the Joint Committee staff could provide additional information about specific proposals. This type of additional analysis is done intermittently now by the Joint Committee staff and, in some cases, by other governmental organizations (such as the Congressional Research Service) or by private consulting. A more systematic approach to disclosure may be warranted.

This disclosure could have two components. First, the Joint Committee staff could provide additional information to the Congress as to the methodology that it has employed in preparing a revenue estimate, with particular emphasis placed on the types of taxpayer behavioral responses assumed in preparing an estimate. Further, the Joint Committee staff could provide information as to the likely effects a proposal might be expected to have on the economy.

For example, in addition to providing a revenue estimate for a large increase in the cigarette tax, the Joint Committee staff could provide information explaining that the cigarette tax increase may be expected to reduce demand for cigarettes significantly, resulting in a long-run decline of the tobacco industry. Similarly, in addition to providing a revenue estimate for a "neutral cost recovery" depreciation system, the Joint Committee staff could provide information explaining how such a system could be expected to increase investment and economic growth in the long run.

For many proposals, the potential economic impact will be well known by both proponents and opponents of the proposals and additional information from the Joint Committee staff may be unnecessary. Most revenue proposals would likely have an immeasurably small effect on the economy. However, in cases in which the effects of a revenue estimate may not be well understood, Congressional decision making might be enhanced by the additional information that might be provided by the Joint Committee staff. It should be noted that, in some cases, this type of analysis may be difficult or impossible for a variety of reasons, e.g., lack of data, complexity of interactions within the proposals, differences of views within the economic community, etc.

In addition, it may be appropriate for the Congress to direct the utilization of resources to develop reliable macroeconomic models that might be used to assist in the measurement of potential macroeconomic effects of certain proposed legislation. It may be difficult to determine the types of proposals for which the macroeconomic effects should be measured, but guidelines could be established to assist in this determination.

The Joint Committee staff is always interested in exploring ways to improve the accuracy of our revenue estimates. The Joint Committee staff's goal in producing revenue estimates is now, as it always has been, to provide the Congress with an accurate and unbiased assessment of the impacts of tax legislation on Federal receipts. The Joint Committee staff views the constant updating and revision of revenue estimating methodology as a necessary process for achieving that goal, and the Joint Committee staff is looking forward to studying the feasibility of any suggested improvements. In addition, the Joint Committee staff believes that the Congress should have as much information as is reasonably possible about the revenue estimates we prepare.

We appreciate the opportunity to appear before you today to explain our existing revenue estimating methodology and look forward to your comments and the comments of the experts that you have assembled.

Appendix I. Overview of the History and Operation of the Joint Committee on Taxation

1. Establishment of the Joint Committee on Taxation

The Joint Committee on Taxation (the "Joint Committee") was established by the Revenue Act of 1926. As originally conceived by the House of Representatives, (a temporary) "Joint Commission on Taxation" was to be created to "investigate and report upon the operation, effects, and administration of the Federal system of income and other internal revenue taxes and upon any proposals or measures which in the judgment of the Commission may be employed to simplify or improve the operation or administration of such systems of taxes..."[10]

The Senate expanded significantly the functions contemplated by the House and transformed the proposed Joint Commission to a Joint Committee with a permanent staff. The Senate was acting largely in response to the findings of a select committee that had been investigating misconduct and corruption at the Bureau of Internal Revenue (the earlier name of the Internal Revenue Service). That select committee emphasized

> "the need for the institution of a procedure by which the Congress could be better advised as to the systems and methods employed in the administration of the internal revenue laws with a view to the needs for legislation in the future, simplification and clarification of administration, and generally a closer understanding of the detailed problems with which both the taxpayer and the Bureau of Internal Revenue are confronted. It is more properly the function of the Senate Finance Committee and the House Ways and Means Committee, jointly, to engage in such an activity."[11]

The Senate version was incorporated into the Revenue Act of 1926 and the Joint Committee on Taxation was created.[12]

By statute, the Joint Committee is composed of 10 Members of Congress: 5 Members from the Senate Committee on Finance (3 majority and 2 minority) and 5 Members from the House Committee

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[10] Revenue Act of 1926, House Report 1, 69th Cong., 1st Sess. (1925).

[11] Revenue Act of 1926, Senate Report 52, 69th Cong., 1st Sess., (1926).

[12] Revenue Act of 1926, House Report 356 (Conference Report), 69th Cong., 1st sess. (1926); Revenue Act of 1926, Public--No. 20--69th Cong. (44 Stat. 127).

on Ways and Means (3 majority and 2 minority).[13]

The statutorily prescribed duties of the Joint Committee are to: (1) investigate the operation and effects of internal revenue taxes and the administration of such taxes; (2) investigate measures and methods for the simplification of such taxes; (3) make reports to the House Committee on Ways and Means and the Senate Committee on Finance (or to the House and the Senate) on the results of such investigations and studies and to make recommendations;[14] and (4) review any proposed refund or credit or income or estate and gift taxes in excess of $1,000,000.[15]

Under Internal Revenue Code section 8021, the Joint Committee is empowered to: (1) obtain and inspect tax returns and return information (as specified in sec. 6103(f)); (2) hold hearings, require attendance of witnesses and production of books, administer oaths, and take testimony; (3) procure printing and binding; and (4) make necessary expenditures. In addition, section 8023 authorizes the Joint Committee (or the Chief of Staff), upon approval of the Chairman or Vice-Chairman, to secure tax returns, tax return information or data directly from the Internal Revenue Service or any other executive agency for the purpose of making investigations, reports, and studies relating to internal revenue tax matters, including investigations of the Internal Revenue Service's administration of the tax laws.

2. Role of the Joint Committee on Taxation in the legislative process

The staff of the Joint Committee on Taxation is closely involved in every aspect of the tax legislative process. Among other things, the Joint Committee staff (1) prepares hearing pamphlets for the use of the House Committee on Ways and Means and the Senate Committee on Finance, (2) writes the first drafts of all committee reports and conference reports (statements of managers) for all tax legislation, (3) assists the office of legislative counsel in the drafting of statutory language, (4) assists Members of Congress with the development and analysis of

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[13] Section 8002 of the Internal Revenue Code of 1986. The statutory authority relating to the Joint Committee on Taxation is contained in sections 8001-8005 and 8021-8023 of the Internal Revenue Code of 1986, and predecessor sections of the Internal Revenue Code of 1954, the Internal Revenue Code of 1939, and preceding Revenue Acts dating back to the Revenue Act of 1926. These legislatively prescribed duties are essentially unchanged since the Revenue Act of 1926.

[14] Section 8022 of the Internal Revenue Code of 1986.

[15] Section 6405 of the Internal Revenue Code of 1986.

legislative proposals, (5) assist Members of Congress in addressing constituent issues and problems, (6) prepare revenue estimates of all revenue legislation considered by the Congress, (7) review proposed large income tax refunds, and (8) initiate investigations of various aspects of the Federal tax system. If the Joint Committee on Taxation staff does not perform these functions, the staffs of the Ways and Means and Finance Committees would have to be expanded to pick up these responsibilities.

3. The Joint Committee on Taxation staff

In general

The professional staff of the Joint Committee on Taxation currently includes lawyers, certified public accountants (CPAs), economists, and computer specialists. Most of the lawyers and accountants have substantial tax experience before coming to work for the Joint Committee, including private practice experience with law firms or Big 6 accounting firms or experience with the Internal Revenue Service.

The Joint Committee on Taxation revenue estimating staff

The Joint Committee staff economists all have advanced degrees. These economists have substantial experience with economic modelling, much of it obtained working for other Government agencies, including the Office of Tax Analysis in the Treasury Department, the Department of Agriculture, the Internal Revenue Service, and State governments. Some of the economists have significant private sector experience working for economic consulting firms or accounting firms.

The Joint Committee revenue estimating staff is responsible for the data collection and modelling necessary to estimate the revenue effects of proposed changes in the Internal Revenue Code. These economists draw on the professional expertise of other Joint Committee staff (i.e., the staff attorneys and accountants), other tax professionals, and academic literature on the economics of taxation to assist them in their analyses. In particular, the Joint Committee economists rely heavily on the staff's tax lawyers and accountants to describe and interpret the specifics of the other technical proposals within the broader context of the tax system.

Some proposals to reorganize the operations of the Congress have proposed merging the Joint Committee on Taxation revenue estimating staff with the Congressional Budget Office. Such a move would seriously impair the unique relationships that permit the Joint Committee's lawyers and economists to work together to provide the best possible assistance to the Members of Congress with respect to revenue legislation. The Federal tax system is

so complex and highly technical that the staff economists must rely on the technical expertise and experience of the staff attorneys and accountants to analyze the potential effects of proposed tax legislation. From time to time during consideration of health reform legislation during 1994, the Congressional Budget Office (CBO) economists estimating the outlay effects of the legislation also drew upon the expertise of the Joint Committee staff's attorneys to assist in the interpretation of tax provisions in the health reform legislation.

4. Work of the Joint Committee on Taxation revenue estimating staff

Revenue estimate requests

The Congressional Budget Act of 1974[16] requires the Joint Committee on Taxation to provide revenue estimates for all tax legislation considered by either the House or the Senate. Such estimate are the official Congressional estimates for reported tax legislation.[17] In addition, under the Budget Enforcement Act of 1990, any proposed reduction in taxes must be "paid for" with either an offsetting tax increase or a direct spending (entitlement) decrease.

Distribution analysis

To accompany revenue estimates prepared by the Joint Committee staff, data are often prepared on the estimated changes in the benefit or burden by income class that result from adoption of a given proposal. Distributional analyses attempt to measure the changes in taxpayers' economic welfare that result from changes in the tax law. The distributional analysis is consistent with the five-year budget horizon used for revenue analysis.

Tax expenditure analysis

The Joint Committee on Taxation staff prepares and publishes annually a list of tax expenditures, which are submitted to the House Committees on Ways and Means and Budget and the Senate Committees on Finance and Budget. Tax expenditures are defined under the Congressional Budget and Impoundment Control Act of 1974 as reductions individual and corporate income tax liabilities that result from special tax provisions or regulations that provide tax benefits to particular taxpayers.

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[16] Section 201(g), as amended by the Balanced Budget and Emergency Deficit Control Act of 1985 (Gramm-Rudman-Hollings), P.L. 99-177, 99 Stat. 1037.

[17] Id.

These special tax provisions can take the form of exclusions, credits, deductions, preferential tax rates, or deferrals of tax liability.

Tax expenditures are considered to be analogous to direct outlay programs, and the two can be viewed as alternative means of accomplishing similar budget policy objectives. Tax expenditures are most similar to those direct spending programs that have no spending limits, and that are available as entitlements to those who meet the stuatutory criteria established for the programs.[18]

Estimates of tax expenditures are prepared for use in budget analysis. They are a measure of the economic benefits that are provided through the tax laws to various groups of taxpayers and sectors of the economy. The estimates also may be useful in determining the relative merits of achieving specified public goals through tax benefits or direct outlays.

Requests for data or estimating methodology

Members occasionally request that the Joint Committee staff provide background material relating to proposed changes in the tax laws, such as an analysis of changes in the Federal tax burdens over a period of time or an analysis of the extent to which proposed legislation exacerbates or reduces the so-called marriage penalty.

In addition, Members may request information as to the methodology employed by the Joint Committee staff in preparing a particular revenue estimate. If a Member wishes to obtain additional information regarding an estimate, the Joint Committee staff attempts to respond to the Member's request. This most often entails meeting with the Member or the Member's staff to review the relevant assumptions employed. If warranted, the Joint Committee staff also produces documents or letters describing a particular estimating methodology in detail. For example, in 1990, the Joint Committee staff published a pamphlet that provided extensive detail on the methodology employed to estimate the effects of President Bush's proposed reduction in the tax rate on capital gains.

Volume of requests received by the Joint Committee on Taxation

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[18] There are a few tax expenditures that have spending limits. One example is the tax credit for low-income rental housing. This credit is available only to those who have received credit allocations from State housing authorities. There are statutory limits on the total amounts of credit allocations that can be issued in any given year.

Over the last 12 years, the Joint Committee has received ever increasing numbers of requests for revenue estimates and other information from Members of Congress and Committee staff. In the first year in which such records were kept (1983), the Joint Committee received 150 requests for estimates. By contrast, during 1993, the Joint Committee received 2,380 requests. In 1994, the Joint Committee staff received only 1,350 requests for revenue estimates. Although this number is significantly smaller than the 1993 total number of requests, most of the requests received during 1994 related to complex proposals relating to health care reform. These proposals often had significant interaction with other elements of any particular health reform package and required, on average, more staff time than the majority of requests received in 1993.

The Joint Committee staff expects the number of revenue estimate requests received in 1995 to be much closer to the total number of requests received in 1993 given the likelihood of substantial tax legislation as the Congress considers the Contract With America.

The Joint Committee on Taxation has responded to approximately 80 percent of the requests received in the last 4 years. In 10-20 percent of the requests answered, additional information or followup responses were also provided. The remaining requests were not answered for a variety of reasons, including (1) insufficient staff manpower and resources to respond to all the requests, (2) inadequate specification of the proposal by the Member or Committee staff, and (3) insufficient data available to respond to the request.

Appendix II. Compilation of Letters to Senator Bob Packwood (R-OR) Relating to 100-Percent Tax Rate on Certain Income

The following letters represent a compilation of letters that have been sent to Senator Bob Packwood in response to his request for certain analysis concerning a 100-percent individual income tax rate with respect to income in excess of certain levels. These letters have been included with the consent of Senator Packwood.

Congress of the United States
JOINT COMMITTEE ON TAXATION
1015 LONGWORTH HOUSE OFFICE BUILDING
WASHINGTON, DC 20515-6453
(202) 225-3621

OCT 12 1994

Honorable Bob Packwood
United States Senate
Washington, DC 20510-6200

Dear Senator Packwood:

This is in response to your letter of September 30, 1994, for revenue estimates of imposing a 100-percent tax on all income over $100,000, and alternatively, income over $200,000. We are unable to provide a revenue estimate for these options for the reasons given below. However, the following table, which gives the amount of taxable income above those levels reduced by the current Federal income tax attributable to such income shows the amount of tax that could be raised by such change assuming no behavioral or macroeconomic responses.

	Calendar Years [Billions of Dollars]					
Item	1995	1996	1997	1998	1999	1999-95
After tax income in excess of:						
$100,000.....	289.1	314.4	342.8	370.1	399.6	1,716.1
$200,000.....	182.3	195.5	212.6	227.0	243.5	1,061.9

As mentioned above, we are unable to provide a complete analysis of the proposal outlined. Our estimating models and methodology incorporate behavioral effects based on available empirical evidence to produce reliable estimates of the effects of tax changes in general. Even when tax rate changes are relatively small, our analyses include significant changes in behavior to account for portfolio shifts and the timing of income realizations. At a proposed tax rate of 100 percent, however, we lack historical experience on which to base an estimate of the significant behavioral effects. One may speculate that these effects would be extraordinary. If the 100-percent tax rate were to be in effect for a substantial period of time, so that taxpayers would have no rational hope of avoiding or evading the 100-percent tax in the outyears by deferring income to lower rate

Congress of the United States
JOINT COMMITTEE ON TAXATION
Washington, D.C. 20515

OCT 12 1994

years or using other tax avoidance or deferral plans, then in our judgment there would be a substantial reduction in income-producing activity in the economy and, thus, a significant reduction in tax receipts to the Federal government.

I hope this information is helpful to you. If we can be of further assistance, please let me know.

Sincerely,

John L. Buckley

Congress of the United States
JOINT COMMITTEE ON TAXATION
Washington, DC 20515-6453

MAR - 9 1993

MEMORANDUM

TO: Lindy Paull

FROM: Harry L. Gutman

SUBJECT: Revenue Estimates

In response to your request dated March 4, 1993, we are providing information concerning taxpayers with taxable incomes over $100,000 and over $200,000.

You asked for a revenue estimate for a hypothetical 100-percent tax imposed on taxpayers with taxable incomes over $100,000 and over $200,000. We are unable to provide an estimate for this provision. Our estimating models and methodology incorporate behavioral effects based on available empirical evidence to produce reliable estimates of the effects of tax rate changes in general. As a proposed tax rate nears 100 percent, however, we lack historical experience on which to base an estimate of the behavioral aspects. While we can provide a purely static tabulation of the revenue collected by a 100-percent tax, this figure does not reflect the behavioral response of taxpayers that likely would occur.

You also asked for a tabulation of the amounts of taxable income over $100,000 of taxable income and the amount of taxable income over $200,000 of taxable income. Our model indicates that for 1994 the amount of taxable income over $100,000 of income is $386.6 billion, and the amount of taxable income over $200,000 of taxable income is $248.7 billion.

Congress of the United States
JOINT COMMITTEE ON TAXATION
Washington, DC 20515-6453

MAR 11 1992

MEMORANDUM

TO: Lindy Paull

FROM: Harry L. Gutman

SUBJECT: Revenue Estimate Request

In response to your request dated March 4, 1992, we are providing information concerning the top 1 percent of the income distribution of individual taxpayers.

At 1992 levels, the top 1 percent of the income distribution is defined as those taxpayers with adjusted gross income in excess of $185,000. These taxpayers are expected to incur tax liability of $127 billion.

You also asked for a revenue estimate for a hypothetical 100-percent tax imposed on taxpayers in the top 1 percent of the income distribution. We are unable to provide an estimate for this provision. Our estimating models and methodology incorporate behavioral effects based on available empirical evidence to produce reliable estimates of the effects of tax rate changes in general. As a proposed tax rate nears 100 percent, however, we lack historical experience on which to base an estimate of the behavioral aspects. While we could provide a purely static tabulation of the revenue collected by a 100-percent tax, this figure would not reflect the behavioral response of taxpayers that likely would occur.

We would be happy to review any data or statistical evidence of which you might be aware that would help us provide the estimate you have requested.

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WASHINGTON, DC 20515-6453
(202) 225-3621

MAR 21 1990

Honorable Bob Packwood
United States Senate
259 Senate Russell Office Building
Washington, DC 20510

Dear Senator Packwood:

This is in response to your request for revenue estimates of proposals imposing a 100-percent tax rate on income above $100,000 and $200,000. Specifically, the proposal would compute the tax under present law for individual returns, but would impose a tax of 100 percent on income (1) over $100,000 or (2) over $200,000.

Assuming an effective date of January 1, 1990, and subject to the qualifications noted below, we have estimated this proposal to have the following effect on fiscal year budget receipts:

	Fiscal Years (Billions of Dollars)					
Item	1990	1991	1992	1993	1994	1990-94
100% tax on income over $100,000.....	194.1	378.9	429.6	486.9	552.2	2,041.7
100% tax on income over $200,000.....	122.3	237.7	267.2	300.4	337.7	1,265.3

These estimates do not account for any behavioral response (tax avoidance, compliance, change in work effort and savings behavior, etc.) that would result from the imposition of a 100-percent tax rate. Accordingly, they should not be given the same weight as an estimate that does take behavioral response into account. However, if the 100-percent tax rate were to be in effect for a substantial period of time, so that taxpayers would have no rational hope of avoiding or evading the 100-percent tax in the outyears by deferring income to lower rate years or using other tax avoidance or deferral plans, then in our judgment there would be a substantial reduction in income-producing activity in the economy and, thus, a significant reduction in tax receipts to the Federal government.

I hope this information is helpful to you. If we can be of further assistance, please let me know.

Sincerely,

Ronald A. Pearlman

Congress of the United States

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1018 LONGWORTH HOUSE OFFICE BUILDING
WASHINGTON, DC 20515-6453
(202) 225-3621

MAR 15 1990

Honorable Bob Packwood
United States Senate
Washington, DC 20510

Dear Senator Packwood:

This is in response to your letter of March 6, 1990, as modified by your letter of March 7, 1990, requesting a revenue estimate for the proposals described below.

The first proposal would raise the rate of tax on income over $100,000. For the years 1990-1992, the tax rate on such income would be 100 percent; for years after 1992, the rate would be 50 percent. The second proposal would apply these tax rates to incomes over $200,000.

During 1989, we provided you the "static" estimates of these proposed rate changes, and we have been asked to update those estimates to reflect our 1990 baseline. These estimates are:

	Fiscal Years [Billions of Dollars]					
Item	1990	1991	1992	1993	1994	Total
100% tax on income over $100,000.....	194.1	378.9	429.6	486.9	552.2	2,041.7
100% tax on income over $200,000.....	122.3	237.7	267.2	300.4	337.7	1,265.3

As you know, a static estimate is merely a mathematical calculation of the increased revenues the Federal Government would receive assuming enactment of a tax legislative proposal and further assuming no behavioral response to the tax law change. In the case of your proposals, the static estimates represent the upper bound of possible Federal Government receipts.

As your letter suggests, we would expect there to be a very substantial behavioral response to a temporary tax rate of 100 percent. Indeed, we assume taxpayers would attempt to avoid completely the effects of the 100-percent rate (e.g., by deferring income to lower-rate years, by expanding the non-taxable portion of their incomes, by inaccurate reporting, or otherwise). These

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JOINT COMMITTEE ON TAXATION
Washington, D.C. 20515

behavioral responses likely would have a significant effect on the projected revenues. However, because a temporary 100-percent tax rate is so vastly different from any other proposal we have analyzed in the past, we are unable to quantify these factors with the degree of confidence necessary for us to provide a specific revenue estimate at this time.

Should you so desire, it would be possible for us to undertake a further review of the economic literature and consult with outside experts in an effort to develop an acceptable methodology for estimating the behavioral effects of your proposal. However, because we expect to be breaking new ground, it is unlikely we would be able to provide a specific revenue estimate in the near future.

I regret we are not at present able to provide the information you have requested. If you would like to discuss further the reasons for our inability to do so or what we believe we would have to do in order to properly estimate the proposal, please let me know.

Sincerely,

Ronald A. Pearlman

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Washington, DC 20515-6453
(202) 225-3621

NOV 15 1988

Honorable Bob Packwood
United States Senate
Washington, DC 20510

Dear Senator Packwood:

This is in response to the request by Lindy Paull of the Senate Finance Committee Staff for revenue estimates of proposals imposing a 100 percent tax rate on income above $100,000 and $200,000. Specifically, the proposal would compute the tax as under present law for individual returns, but would impose a tax of 100 percent on income (1) over $100,000 or (2) over $200,000.

Assuming an effective date of January 1, 1989, and subject to the qualifications noted below, we have estimated this proposal to have the following effect on fiscal year budget receipts:

Fiscal Years
(Billions of Dollars)

Item	1989	1990	1991	1992	1993
100% tax on income over $100,000	166.7	326.6	372.7	425.3	485.4
100% tax on income over $200,000	104.6	204.3	232.1	263.6	299.3

These estimates do not account for any behavioral response (tax avoidance, compliance, change in work effort and savings behavior, etc.) that would result from the imposition of a 100 percent tax rate. Accordingly, they should not be given the same weight as an estimate that does take behavioral response into account.

Congress of the United States
JOINT COMMITTEE ON TAXATION
Washington, D.C. 20515

NOV 15 1988

I hope this information will be helpful to you. If we can be of any further assistance to you, please do not hesitate to let me know.

Sincerely,

(signed) Ronald A. Pearlman

Ronald A. Pearlman

Congress of the United States

JOINT COMMITTEE ON TAXATION
1015 LONGWORTH HOUSE OFFICE BUILDING
Washington, D.C. 20515

FEB 15 1984

Honorable Bob Packwood
United States Senate
Washington, D.C. 20510

Attn: John Colvin

Dear Senator Packwood:

This is in response to a request from John Colvin to reestimate the effects on individual income tax liability of a proposal to impose a 100 percent tax on income in excess of selected thresholds. Under this proposal, tax liability would be computed as the larger of the present-law tax or 100 percent of income over the selected threshold.

The revenue impact of this proposal has been estimated using two different income concepts for the application of the 100 percent tax rate--either expanded income or a more broadly-defined measure of income. Expanded income is defined as adjusted gross income plus excluded capital gains and various other tax preference items, less investment interest to the extent of investment income. The broadly-based income measure includes everything in expanded income plus the two-earner deduction and other statutory adjustments, tax-exempt interest, excluded life and health insurance payments paid by employers, and presently untaxed social security, veteran, AFDC and SSI benefits.

The estimated revenue effects for calendar year 1984, under the various specifications, are as follows:

(Billions of Dollars)

Income Concept	100% Tax Applied Against Income Over:			
	$20,000	$30,000	$50,000	$100,000
expanded income	658.4	372.1	165.7	74.1
broadly-based income	793.5	450.2	190.7	81.5

FEB 15 1984

It should be noted that these estimates are quite sensitive to economic forecasts. For example, a ten percent increase in the forecast for per capita incomes, increases the projected revenue effects of a proposal of this type by approximately 20 percent. The estimates shown above are based on January, 1984, CBO economic projections.

It should also be noted that these numbers do not represent actual revenue estimates, since taxing 100 percent of anyone's income would force taxpayers to invest in tax avoidance devices or simply encourage then not to earn income in the first place.

Sincerely,

David H. Brockway

Congress of the United States
JOINT COMMITTEE ON TAXATION
1015 LONGWORTH HOUSE OFFICE BUILDING
Washington, D.C. 20515

JAN 24 1983

Honorable Bob Packwood
United States Senate
Washington, D.C. 20510

Dear Senator Packwood:

This is in response to your request for revenue estimates of two proposals to impose a 100 percent tax rate on income in excess of $100,000. The first proposal applies this 100 percent tax to taxable income in excess of $100,000; the second proposal computes the tax as the larger of the present law tax or 100 percent of expanded income over $100,000.

We have estimated the revenue impact of these proposals, assuming an effective date of January 1, 1983 as follows:

(Billions of Dollars)

		Calendar Year or Fiscal Year				
100% tax on		1983	1984	1985	1986	1987
taxable income over $100,000	CY	22.6	28.2	35.3	44.1	55.2
	FY	9.1	24.9	31.2	38.9	48.6
expanded income over $100,000	CY	59.7	75.6	95.6	120.9	152.9
	FY	24.1	66.1	83.7	105.8	133.8

These revenue numbers are somewhat higher than was the case for similar estimates made in previous years. There are two reasons for this. First, the 1981 tax cuts, particularly the cut in the top marginal tax rate from 70 percent to 50 percent, provided substantial tax relief to high-income individuals, thereby increasing the revenue gain from taxing 100 percent of their income. For example, income which was in the 70-percent bracket under prior law would have experienced a 30-percentage-point tax increase if the tax rate were raised to 100 percent. Today, that income is taxed in the 50-percent bracket and would experience a 50-percentage-point tax increase if taxed at 100 percent. This increase from 30 percentage points to 50 percentage points increases the revenue gain from confiscatory taxation of that income by two-thirds.

Congress of the United States
JOINT COMMITTEE ON TAXATION
Washington, D.C. 20515

Second, the effect of bracket creep and economic growth causes the number of taxpayers with income above $100,000 to grow rapidly from year to year. Using 1981 data, approximately 400,000 taxable returns have taxable income in excess of $100,000 and approximately 800,000 taxable returns have expanded income in excess of $100,000. These factors also cause a higher and higher fraction of the income of these taxpayers to be above the $100,000 threshold. As a result, the revenue gain from these proposals grows rapidly from year to year. We have not yet received CBO's economic assumptions for the upcoming year. Very likely, these will include less inflation in the future, in which case we would scale down these revenue estimates.

Needless to say, the numbers presented above do not represent actual revenue estimates, since taxing 100 percent of anyone's income would force taxpayers to invest in tax avoidance devices or simply encourage them not to earn income in the first place.

Sincerely,

David H. Brockway