Cost Benefit Analysis of Tax Regulations: The Marginal Revenue Rule

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The MOA

- Subjects certain tax regulations to Executive Order 12866.
- If the regulation has *annual non-revenue effect* on the economy of *$100 million or more*, measured against a no-action baseline, Treasury must quantify the costs and benefits.

- 12866(1)(a)(6):

> Each agency shall assess both the costs and the benefits of the intended regulation and, recognizing that some costs and benefits are difficult to quantify, propose or adopt a regulation only upon a reasoned determination that the benefits of the intended regulation justify its costs.

The Challenge: transfers v. real resources

- Circular A-4:
  - CBA is an estimate of the change in real resources.

    "Benefit and cost estimates should reflect real resource use."
  - Transfers do not change real resources, so they are not included in CBA.
  - Taxes are transfers.
  - Ergo . . .

- But changes to tax rules *can* change real resources.
  - E.g., they change work effort.

The Challenge: distribution and revenue

- Non-tax regulations primarily seek to correct market failures.
  - Raising revenue is secondary and usually not relevant at all.
  - Distributional issues are secondary because the tax/transfer system is the primary distributional tool.

- Tax regulations usually do not seek to correct market failures.
- Revenue and distribution are central.

- Standard tools of cost-benefit analysis developed for non-tax regulations.

Our approach

- The Marginal Revenue Rule is an estimate of the change in real resources due to a regulation.

- Separately state the distributional effects.
  - A-4 requires this.

- Separately state the revenue effects.

The MRR: the change in real resources

- Extension of the “elasticity of taxable income” concept from economics.

- Large literature. Papers include:
  - Feldstein (1995)
  - Feldstein (1999)
  - Chetty (2009)
  - Keen and Slemrod (2017)

Example

- Individual can decide how many hours to work.
- Earns $100/hour for each hour.
- Subject to a 30% tax.
- Each hour, the individual keeps $70 after taxes.

- Works just enough hours so the cost of one more hour, in terms of reduced free time, is $70.

- Individual is indifferent between one more, or one less, hour of work.
- E.g., works one more hour: gets $70 in after-tax wages but gives up an hour of free time worth $70.

Example cont.

- Suppose there is a change in a tax rule that causes the individual to work one additional hour.
- The individual is indifferent.
- But the government gets $30 more in tax revenue.
- The change in the rule increases total resources by $30.
- The $30 is *not* just a transfer.

Example cont.

- Same if the regulation causes one less hour of work.
- Individual is indifferent but revenues go down by $30.
- Society has $30 fewer total resources.

Compliance and administrative costs

- If the individual must keep records or incur other compliance costs, this is a cost.
- Or if the regulation reduces compliance costs, this is a net benefit.
- Same for the costs of tax administration incurred by the government.

The MRR

- Change in total resources from a change in the tax law is:

The change in tax revenue due to behavioral or reporting changes

minus

The change in compliance and administrative costs

(plus any net benefit or cost under standard CBA).

Scope

- Applies to all choices where the taxpayer can optimize.
  - Formal v. informal sector.
  - Taxable v. non-taxable compensation.
  - Reporting v. not reporting income.
  - Lower-taxed investments (e.g., tax-exempt bonds)
  - Sheltering.
  - Shifting across tax bases (e.g., from individual to corporate base).
- Extends to discrete choices as long as there are enough taxpayers.
- Non-marginal changes: provides rough estimate (can show it provides an upper or lower bound)

Transfers

- Same example but now assume there are many taxpayers.

- Some will work one more hour. They pay $30 more in tax but are not worse off.

- Others may not change their work effort but have to pay more or pay less tax.
- They are worse (or better) off.

- But the government is better (or worse) off.

- These transfers do not change total resources. Not part of the MRR.

Transfers cont.

- Change in tax revenue is important for tax regulations.
- Central goal of the tax system is to fund government.
- Transfers *are* part of change in tax revenue.

- People will have very different views about the value of money in the hands of individuals versus the government.
- But this is distinct from views about whether a regulation increases total resources.

- Separately state revenue effects.

Distribution

- Who pays matters.

- Important goal of the tax system is to distribute the burden of funding the government in a fair manner.

- Two options:

  - Weight costs and benefits by who pays.

  - Do not weight but separately state distributional effects.

Separate statement of distributional effects

- Provides more information.
- Provides the information in a clearer fashion.

- Do not weight costs and benefits for distributional effects.

- This is the current approach in Circular A-4.

  "Your regulatory analysis should provide a separate description of distributional effects (i.e., how both benefits and costs are distributed among sub-populations of particular concern) so that decision makers can properly consider them along with the effects on economic efficiency."

Summary

Treasury should supply three pieces of information:

1. The change in total resources from a regulation, using the MRR.
2. The revenue effects.
3. The distributional effects.

Each is important.

Also important not to confound them.