Cost-Benefit Analysis of Tax Regulations

Greg Leiserson
Washington Center for Equitable Growth

Tax Policy Center

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Cost-benefit analysis of tax regulations

- The traditional tools of tax analysis are the appropriate tools for cost-benefit analysis of tax regulations
  - Fundamental tradeoff: taxes impose burden/compliance costs to raise revenue
  - Analytic frameworks already exist for estimating these quantities
    - Distribution analysis provides estimates of burden changes
    - Revenue analysis provides estimates of revenue changes
    - Estimates of compliance costs are produced, though not as prominent
  - Cost-benefit analysis should report revenue, distribution, and compliance cost estimates
  - Not a paint-by-numbers exercise: estimates rely on potentially complex economic analyses that reflect the full range of effects of a regulation
    - Baseline assumptions may need to be modified to reflect the specifics of a proposed regulation

Contrast with traditional cost-benefit analysis

- Social benefits and costs are not quantified, and should not be quantified
  - Translating revenue and burden impacts into benefits and costs requires assumptions about the value of revenues and the appropriate distribution of the tax burden
  - Treasury/IRS should not claim to have definitive answers to these questions in the regulatory impact analysis
- Policymakers and the public should use the analysis conducted in the regulatory impact analysis to draw conclusions about the merits of the regulation

Why distribution analysis is the answer

- Burden is the welfare impact of a change in tax policy (ignoring revenues)
- (Most) distribution analyses aim to estimate burden
  - Under standard economic assumptions, changes in behavior in response to a (small) change in policy don’t matter for the well-being of the affected actor
  - Incidence assumptions for each tax allocate the burden of the tax to the groups thought to bear the tax
- Challenge: need incidence assumptions for regulations
  - May be able to apply existing corporate or individual incidence assumptions
  - Important source of uncertainty given limited research typically available for Treasury/IRS when regulating

Adapting distribution analysis to more complex settings

- Adjustments required when benchmark assumptions fail
  - Externalities and market failures
  - Policy changes that lead to large changes in marginal incentives
- Compliance costs can be understood as another form of modification to the distribution table
  - Benchmark is the estimate for maintaining current behavior
  - Adjustments required when policy changes lead to large changes in incentives

The baseline for analysis of tax regulations

- Tax regulations should be judged against a no-action baseline
    - Post-statutory in the case of new legislation
    - Current practice in the case of other regulations
- A no-action baseline focuses the analysis where it is most useful to policymakers and provides valuable transparency into the regulatory process
- JCT will have estimated the change in revenues and burden (exclusive of compliance costs) during the legislative process

Criteria for an economically significant tax regulation

- A tax regulation should be deemed economically significant if it
  - Increases or decreases revenues by more than $100 million in any year
  - Increases or decreases the sum of
    - the total tax change shown in a distribution analysis
    - total compliance costs

    by more than $100 million in any year
- Without normative assumptions cannot convert revenues and burden into benefits and costs, but can still use these impacts as indicators of the scale of the regulation
- Could increase the $100 million threshold given the scale of the tax system

Summary Recommendation

- The traditional tools of tax analysis are the appropriate tools for cost-benefit analysis of tax regulations
- Cost-benefit analysis of tax regulations should report revenue, distribution, and compliance cost estimates
- Social benefits and costs are not quantified in this approach, and should not be quantified