

# ISSUE BRIEF

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## Analyses of 2016 Candidates' Tax Plans Demonstrate That Dynamic Scoring Is Now Mainstream

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In a significant victory for proponents of better tax policy, dynamic scoring has replaced static scoring as the preferred method for estimating the effect of changes in tax policy by tax policy experts across the ideological spectrum. The final step in this process was taken when the Tax Policy Center (TPC) dynamically scored the tax plans of presidential candidates Hillary Clinton and Donald Trump.

Dynamic scoring accounts for fluctuations in the economy when families, businesses, investors, and entrepreneurs adapt their behaviors in response to changes in tax policies. It also incorporates how changes in the size of the economy affect tax revenue.

Static scoring, the previously accepted method for scoring tax policy, holds macroeconomic variables (such as the size of the economy or employment) constant when evaluating changes in tax law. It accounts for microeconomic changes in behavior. If Congress created a tax-preferred savings account, static scoring would capture the fact that families would reduce their taxable income by investing in the accounts. However, it does not take account of how behavioral changes alter macroeconomic factors. When changes in tax law are significant, static scoring has a tendency to produce large errors.

The economic policy community and the official tax and budget scoring agencies of Congress, the Congressional Budget Office (CBO) and Joint Committee on Taxation (JCT), hesitated to adopt dynamic scoring out of concern that dynamic scoring could not be done accurately or precisely enough for budgetary purposes due to the difficulty of modeling macroeconomic impacts. The convention that Congress should evaluate legislation based on the first-order merits of policy changes and not the feedback effects of those changes also supported the use of static scoring.

However, as the government has grown and recommended policy changes have become more significant relative to the size of the economy, excluding the macroeconomic feedback effects of legislation creates the possibility of increasingly significant errors. Such errors would mean that Congress could be working with inaccurate estimates of the cost of legislation.

### **The Shift to Dynamic Scoring**

A significant breakthrough for dynamic scoring came in early 2015 when Congress, in its joint budget resolution, required the CBO and JCT to dynamically score bills that had a sufficiently large impact on the economy, which it defined as more than 0.25 percent of gross domestic product (GDP).<sup>1</sup> The Heritage Foundation and the Tax Foundation have been dynamically scoring major tax legislation for years, demonstrating in their research that it is a marked improvement over static scoring. Both organizations dynamically scored the tax reform draft that then-Chairman of the House Ways and Means Committee Dave Camp (R-MI) released in 2014.<sup>2</sup> To its

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credit, the JCT also produced a dynamic score of the Camp draft even though it was not required to do so at the time.<sup>3</sup> The Tax Foundation subsequently dynamically scored the tax plans of all of the 2016 presidential candidates' tax plans, further exemplifying the efficacy of dynamic scoring.<sup>4</sup>

Nevertheless, dynamic scoring was not fully accepted across the ideological spectrum until the TPC used it to conduct its analyses of the Clinton and Trump tax plans.<sup>5</sup> Now that the TPC has accepted it, dynamic scoring is being conducted by all of the major players in the tax policy world, making it standard practice. Reverting to static scoring now would be akin to using the Postal Service to mail a letter rather than sending an e-mail or a text message.

The move to dynamic scoring is significant because it will provide Congress and the American public with more accurate and less biased information about how changes in the tax code will affect the economy and tax revenues. With more precise data, Congress will be able to make better informed and hopefully more transparent policy decisions.

Now that dynamic scoring is the accepted standard for fiscal policy analysis, the debate shifts to identifying best practices. While there is broad agreement about dynamic scoring practices, substantial differences in opinion exist in certain areas. Comparing the results of the dynamic analyses conducted by the Tax Foundation and the TPC on the 2016 candidates' tax plans illustrates the different methods of dynamic scoring.

## Dynamic Analyses of the Trump Tax Plan

Donald Trump's tax plan compresses the current set of seven tax rates into three brackets with rates of 12 percent, 25 percent, and 33 percent. The 33 percent top rate would be lower than the current 39.6 percent top rate. The plan lowers the top capital gains rate to 20 percent and the rate for businesses to 15 percent, although it remains unclear to which businesses the rate applies. The Trump plan allows more businesses to expense their capital purchases, although it maintains a worldwide tax system.

The Tax Foundation found that the Trump plan would grow the economy between 6.9 percent and 8.2 percent, depending on how it treats pass-through businesses.<sup>6</sup> If those businesses pay the 15 percent business rate, the plan would be more pro-growth. According to the Tax Foundation report, "the larger economy [is] due chiefly to the significantly lower cost of capital under the proposal, which is due to the lower corporate income tax rate and expensing for those firms that choose to adopt it instead of deducting interest."<sup>7</sup>

The TPC found smaller growth effects for the Trump plan than it found for the Tax Foundation. It estimates that the Trump plan would increase aggregate demand "by about 1.7 percent in 2017, by 1 percent in 2018, and by smaller amounts in later years." It also reports a range of growth estimates under varying assumptions. After less than 10 years, the TPC estimates that Trump's tax cuts would reduce the size of the economy.<sup>8</sup>

1. Senate Concurring Resolution 11, 114th Cong., 1st Sess., §3112, <http://www.gpo.gov/fdsys/pkg/BILLS-114sconres11enr/pdf/BILLS-114sconres11enr.pdf> (accessed October 19, 2016).
2. See Rea Hederman, John Ligon, and Rachel Greszler, "Heritage's Macroeconomic Estimate of Camp's Tax Reform Proposal," *The Daily Signal*, February 26, 2014, <http://blog.heritage.org/2014/02/26/heritages-macroeconomic-estimate-camps-tax-reform-proposal/>, and Stephen Entin, Michael Schuyler, and William McBride, "An Economic Analysis of the Camp Tax Reform Discussion Draft," *Tax Foundation Special Report* No. 219, May 2014, <http://taxfoundation.org/sites/taxfoundation.org/files/docs/SR219.pdf> (accessed October 19, 2016).
3. Staff Report, *Macroeconomic Analysis of the "Tax Reform Act of 2014,"* Joint Committee on Taxation, U.S. Congress, February 26, 2014, [https://www.jct.gov/publications.html?func=download&id=4564&chk=4564&no\\_html=1](https://www.jct.gov/publications.html?func=download&id=4564&chk=4564&no_html=1) (accessed October 20, 2016).
4. See Tax Foundation, "Comparing the 2016 Presidential Tax Reform Proposals," <http://taxfoundation.org/comparing-2016-presidential-tax-reform-proposals> (accessed October 19, 2016).
5. See James R. Nunns, Leonard E. Burman, Jeffrey Rohaly, and Joseph Rosenberg, "An Analysis of Donald Trump's Revised Tax Plan," *Tax Policy Center*, October 18, 2016, <http://www.taxpolicycenter.org/publications/analysis-donald-trumps-revised-tax-plan/full> (accessed October 19, 2016), and Richard Auxier, Leonard E. Burman, Jim Nunns, Ben Page, and Jeffrey Rohaly, "An Updated Analysis of Hillary Clinton's Tax Proposals," *Tax Policy Center*, October 18, 2016, <http://www.taxpolicycenter.org/publications/updated-analysis-hillary-clintons-tax-proposals/full> (accessed October 19, 2016).
6. Alan Cole, "Details and Analysis of the Donald Trump Tax Reform Plan, September 2016," *Tax Foundation Fiscal Fact* No. 528, September 19, 2016, <http://taxfoundation.org/article/details-and-analysis-donald-trump-tax-reform-plan-september-2016> (accessed October 19, 2016).
7. *Ibid.*
8. Nunns et al., "An Analysis of Donald Trump's Revised Tax Plan," p. 14.

The TPC sees short-term growth resulting from the Trump tax plan because it increases after-tax incomes for most households, which they would likely spend, and because the expensing provisions would increase business investment.

### Dynamic Analyses of the Clinton Tax Plan

Hillary Clinton's plan is mostly a collection of tax increases, including:

- A 4 percent surcharge on adjusted gross incomes (AGIs) over \$5 million;
- A 30 percent minimum tax for AGIs over \$1 million (the so-called Buffett Rule);
- Limiting the value of itemized deductions to 28 percent;
- Increasing capital gains tax rates;
- Capping individual retirement accounts (IRAs);
- Raising the death tax rate to 65 percent for estates over \$1 billion and reducing the exemption amount from \$5 million to \$3.5 million per person; and
- Assessing an exit tax on businesses that move overseas to reduce the tax burden on income.

Recently, Clinton added an expanded child tax credit, which would increase the current tax credit from \$1,000 per child to \$2,000 per child and increase how much of the credit is refundable. This expansion would cut taxes for families earning up to \$200,000.

The Tax Foundation found that Clinton's plan would reduce GDP by 2.6 percent after 10 years because of "somewhat higher marginal tax rates on capital and labor income."<sup>9</sup> The TPC found that Clinton's plan would reduce GDP by less than the Tax Foundation's estimate. It estimates that the size of the economy would decline "by 0.4 percent in 2017, by 0.2 percent in 2018, and by smaller amounts in later years." The TPC also reports a range of estimates for

those years based on varying assumptions. After 10 years, the TPC estimates that Clinton's tax increases would expand the economy slightly.<sup>10</sup>

The TPC estimates short-term economic decline because Clinton's plan would raise taxes and therefore reduce incomes for high-income households, which means they would spend less. The plan would further reduce growth because it would reduce incentives for business investment.<sup>11</sup>

### Comparing Different Approaches to Dynamic Scoring

Despite the fact that the Tax Foundation found significantly higher levels of growth for Trump's plan and a greater negative economic impact for Clinton's plan than the TPC found, there are several important areas of agreement. Most notably, both models find that allowing businesses to expense or immediately deduct the cost of capital expenses rather than deducting them slowly over many years through depreciation has a strong positive impact on the economy.

The Tax Foundation and TPC analyses of the two tax plans differ in their estimates of the long-term effects of each plan and in the rate of economic growth that would result from each because of differences in their models and in the assumptions they make, most importantly about the effect of changes in the deficit.

The Tax Foundation's model, the Taxes and Growth Model, is a price-based model that estimates changes in the size of the economy based on how tax policy changes the price of labor and capital. The model assumes that people and businesses respond to changes in incentives. For instance, if Congress reduces tax rates on work and capital, the model assumes that there will be more work and more capital accumulation across the economy because of the decline in the price of doing those things. Hence, the economy will grow larger than it would have absent the change in tax policy.

The TPC uses two different models to conduct its dynamic analysis. For the short-term impacts of the plans (the first few years after implementation), it uses a Keynesian model that estimates how macroeconomic factors change based on how much

9. Kyle Pomerleau, "Details and Analysis of Hillary Clinton's Tax Proposals, October 2016," Tax Foundation *Fiscal Fact* No. 531, October 12, 2016, <http://taxfoundation.org/article/details-and-analysis-hillary-clinton-s-tax-proposals-october-2016> (accessed October 20, 2016).

10. Auxier et al., "An Updated Analysis of Hillary Clinton's Tax Proposals," pp. 14-15.

11. Ibid.

after-tax income households and businesses have and their propensity to spend that income. For instance, if the after-tax incomes of middle-income families increase due to a policy change and the model assumes that their propensity to consume is 100 percent, then the model will show that aggregate demand (in other words, the economy) grows by the amount after-tax incomes grew for all middle-income families. For long-run dynamic changes, the TPC uses the Penn-Wharton Budget Model (PWBM), which accounts for changes in incentives *and the budget deficit*.<sup>12</sup>

The large differences in the findings of the organizations regarding the long-term effects of the Trump and Clinton plans is key to understanding how their differing assumptions affect their analyses. The Tax Foundation sees growth from the Trump plan expanding over time; the TPC sees growth declining and turning negative in those years. Conversely, the Tax Foundation estimates that the Clinton plan will depress growth more over time, whereas the TPC sees the plan suppressing growth less and eventually resulting in positive growth.

These disparities exist because of differences in how the Tax Foundation and the TPC treat changes in deficits and the degree to which “crowding out” occurs when they rise.<sup>13</sup> In textbook examples, crowding out occurs when deficits rise and the government soaks up more of the available capital economy. The capital the government takes to fund higher deficits is therefore not available for families, businesses, and entrepreneurs to borrow and invest, which drives down private investment and lowers GDP. Crowding out also increases interest rates as the supply of available capital decreases and lenders demand higher rates. Those higher rates also contribute to crowding out. In models that assume large effects from crowding out, the reduction of investment and therefore GDP offsets in varying degrees

the growth effect from policies that increase the deficit, such as tax cuts.

The degree to which crowding out actually occurs in the real world is subject to considerable debate.<sup>14</sup> How much of an impact it has within different models depends largely on how open an economy is to the rest of the world in the model. If an economy is fully integrated with global markets and does not impede the inflow and outflow of capital, crowding out is less of a factor because foreign investors can purchase new government debt rather than the new government debt being purchased by domestic investors that otherwise would have made loans to domestic families and businesses.

The Tax Foundation assumes that the U.S. economy is fully open in their model, which means that when deficits rise because of tax cuts, as in the Trump plan, enough savings enters the country from abroad to purchase the extra government debt. Hence, the government does not soak up too much of the available domestic capital available for businesses and families to invest, and there is little to no crowding out of private investment.

Conversely, the TPC assumes a less open economy and a large crowd-out effect (\$0.60 of every additional \$1 of government borrowing comes from domestic savers, similar to the assumptions that the CBO makes<sup>15</sup>). In the TPC’s model, Trump’s tax cuts depress growth in the long run because the increased debt crowds out private investment more and more over time. Eventually, the reduction of investment is more than the increase in growth from greater incentives for production.

For Clinton’s plan, the TPC’s model assumes that the increased revenue will decrease the deficit, which will reduce crowding out and in turn increase investment. This is why the model finds that growth increases in later years. However, the TPC’s model does not account for the fact that Clinton does not

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12. Nunns et al., “An Analysis of Donald Trump’s Revised Tax Plan,” p. 13.

13. Alan Cole, “Comments on the Penn Wharton Budget Model and Candidate Tax Plans,” Tax Foundation *Tax Policy Blog*, October 17, 2016, <http://taxfoundation.org/blog/comments-penn-wharton-budget-model-and-candidate-tax-plans> (accessed October 21, 2016).

14. See Alan Cole, “The Deficit, Interest Rates, and Growth,” Tax Foundation *Fiscal Fact* No. 503, March 8, 2016, <http://taxfoundation.org/article/deficit-interest-rates-and-growth> (accessed October 21, 2016), and Richard Rubin, “Is the Federal Budget Deficit an Urgent Problem?” *The Wall Street Journal*, October 20, 2016, <http://blogs.wsj.com/economics/2016/10/20/is-the-federal-budget-deficit-an-urgent-problem/> (accessed October 21, 2016).

15. Curtis S. Dubay, “2017 Budget Analysis Shows CBO Methods Need Improvement,” *Tax Notes*, August 29, 2016, <http://www.taxnotes.com/tax-notes-today/tax-history/2017-budget-analysis-shows-cbo-methods-need-improvement/2016/09/15/18601446> (accessed October 21, 2016).

plan to use the increased revenue to increase spending, which means that deficits will not decline due to higher taxes and crowding out will not decrease. The TPC makes that clear in its report.<sup>16</sup>

## Conclusion

Although the Tax Foundation and TPC models use different approaches, they are both serious and economically grounded methods for accomplishing the difficult but feasible task of dynamically estimating complex changes in the tax code. The debate over dynamic scoring now shifts to resolving differences in approach. In the near term, the question of crowding out will be central. Replacing biased and inaccurate static scoring with the more precise dynamic scoring is a significant victory for those working toward tax reform.

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16. Auxier et al., “An Updated Analysis of Hillary Clinton’s Tax Proposals,” p. 10.