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A Framework for Economic Analysis of Tax Regulations

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Executive Summary

In April 2018, the U.S. Treasury and the Office of Management and Budget (OMB) agreed to a new process under which OMB would review tax regulations prior to their release. Under this agreement, the analytic requirements imposed on economically significant non-tax regulations apply to many more tax regulations than in the past. However, neither OMB nor Treasury have issued a formal statement about their approach to conducting economic analysis of tax regulations. Moreover, applying OMB's standard guidance for regulatory analysis to tax regulations would bias the regulatory process against raising revenue and stopping abuse, and would impair the effective administration of tax law.

This brief outlines an alternative framework for the economic analysis of tax regulations that can aid Treasury and the IRS in the development of effective regulations. The resulting analysis would also provide legislators and the public with the relevant information for assessing tax regulations' economic merits.

Treasury and the IRS should conduct a formal economic analysis of regulations in two cases. First, for regulations that implement recent tax legislation, the agencies should conduct an analysis if they have substantial discretion in designing the regulation and if different ways of doing so would vary substantially in their economic effects. Second, for regulations unrelated to recent legislation, the agencies should conduct an analysis if the regulation would have large economic effects relative to current practice.

The economic analysis conducted in these cases should focus on the revenues raised and the economic burden imposed on the public as a result of the agencies' exercise of discretion or the new application of existing authority. The revenues raised and the burden imposed reflect the fundamental tradeoff in taxation, and thus determine a regulation's costs and benefits. However, the analysis should not attempt to quantify the net benefit or net cost of a regulation as doing so would require the agencies to make controversial assumptions about the social value of revenues and the appropriate distribution of the tax burden. Treasury's Office of Tax Analysis is well-equipped to provide estimates of revenues and burden as they can be built from analyses the Office already produces: revenue estimates, distributional analyses, and compliance cost estimates.

We are optimistic that an increased role for economic analysis has the potential to improve tax regulations, but the experience since the April agreement raises significant concerns. The new review process has delayed the release of guidance implementing the 2017 Tax Act, and it has increased the resources required to complete each regulatory project. However, there is little evidence to suggest it has improved the resulting regulations. Should that continue to be the case, it raises a more fundamental question of whether the new review process should be continued. Absent improvements, a future administration may want to consider reverting to the more limited review of tax regulations that existed prior to the recent agreement between Treasury and OMB.

Introduction

In April 2018, the U.S. Treasury and the Office of Management and Budget (OMB) agreed to a new process under which OMB would review tax regulations prior to their release. Previously, most tax regulations were not formally reviewed by OMB. This brief focuses on one aspect of the new agreement: it applied the analytic requirements for economically significant non-tax regulations to many tax regulations that were not subject to those requirements in the past. Critically, however, the details of the analysis required were left unspecified in the agreement.

This ambiguity has had predictable consequences. The analyses of proposed regulations implementing the 2017 Tax Act have thus far provided little useful information for either regulators or the public. Partly, this reflects growing pains as OMB expands its oversight to an area where it does not yet have experience or expertise. More than anything else, however, the limited value of these analyses reflects the lack of a clear conceptual framework for Treasury and the IRS to follow. Existing OMB guidance and practice, which was developed with non-tax regulations in mind, is not well-suited to the analysis of tax regulations. As a result, important regulations—including those necessary to implement the 2017 Tax Act—have been mired in an unproductive review process. This review process has delayed the rollout of major reforms and left businesses and individual taxpayers facing considerable uncertainty, without generating demonstrable improvements in the resulting regulations.

Existing review practices are governed primarily by Executive Order 12866 and OMB's Circular A-4 (OMB 2003). Circular A-4 provides concrete instructions to agencies describing the analysis of costs and benefits they should conduct for significant regulations. However, Circular A-4 defines tax revenues as a transfer that generates no net benefits. According to this perspective, any tax system would appear to fail a cost-benefit test: taxation consumes real resources and provides no net benefits. Defining the net benefits of tax regulations in this way thus biases the regulatory process against raising revenue, the core purpose of the tax system.

This brief proposes an alternative framework for the economic analysis of tax regulations that would provide regulators and the public with the relevant information for assessing the economic merits of those regulations, and which fulfills the requirements for cost-benefit analysis established by Executive Order 12866. The framework is an attempt to structure the analysis of tax regulations around the issues that are important for policymakers and the public, and to draw out the modes of economic analysis that are most useful in improving regulations.

In outlining a framework for economic analysis, we focus on three core components: (1) the baseline against which to evaluate the effect of the regulation, (2) the criteria for whether the regulation is economically significant (and thus a formal analysis should be required), and (3) the substance of the analysis itself.

The baseline—the counterfactual scenario against which the effects of a regulation being proposed or finalized are judged—matters not just in determining whether the regulation is significant but also in determining which features of the regulation receive the most scrutiny. Tax regulations should be judged against a baseline that reflects current practice. In the case of regulation unrelated to recent legislation, a current-practice baseline is the world as it would be absent the regulation. In the case of regulations implementing new legislation, the baseline should assume the regulation has already been adopted—the practice envisioned by Congress when they enacted the legislation. While Treasury and the IRS issue regulations to clarify any major legislative change, the legislation itself is largely self-executing. Taxpayers are required to pay tax according to the new law regardless of whether Treasury and the IRS regulate. Moreover, prior to enacting legislation, Congress receives analysis regarding its major economic effects from the Joint Committee on Taxation. Members of Congress—and the staff of the Joint Committee on Taxation when conducting their analysis—assume that Treasury and the IRS will issue implementing regulations.

The use of a baseline that assumes that the regulation being proposed or finalized has already been adopted means that the core of the analysis of implementing regulations is the evaluation of regulatory alternatives that Treasury and the IRS could have selected but did not. This choice of baseline focuses the analysis where it is most useful—on the discretion Treasury and the IRS have in deciding how to regulate—and where it provides valuable transparency into how legislators' intent is being carried out. This approach also provides a consistent benchmark against which to assess the extent of regulators' discretion so as to differentiate regulations that are not themselves significant, because there is no regulatory discretion, from those that are.

A regulation should be deemed economically significant only if either (1) the change in revenues or (2) the sum of the changes in economic burdens across families exceeds a specified threshold in a given year. A regulation implementing new legislation for which the baseline assumes that the regulation being proposed or finalized has already been adopted should be deemed economically significant if either of these tests is met for a reasonable alternative approach to designing the regulation.

Finally, the economic analysis of a tax regulation should focus on evaluating the impact of the regulation on revenues and on the economic burden imposed on each family. In practice, when conducting an economic analysis of a tax regulation, this means Treasury and the IRS should produce and report a standard set of analytic elements: (1) a revenue estimate, (2) a distribution analysis, and (3) an estimate of compliance costs. These are measures policymakers already use when designing tax legislation and are standard products for the U.S. Treasury's Office of Tax Analysis. Together the distribution analysis and the estimate of compliance costs form the basis for an analysis of the impact on economic burden.

Revenues and burden are the critical ingredients for understanding the economic consequences of regulatory tax changes. Indeed, the tools we recommend using were developed to illustrate the effects of legislative tax changes on exactly these quantities. The burden of a tax regulation on a family in a calendar year is the economic impact of the regulation on that family in that year. In practice, the tax burden can be summarized in a distribution analysis supplemented by estimates of compliance costs. Appropriately constructed, estimates of burden and revenues reflect the full array of economic effects of a regulation, including changes in behavior such as increased tax avoidance or increased labor supply.

In theory, Treasury and the IRS could convert the impacts on revenues and burden into social costs and benefits by making assumptions about the social value of the marginal dollar of revenues and the appropriate distribution of the tax burden. Indeed, elected officials and their appointees making judgments about tax policymaking will necessarily—if implicitly—be making judgments about the value of revenues and the appropriate distribution of the tax burden when they do so. The premise of the framework we propose, however, is that the views of political officials on these issues should not be incorporated into the economic analysis itself. Their views would be subjective and controversial. Instead of taking an explicit stance on these issues, the economic analysis of proposed tax regulations should provide transparency into the relevant economic tradeoffs.

As a practical matter, the framework recommended here can be challenging to implement. Often the analysis will require data or assumptions for which little direct evidence is available, and frequently it will be more appropriate to conduct a qualitative analysis then imply a false precision through speculative quantitative estimates. Nonetheless, the proposed framework is the appropriate one in which to conduct a useful economic analysis of tax regulations.

We are optimistic that an increased role for economic analysis can help to improve tax regulations. However, to realize these gains, a suitable conceptual framework for the economic analysis of tax regulations is essential. Thus, Treasury and the Office of Management and Budget should agree to use the framework proposed in this brief to evaluate tax regulations, and OMB should issue guidance to that effect.[1]

While a sounder framework for the economic analysis of tax regulations would be more informative for regulators and the public, even if our proposed framework were adopted it is not clear whether the benefits of OMB oversight exceed the costs and hence whether the review process should be continued. The review process delays the release of regulations and guidance and increases the resources required to complete each regulatory project. While OMB review is promoted as a way to reduce political influence in the regulatory process and provide a second opinion regarding regulatory choices, the experience of this process for tax regulations thus far fails to live up to that standard.[2] Absent improvements, a future administration may want to consider reverting to the more limited review of tax regulations that existed prior to the recent agreement to expand review.

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1. Treasury and OMB would also need to revise the April memorandum of agreement, which contained the criteria determining whether a tax regulation is economically significant, for consistency with the proposed approach.

2. See, for instance, the analysis of proposed regulations under section 199A, which omits a discussion of politically sensitive, legally ambiguous, and potentially economically significant choices like excluding real estate brokerages from the class of businesses providing “brokerage services” and excluding banking from the definition of “financial services.”

This brief first explains why new guidance is necessary for evaluating the economic effects of tax regulations. It then presents our recommendation for how Treasury and the IRS should conduct the economic analysis. Next, we evaluate the approach taken to this point by Treasury and the IRS in issuing regulations implementing the 2017 Tax Act in light of the proposed framework. Finally, it considers the application of this framework to the proposed regulations for the deduction for income from pass-through businesses created by the 2017 Tax Act and to the proposed regulation regarding state programs that allow a credit against state taxes for certain charitable contributions. The latter application differs starkly from the analysis of the regulation offered by Treasury and the IRS and highlights the need for a new approach to the economic analysis of tax regulations.

Why New Guidance is Necessary

Existing OMB guidance on conducting the economic analysis of regulations is contained in Circular A-4. The framework for economic analysis set forth in Circular A-4 is well suited to assessing the costs and benefits of non-tax regulations when distributional impacts are a secondary concern. However, this framework provides little guidance in the case of tax regulations due to the assumption that "the revenue collected through a...tax is a transfer payment" combined with the instruction that "[y]ou should not include transfers in the estimates of the benefits and costs of a regulation. Instead, address them in a separate discussion of the regulation's distributional effects." This treatment obscures the relevant tradeoffs because it implies that certain effects of a tax regulation should be enumerated as social costs (e.g. compliance costs), while the core purpose of raising revenues should be treated as offering no net benefits—even though Congress enacted the tax system for that very purpose. As a result, the analysis would provide a biased picture of the economic tradeoffs involved in imposing taxes.[3]

While the treatment of revenues as a transfer makes sense for the analysis of mandates intended to correct market failures, it is poorly suited to tax analysis. Indeed, taking the A-4 framework at face value, any tax system would appear to fail a cost-benefit test: taxation consumes real resources, like taxpayers' time and IRS enforcement costs, and discourages productive activity, such as work and investment, solely to transfer resources from the public to the government.

Publicizing a measure of net benefits based on this framework introduces a clear bias against enforcement, revenue collection, and the intent of Congress to impose taxes. If regulators assume that one dollar in the hands of the public has the same value as one dollar on the government balance sheet they are effectively assuming there is no reason to raise

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3. Treating revenues as a transfer is the central limitation in conducting cost-benefit analysis of tax regulations according to the guidance of Circular A-4. However, there are also important conceptual ambiguities in Circular A-4 regarding the treatment of deficits, the role of offsetting policies, and the role of income effects. It also embeds implicit assumptions about the appropriate distribution of the tax burden.

revenues. Consequently, the rules that pass muster will be, in most cases, those that collect the least revenue.

In addition, this approach ignores the central role of tax regulations in improving the efficiency of the tax system in a relative sense. A regulation improves the relative efficiency of the tax system if it raises revenues at a cost that is lower than the marginal cost resulting from increasing rates. Adopting such a regulation in combination with a reduction in tax rates (or a reduced need to raise future tax rates) would improve the overall efficiency of the tax system. A traditional understanding of tax regulation would deem regulations in this class, such as those limiting emerging tax avoidance strategies, to be highly desirable.

A useful economic analysis of tax regulations must allow for the possibility that raising revenues has value. In principle, it is possible to conduct a cost-benefit analysis by assigning a specific social value to each dollar of government revenues that exceeds one dollar. Indeed, the natural theoretical analog to the maximization of net benefits in the tax context is the theory of optimal taxation, in which the social marginal benefit of additional tax revenue (based on the use of the revenues) is compared against the social marginal cost of the burden on taxpayers from taxes paid and forgone economic activity. While conceptually the most complete approach, assuming specific values for these parameters in the regulatory analysis is undesirable as it would require analysts to adopt an explicit judgment on the value of revenues and the appropriate distribution of the tax burden.

These normative issues are an intrinsic element of tax policymaking and political officials leading the regulatory process will necessarily be making judgments on these issues, but the economic analysis conducted for regulations should not assert a single, correct answer. In other words, these judgments should be kept separate from the economic analysis. The tax profession has developed a suite of analytic tools to illustrate the tradeoffs policymakers face when developing tax legislation. These tools provide information about the impact of legislators' choices but do not dictate normative conclusions. The same tools should be used for evaluating tax regulations.

Economic Analysis of Tax Regulations

Economic analysis can help policymakers and the public understand the effects of adopting a proposed regulation, clarify the tradeoffs involved, and enhance accountability. Below we outline a framework for the economic analysis of tax regulations that would achieve these ends. The core elements of the analysis are those used to evaluate legislative tax proposals: revenue estimates, distributional analyses, and compliance cost estimates. These analyses would require Treasury and the IRS to be explicit about the economic effects of the regulation: how much revenue would be raised and what burden raising that revenue would impose on the public.

This approach fulfills the requirements of Executive Order 12866. It is also consistent with the underlying conceptual architecture of Circular A-4. The quantities measured and reported in the recommended approach—revenues and burden—reflect the fundamental tradeoffs of taxation expressed in dollar terms and are exactly those ingredients that regulators and the public could use to construct estimates of social benefits and costs if they were to make the necessary value judgments. In other words, the approach we recommend is consistent with the underlying framework that motivates A-4 but stops short of making value judgments to reach conclusions about net benefits. Any effort to go beyond the conceptual framework of this brief to reach a specific quantitative estimate of net benefits effectively makes assumptions about the use of funds and the appropriate distribution of the tax burden.[4]

Defining the Baseline

The traditional core of regulatory analysis is a comparison of the economic outcomes assuming a rule takes effect to the economic outcomes under a baseline scenario. Hence, the definition of the baseline is essential. The baseline should be specified such that the resulting analysis usefully informs regulatory decisions and facilitates transparency into regulators' actions.

As a general rule, tax regulations should be judged relative to a baseline that reflects current practice. In the case of regulations unrelated to recent legislation, a current-practice baseline is the state of the world had regulators not issued the new rule. However, there is an inherent ambiguity in the use of a current-practice baseline for regulations implementing new tax legislation, such as the 2017 Tax Act. In this case, the baseline should assume that the regulation being proposed or finalized has already been adopted—the practice envisioned by Congress when they enacted the legislation. Of course, using this baseline means that the regulation being proposed or finalized has no effect. Instead, the core of the analysis becomes the analysis of regulatory alternatives.

A post-statutory, post-regulation baseline for implementing regulations is appropriate for both theoretical and practical reasons. First, while Treasury and the IRS issue regulations to clarify any major legislative change, the legislation itself is largely self-executing. Taxpayers pay tax according to the new law regardless of whether Treasury and the IRS regulate. The self-executing nature of tax legislation contrasts with many regulatory mandates. The Clean Air Act, for example, directed the Environmental Protection Agency to establish air quality standards through regulation but the law itself did not specify the standard. The post-regulation baseline for tax regulations focuses the analysis where it is relevant and useful to decision-makers and provides transparency into how legislators' intent is being carried out.

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4. The marginal revenue rule of Weisbach, Hemel, and Nou (2018) is an example of this type of approach.

A second and related reason to adopt a post-statutory, post-regulation baseline for implementing regulations is that Congress receives information about the likely effects of legislation during the legislative debate. The Joint Committee on Taxation (JCT) produces estimates of the revenue and distributive impacts of legislation, and that information is generally predicated on the assumption that any necessary implementing regulations will be issued. In enacting legislation, Congress has made a judgment that the change in revenues and burden resulting from the legislation are desirable, and JCT's analysis has estimated and documented those effects. This stands in contrast to legislation creating new regulatory authority unrelated to taxes and spending. In those cases, Congress often does not receive an analysis indicating the costs and benefits of the regulations that will be issued under that authority. Instead, the newly-empowered agency is tasked with identifying appropriate regulations. It thus makes sense that the agency would engage in detailed analysis of proposed regulations, which reflect a policy that has not been subject to scrutiny previously.

Starting with the post-statutory, post-regulation baseline for new legislation and using that baseline to evaluate a series of alternative regulatory options not pursued has additional practical advantages. It streamlines regulatory analysis and reduces the delay between the enactment of tax legislation by Congress and the release of guidance clarifying important issues. In the case of the 2017 Tax Act, for instance, most of the law went into effect on January 1, 2018, but Treasury and the IRS continue to release regulations providing basic guidance on the law and will do so for years. In cases where regulators have little discretion regarding the policy, the post-statutory, post-regulation baseline and alternative feasible scenarios would be little different. An economic analysis would convey little or no additional information to legislators relative to what they were provided by the Joint Committee on Taxation during the legislative process. Such analysis could then be reduced or eliminated, avoiding the costs of regulatory delays.

Using a post-statutory, post-regulation baseline would require that Treasury and the IRS identify hypothetical scenarios in which different regulations are issued. This is exactly where regulatory analysis is useful and important, because it asks the regulating agency to identify, articulate, and rigorously examine the effects of regulatory alternatives and to produce that analysis publicly. The information developed in that process offers the greatest potential for identifying improvements in regulations and shines a light on the decisions made by regulators. Notably, current guidance from the Office of Management and Budget already instructs agencies to include a discussion of regulatory alternatives in their analysis of a regulation. Thus, these are not new requirements; they simply make this portion of the analysis the central focus.

The emphasis on discretion in this framework has parallels in the distinction between interpretative and legislative regulations that governed the OMB review of tax regulations prior to the recent agreement to expand review. Under this prior arrangement, legislative regulations were subject to formal review by OMB while interpretative regulations were exempt. Interpretative regulations are those that restate the law or fill in the gaps in rules specified by Congress. Legislative regulations are those where legislation provides for an end result and delegates to the agency the authority to achieve that result.

In one sense, the definition of the baseline for implementing regulations proposed here fleshes out an alternative, more explicit delineation between regulations that interpret unambiguous statutes and those that exercise discretion. However, a key difference between the prior arrangement and the framework proposed here is that certain interpretative regulations that would have been exempt from OMB under the prior arrangement may be deemed economically significant—and thus subject to the associated analytic requirements—using a current-practice baseline. Namely, if Treasury and the IRS issue interpretative regulations that use existing authority in a new way in response to broader economic developments, those regulations would potentially be economically significant even if the agencies had limited discretion in deciding whether or how to respond to those developments. For example, in the case of the recently proposed regulations relating to contributions made to certain charitable organizations for which a credit against state tax is provided, Treasury and the IRS were compelled to act by statute, but the regulations were still economically significant relative to a current-practice baseline.

One potential alternative baseline for implementing regulations would be a post-statutory baseline that assumes Treasury and the IRS do not issue any regulations. The key advantage of such an approach is that it would clarify why Treasury and the IRS issue implementing regulations and offer a measure of the benefits of those implementing regulations. The disadvantage of this approach is that it would require Treasury and the IRS to speculate about a scenario in which the agencies do not issue any guidance on major elements of the tax code, an implausible scenario for which the economic analysis would be inherently speculative. Moreover, this analysis would be inconsistent with the analysis provided by the Joint Committee on Taxation during the legislative process, which assumes reasonable regulation.[5]

Defining an Economically Significant Regulation

Formal economic analysis, referred to as a regulatory impact analysis, is required for regulations deemed economically significant. A regulation should be deemed economically significant if either the change in revenues or the sum across the entire population of the changes in burden for each family exceeds a specified threshold in any year in the first decade after the regulation takes effect.

A regulation implementing new legislation that uses the post-statutory, post-regulation baseline should be deemed economically significant if either of the tests above is true for a

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5. Regulations could also be judged against a pre-statutory baseline. However, in the case of complex tax legislation, this baseline will generally be of no use. Regulations are issued for specific provisions of tax law, raising complex questions about the interactions between different provisions of the law that result from the sequence in which regulations are released. At best, the analysis will be duplicative of the Joint Committee on Taxation's analysis. At worst, it will be meaningless.

reasonable regulatory alternative.[6] The interpretation of a reasonable regulatory alternative is necessarily ambiguous. However, it is the discretionary authority that Treasury and the IRS have that is the appropriate and useful subject of analysis of implementing regulations. And it is this discretion that should determine whether the rulemaking is economically significant or merely a restatement and clarification of the legislation enacted by Congress and analyzed by the Joint Committee on Taxation during the legislative process.

Non-tax regulations are deemed economically significant if their gross economic impacts exceed $100 million in any year. However, a higher value for determining significance would be appropriate here for at least two reasons. First, the $100 million threshold was specified in 1993 and has never been adjusted for inflation or economic growth.[7] Second, the tax system operates at an economy-wide scale and thus even minor regulations can generate very large impacts on revenue and burden. In such cases a formal economic analysis would not be worth the cost. We make no explicit recommendation on the level of the threshold in this brief.

The definition above deliberately excludes from the class of economically significant regulations implementing regulations for which Treasury and the IRS have—and exercise—limited discretion. For example, Treasury and the IRS sometimes issue regulations that largely amount to a restatement of the legislation. While the legislation itself may well have had dramatic effect, requiring an economic analysis from Treasury serves little purpose and requires resources that likely could have been devoted to more useful activities.

Even without an explicit threshold for significance, a few generalizations are possible. Criteria of this form would likely have included some regulations implementing the 2017 Tax Act, such as the regulations under section 199A (the deduction for income from pass-through businesses) or section 965 (the transition tax), because the potential scope of regulatory authority was broad. However, they would likely also have excluded other regulations where there was limited regulatory flexibility, such as the regulations under section 168(k) (expensing) and potentially the regulations under section 163(j) (interest limitations). Finally, this definition also includes regulations like those issued under section 385 (regarding the distinction between debt and equity) during the Obama administration, which took up unused regulatory authority and would have had large effects.

The Substance of the Economic Analysis

As discussed above, economic analysis can and should help policymakers and the public understand the effects of adopting a proposed regulation, clarify the tradeoffs involved, and enhance accountability.

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6. For purposes of determining significance, regulatory alternatives that could together form a coherent alternative regulation should be combined. Thus, a regulation may be significant even when there is no single provision that is significant.

7. An adjustment for this reason would be merited for non-tax regulations as well, though such regulations are beyond the scope of this brief.

The fundamental tradeoff in taxation is between the economic burden imposed on the public (including compliance costs) and the revenues collected. As we use the term here, the burden of a tax regulation on a family in a calendar year is the economic impact of the regulation on that family in that year. Burden is a disaggregate concept, and, in practice, will often be estimated using a distribution analysis supplemented by estimates of compliance costs. Appropriately constructed, estimates of burden and revenues reflect the full array of economic effects of a regulation, including changes in behavior such as increased tax avoidance or increased labor supply.[8]

Taxes impose burden (including compliance costs) to raise revenues. Thus, the economic analysis of tax regulations—and the regulatory impact analyses Treasury and the IRS produce—should focus on measuring the impacts of a proposed tax regulation on the burden on the public (including compliance costs) and revenues. These impacts can be illustrated in a distribution analysis, a compliance cost analysis, and a revenue estimate.

One approach to conducting economic analysis of tax regulations—in the spirit of academic cost-benefit analysis—would be to attempt to convert these impacts on revenues and burden into social benefits and social costs. However, quantifying the social benefits and costs of a proposed tax regulation would require Treasury and the IRS to assume a social value of revenues and take a stance on the appropriate distribution of the tax burden. These assumptions would be inherently controversial and would reflect a clear departure from efforts to base regulatory analysis on evidence rather than normative judgments. Moreover, these assumptions could be set to justify any range of regulatory alternatives. As a result, the conclusions of the analysis would not be persuasive to those who did not agree with the normative assumptions in the first place.

Instead of taking an explicit stance on these issues, the economic analysis of proposed tax regulations should be structured to provide transparency into the relevant economic tradeoffs. Decision-makers in Treasury and the White House, as well as members of Congress and the public, can use these inputs to form their judgments about the merits of a proposed regulation. However, these judgments should be kept separate from the underlying economic analysis. That analysis should produce estimates of revenues, burden, and compliance costs and proceed no further.

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8. Most tax regulations increase or decrease revenues. As a result, relevant economic concepts—including excess burden and efficiency—are often un- or ill-defined. However, if all regulations included lump-sum offsets to neutralize any deficit impact, then the burden measure we propose would reflect the increase or decrease in excess burden from the policy change (ignoring compliance costs), the welfare impact of any change in compliance costs, and transfers across families. (The deficit impact in this case would, of course, be zero and thus no longer relevant.) In practice, for regulations that increase or decrease revenues, the burden measure we propose is intended to reflect the dollar-valued impact of the regulation on the period utility function and is motivated by an application of the envelope theorem. The inherent ambiguities of the analysis that result from the incompleteness of any policy that affects the deficit are shunted into the long run (for which no analysis is conducted). Any attempt to do a long-run or present-value welfare analysis would thus run into the same challenges that make efficiency and excess burden un- or ill-defined. While cost-benefit analysis of non-tax regulations typically ignores these issues, such an approach is not appropriate for tax regulations as the primary economic reason that the tax system exists is to manage the government's intertemporal budget constraint by raising revenues.

As with any non-tax regulation, identifying the key quantities of interest is far easier than estimating the values of those quantities. Impacts on revenues and impacts on burden summarize a wide array of economic impacts, each of which may require a separate and complex analysis, and all of which can vary with the specific substance of the proposed regulation. Estimating impacts on revenue and burden could require estimates of impacts on avoidance behavior, labor supply, and prices, for example. The central observation of this brief, however, is to recognize that these analyses should be summarized in the form of impacts on revenues and burden. Moreover, note that there is no requirement that the impact on revenues and the impact on burden have the same sign. In theory, at least, it is possible to raise revenue while lowering burden and to lower revenues while increasing burden. In the legislative context, for example, a base-broadening, rate-lowering reform could lead to this combination of outcomes.

The remainder of this section will consider the estimation of these quantities in greater detail.

Revenue Estimates

The first element of the economic analysis of a tax regulation is the impact of the regulation on revenues. This estimate, like revenue estimates in general, reflects a comparison between current law and regulation and a counterfactual in which the regulation takes effect. (For regulatory alternatives, the comparison is between the alternative regulation and the regulation as designed.)

Revenue estimates are typically conducted on either a conventional basis, in which macroeconomic aggregates such as income are held fixed (but microeconomic behavior may change), or a dynamic basis, in which these macroeconomic aggregates are allowed to vary. Dynamic analysis is complicated by the need to model long-run economic behavior and to make assumptions about how the deficit evolves and other factors. For instance, a major challenge of the latter mode of analysis is that any change that increases or decreases the deficit necessarily leads to ever increasing or ever decreasing budget deficits in the infinite horizon, which analytic methods are ill-suited to evaluating. Typically, such analyses assume either an explicit policy change to restore budget balance in the future or stop the analysis before the behavior becomes explosive.[9]

In evaluating potential tax regulations, the desired mode of analysis would be one reflecting all future behavioral changes except those reflecting future federal policymaking (legislation or regulation). Such an analysis would reflect the microeconomic behavior embedded in a conventional score, changes in macroeconomic aggregates embedded in a dynamic score, and other changes in behavior often excluded from dynamic scores, such as changes

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9. Notably, formal economic modeling generally imposes a government budget constraint, which binds at the optimum. That the constraint binds indicates that it has a first-order impact on the outcomes. Thus, even when a change in deficits is not thought to have a significant economic impact in the short-term, to assume that deficits do not have a first-order impact in present value is to assume, effectively, that deficits do not matter. This would have radical implications for tax and non-tax policies.

in the behavior of foreign governments. However, in practice, many of these dimensions of behavior may be negligible for any particular regulation.

These revenue estimates should also reflect any changes in IRS behavior that would result as a change in the regulation. Such effects are typically excluded from revenue estimates for legislation.[10] For example, the Health Coverage Tax Credit extension enacted as part of the Trade Preferences Extension Act of 2015 cost $173 million according to the score produced by the Joint Committee on Taxation (Congressional Budget Office 2015). Yet administering the credit required substantial IRS resources, plausibly of the same order as the transfer itself (Fernandez 2015). This increase in resources was not reflected in the score itself nor did the legislation appropriate money for this purpose. Thus, the IRS redirected resources to administer this provision. That redirection could have reduced revenues elsewhere. The revenue estimate for a regulation should include such costs. (In the case of the Health Coverage Tax Credit, the reallocation of IRS resources may also have increased compliance costs for the public, which should be reflected in the estimate of the impact of the regulation on compliance costs, discussed below.)

In general, Treasury is well equipped to estimate the revenue impact of regulations. Revenue estimates are already a core input in the development and evaluation of tax legislation, and Treasury staff frequently estimate revenue impacts for a wide variety of policy proposals.

In practice, revenue estimates for many regulations will require data or analysis that does not exist, such as empirical estimates of behavioral responses to changes in technical definitions. This challenge is not unique to tax regulations, of course, but given the nature of the regulations Treasury must issue it is likely to be a more substantial hindrance in quantifying the impacts of regulations. While this brief focuses on establishing the appropriate conceptual framework for conducting cost-benefit analysis of tax regulations, the practical challenges of implementing this framework can be significant.

Distribution Analysis

The second element of the analysis is the impact on the public in the form of a distribution analysis. Distribution analysis can be understood as a form of applied welfare analysis in that it estimates the impact of a change in tax law on the well-being of the public. In other words, distribution analysis provides an estimate of the change in the tax burden. (In practice, compliance costs, which contribute to burden, are excluded from distribution analyses and examined separately. Conceptually, however, they could be estimated as part of the same analysis.)

Distribution analysis typically ignores changes in behavior in estimating the impact of changes in tax law. With the caveats below, this is the appropriate mode of analysis in the

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10. Administrative costs are not included in the analysis separately because their implications are reflected in revenue estimates and compliance cost estimates as described here and in the section below.

case of proposed tax regulation as it yields a first-order approximation to the change in utility. Distribution analysis also shows how the impact of the change in tax policy is allocated throughout the population. It is most frequently conducted to illustrate variation across the income distribution, but heterogeneity in impacts can also be explored by other individual characteristics (such as age or family structure) or business characteristics.

Distribution analysis provides an estimate of the change in the tax burden precisely because it relies on the assumption that people do not change their behavior in response to a change in tax law. It is a standard result in microeconomic theory that—in evaluating the impact of a policy change on the well-being of an optimizing agent—changes in the agent's behavior in response to the policy change can be ignored and only the direct impact of the policy change is relevant (Leiserson 2017).[11]

Distribution analysis requires incidence assumptions, which are themselves assumptions about price changes that result from a change in tax law. In this sense, a distribution analysis is itself reflective of the broader economic analysis required to evaluate a proposed tax regulation. Indeed, one major challenge in conducting distribution analysis of tax regulations is that it will likely require more complex incidence assumptions that may be less well understood than those used in modeling common legislative proposals.

Distribution analysis can require other adjustments to be interpreted as burden analysis in more complex settings. Market failures, behavioral imperfections, and other similar violations of competitive assumptions can require adjustments to distribution analysis to retain the burden interpretation.[12] In the case of a carbon tax, for example, the utility gains from reduced environmental damages should be added to the utility losses shown in a traditional distribution analysis of the underlying excise tax to obtain the estimates of burden required for economic analysis of tax regulation. These types of adjustments could be required for regulations relating to taxes on public health hazards or that affect decisions for which behavioral imperfections are likely quantitatively important. Very large changes in policy can also require changes in the analysis. The potential need for these adjustments again reflects the fact that the impacts on revenues and burden reflect a wide array of underlying economic effects and are not simple paint-by-numbers exercises.[13]

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11. Distribution analyses produced by the U.S. Treasury's Office of Tax Analysis rely on the assumption that people do not change their behavior (U.S. Treasury 2015). In contrast, distribution analyses produced by the congressional Joint Committee on Taxation include a larger set of behavioral changes. For the reasons discussed here, the approach used by the U.S. Treasury likely provides a better estimate of the change in burden and thus is the correct approach for use in conducting economic analysis of tax regulations in the framework recommended here.

12. The core revenue and distribution analysis framework proposed here corresponds to the "public allocation" analysis recommended in Wallace (2018). The modifications to that analysis referenced in this paragraph correspond to the "private allocation" analysis.

13. As noted above, the burden measure we propose is intended to reflect changes in utility. Distribution analysis delivers an approximation to these changes motivated by the envelope theorem. Adjustments are required when the assumptions of the envelope theorem are violated. The scenarios described in this paragraph are precisely those in which the envelope theorem does not apply.

As with revenue impacts, Treasury is well-equipped to conduct distribution analysis. Distribution estimates are a standard element of the legislative and policy development process, and Treasury has been at the forefront of innovations in the conduct of distribution analysis over the past three decades.

Compliance Cost Estimates

The third element of the analysis is an estimate of the compliance costs associated with the proposal. Estimates of compliance costs are less frequently estimated as part of the legislative process. In part, this may reflect the fact that for many proposals changes in compliance costs are negligible relative to other impacts. For example, a change in a tax rate leads to large changes in revenue and distributive impacts with very little impact for the compliance costs of individual taxpayers. At the same time, provisions with a small revenue impact can have compliance costs much larger relative to that revenue impact (as was the case of administrative costs in the Health Coverage Tax Credit example above).

In evaluating a regulation, changes in compliance costs should be understood as an element of the change in burden. Conceptually they could be included directly in the distribution analysis, but, in practice, they are estimated separately. As with the distribution analysis itself, compliance cost impacts should be estimated under the assumption that behavior does not change other than to fulfill the obligations that arise directly from the regulation such as completing forms, maintaining appropriate documentation, and the like. (The parallel assumption in distribution analyses is that people pay tax according to the new regulation but do not change their underlying behavior.) To the extent that a regulation increases the compliance costs associated with maintaining the same behavior as was occurring prior to the regulation, then the total increase in burden is the sum of the higher tax payment (shown in a distribution analysis) and the additional compliance costs.[14]

As with revenue estimates and distribution analyses, Treasury has experience in estimating compliance cost impacts of legislation and regulation and is well-equipped to produce these analyses in the case of developing new regulations.

Supplemental Analyses

Revenue estimates, distribution analyses, and compliance cost estimates should form the core of the economic analysis. They answer the questions of how much revenue is raised and what the burden of that revenue increase is on various members of the public. In addition to these core elements, other supplemental analyses may be appropriate.

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14. Just as in the case of a distribution analysis, adjustments to the compliance cost analysis may be required in certain cases, such as those in which where there are large changes in the private incentives to engage in certain behavior. Indeed, in such cases the conceptual distinction between the change in the tax payment shown in a distribution analysis and the change in compliance costs can break down and a direct focus on utility impacts may be more useful.

For example, supplemental analysis could examine an economic effect of the regulation that affects welfare but does not manifest in the revenue or burden estimates. Then a supplemental analysis evaluating this issue could be useful, though it is important to distinguish the welfare-relevant measure of the economic effect from discussion of the effects in general. Changes in the tax treatment of nonprofits that lead to changes in the availability of services typically provided by charitable organizations, for example, might be difficult to translate into a revenues and burden framework, and may be more usefully evaluated in a supplemental analysis.

This issue may also arise when significant non-tax issues are implicated in a regulation. For example, the Affordable Care Act relied extensively on the tax system to implement the system of regulations and subsidies underlying the reforms to the market for individual health insurance. In such a scenario, the economic analysis of tax regulations related to the Affordable Care Act might appropriately consider supplemental analyses as they relate to the functioning of the individual market for health insurance.

More broadly, many tax expenditures are designed to promote non-revenue policy goals, such as retirement savings, home ownership, and educational attainment. In evaluating regulations relating to these tax expenditures, it may be appropriate to provide a supplemental economic analysis of the regulation's impact on those goals.

Another mode of supplemental analysis that may be appropriate is analysis of the regulation being proposed or finalized combined with additional policies to offset any resulting changes in the federal deficit. This type of balanced-budget analysis reflects the long-run tradeoffs in tax policy. However, the additional tax or spending policies used to offset any resulting change in deficits (either positive or negative) will necessarily be hypothetical. This type of analysis is most useful when changes in tax policy both (1) increase or decrease the deficit substantially and (2) have short-run behavioral effects that are large relative to the deficit impact such that the short-run analysis that is the focus of this brief would provide a misleading picture of the true tradeoffs involved in the regulation. While this type of analysis tends to have greater relevance to tax legislation than regulation, the recently proposed regulations relating to state programs that provide credits against state tax would be a scenario in which this type of analysis could be appropriate.

Treasury's Approach to Date

Neither the Office of Management and Budget nor Treasury have issued a formal statement about their approach to conducting economic analysis of tax regulations. However, some insights as to the emerging approach can be gleaned from a study of the economic analyses for regulations implementing the 2017 Tax Act released to this point. We focus here on the regulations proposed under sections 965 (the transition tax), 199A (the deduction for income from pass-through businesses), 951A (the tax on global intangible low-taxed income, or GILTI), and the regulations relating to state laws that provide credits against state tax for charitable contributions to specified organizations.

The recurring theme in the regulatory impact analyses (RIAs) for these proposed regulations is an emphasis on efficiency. The RIA for the 199A regulations, for example, asserts at the beginning of each section on anticipated benefits that the proposal will implement the deduction in "an economically efficient manner". The RIA for the GILTI regulations states "[i]n developing these proposed regulations, the Treasury Department and the IRS have generally aimed to apply the principle that an economically efficient tax system would treat income derived from similar economic decisions similarly, to the extent consistent with the statute and considerations of administrability of the tax system." The state and local tax (SALT) charitable contribution regulations assert that the "proposed regulations likely reduce economically inefficient choices motivated by the potential tax benefits described above if these proposed regulations were not promulgated."

However, it is not possible to measure the efficiency impacts of tax regulations that increase or decrease revenues without assuming some offset or ignoring the role of the government budget constraint entirely. In the case of tax regulations, ignoring the government budget constraint makes any analysis uninformative. How can one know whether a revenue-reducing tax regulation increases or decreases efficiency if you don't know how the government budget constraint will be satisfied? As a result, efficiency analysis of regulations that increase or decrease revenues is not strictly about the proposed regulation, but the proposed regulation in combination with other (unspecified) policies. Moreover, the implicit (and unstated) assumption of treating revenues as a transfer—that lump-sum taxes are used to close the budget constraint—provides little useful guidance as it assumes there are no net benefits in raising revenue and it discourages the adoption of regulations that would improve the tax system relative to its current state.[15]

In addition to the misplaced emphasis on efficiency, there is a striking absence of discussion of revenues in the regulatory impact analyses released to this point.[16] Raising revenues is the primary purpose of the tax system, and as such any economic analysis of tax regulations must necessarily discuss the revenue impacts. This is particularly striking in the case of the SALT charitable regulations, discussed in greater detail below, which would raise substantial revenues (likely measured in the hundreds of billions of dollars over a decade) relative to a baseline in which the regulations were not issued and the credits widely adopted.

While the focus on efficiency and the dismissal of revenues is inappropriate, there is a close relationship between the analysis of revenues and burden recommended in this brief and . . .

15. A lump-sum tax is a hypothetical change in taxes that exactly offsets the change in deficits that results from a policy and does not affect prices or other similar financial incentives. A $1,000 tax charged to every U.S. citizen regardless of income, consumption, or any other behavior would be a lump-sum tax, for example. In the special case of a revenue-neutral regulation it is possible to evaluate the efficiency impact of a proposed regulation without assuming offsetting policies. However, equating net benefits and efficiency in this case would still imply a normative stance on the appropriate distribution of the tax burden that is inconsistent with the stance implied by the statutory framework establishing the tax system. Thus, even in this case, the cost-benefit analysis required by Executive Order 12866 should not be interpreted as an efficiency analysis.

16. A notable exception to this generalization is the foreign tax credit regulations issued in November 2018, the analysis of which notes the potential for reduced federal tax revenues. This reference to revenues is a positive development and hopefully indicates that increased attention will be paid to revenues going forward. Nonetheless, the RIA for these regulations continues to emphasize efficiency.

the analysis that is presented in the RIAs for these recent regulations under the label of efficiency. Two examples from the 199A regulations illustrate these relationships.

One of the anticipated benefits of the proposed 199A regulations is that they "will discourage the creation of tiered partnerships purely for the purposes of increasing the section 199A deduction….Such an organizational structure would likely be economically inefficient because it was, apparently, created solely for tax minimization purposes and not for reasons related to efficient economic decision-making."

Reframed as an analysis of revenue impacts and burden, discouraging tiered partnerships would increase revenues and increase burden, but the implicit judgment in including the provision in the regulation is that the increase in burden would be modest relative to the increase in revenues. Absent the regulations, Treasury posits that businesses would create tiered partnerships to avoid tax. By discouraging the creation of tiered partnerships, the regulation would eliminate this avoidance opportunity and raise revenue. In doing so it imposes burden. However, because reorganizing business affairs to avoid the tax would impose a cost that the businesses would no longer incur when the avoidance strategy is prohibited, the burden imposed is modest.

A similar reframing applies to the analysis of the aggregation rules of the proposed 199A regulations. Here Treasury states "Allowing taxpayers to aggregate trades or businesses offers taxpayers a means of putting together what they think of as their trade or business for the purposes of claiming the deduction under 199A without otherwise changing ownership and management structures. If such aggregation were not permitted, certain taxpayers would restructure solely for tax purposes, with the resulting structures leading to less efficient economic decision-making." In this case, the proposed regulation would reduce revenues modestly and reduce burden more substantially, by allowing taxpayers to achieve tax savings without reorganizing their businesses.

Notably, in addition to discussion of efficiency, certain RIAs have also emphasized equity. The 965 regulations identify the issue of taxpayers paying the tax once, twice, or not at all on the same type of income, for example. This analysis can be reframed as a distribution analysis as recommended in the body of this paper. This analysis is thus a useful component of the analysis. It considers the distribution of burden across different taxpayers. Of course, the appropriateness of including these effects in the conceptual framework does not make the quantification of which businesses pay the tax once, twice, or not at all any easier. Indeed, many of the factors discussed here will be quite difficult to quantify in practice.

Finally, the RIAs do discuss compliance costs. Discussion of compliance costs is entirely appropriate and can be understood as an addition to the burden calculation.

Treasury and the IRS appear to have adopted a post-statutory, no-regulation baseline for the case of implementing regulations. In contrast, we propose a post-statutory, post-regulation baseline for implementing regulations. The key difference between the two is that the former shows an impact of the regulation itself, while the latter ignores this effect and focuses the analysis instead on the comparison of regulatory alternatives that could have been adopted. A core benefit of implementing regulations is the reduction in compliance costs that results from clarity, but estimation of this impact will be inherently speculative as it requires assumptions about scenarios in which Treasury and the IRS do not issue regulations on major provisions of tax law. These scenarios are outside observed experience. Moreover, estimation of this impact will generally be only tangentially related to the analysis of regulatory alternatives that could guide refinements to the analysis.

Nonetheless, while it uses a different baseline, much of the analysis that Treasury has done to date (including the examples from 199A above) can be usefully reframed as the analysis of potential regulatory alternatives of the type that should be included in the analysis of implementing regulations using the post-statutory, post-regulation baseline we propose.

What Should Treasury and the IRS Have Done Differently? Applications to SALT and 199A

We conclude with two applications of the framework in this paper: to the proposed regulations regarding credits against state taxes for charitable contributions to certain specified organizations and to the proposed regulations under 199A (the new deduction for income from pass-through businesses).

The application to the SALT charitable contributions regulation demonstrates the value of the proposed approach. It is straightforward to implement, clarifies the key economic impacts of the proposed regulation, and allows regulators and the public to make their own judgments about the merits of the regulation. The application also illustrates the limitations of analyses that assume that revenues are worth $1 in the hands of the public and on the government balance sheet. Though Treasury did not explicitly adopt such a perspective in the analysis, taken at face value Circular A-4 would require such an approach. And, in this case as in many others, such an approach would have failed to provide useful guidance, identifying regulations widely applauded by the tax community as having negative net benefits.

The application under 199A shows that the proposed framework remains the appropriate one for more technical regulations—providing information that regulators can use to refine and improve potential regulations. However, it also highlights the difficulty of quantifying certain impacts. Indeed, for these types of regulations, qualitative statements will often be more appropriate. In addition, this application highlights that the primary value of economic analysis for implementing regulations lies in comparing regulatory alternatives, not in determining whether to regulate or not.

SALT Charitable Contribution Regulations

Prior to the 2017 Tax Act, charitable contributions and state and local taxes were treated largely symmetrically by the individual income tax. Both provided the taxpayer with an itemized deduction. After the 2017 Tax Act, charitable contributions are treated much more favorably than state and local taxes for high-income taxpayers. As a result, several state legislatures proposed or enacted laws that would allow taxpayers to make payments that would be eligible for charitable tax treatment for federal tax purposes and largely replace their state and local tax obligations. In August 2018, Treasury and the IRS proposed regulations that largely forbid this type of strategy.

Treasury and the IRS, in our view correctly, adopted a baseline under which existing guidance would have allowed the charitable SALT workarounds. Had the agencies not regulated, many states accounting for a large share of state tax revenues would have adopted these types of workaround arrangements as they are easy to set up and operate.[17]

Per the framework proposed above, the economic analysis should focus on estimating impacts on revenues, burden, and compliance costs.[18] We address each of these in turn.

First, compared to a baseline under which these programs would have been widespread, shutting down these workarounds would raise substantial revenues, likely in the hundreds of billions of dollars over the next decade. A key element of the regulatory impact analysis for the SALT charitable contributions regulation should be a formal estimate of this revenue impact.

Second, in addition to this revenue estimate, Treasury should have produced a distribution analysis for the proposed regulation showing the impact of the proposed regulation against a baseline in which many states have adopted charitable SALT workarounds. This distribution analysis would have highlighted two things. First, the aggregate tax increase shown in the distribution analysis would be larger than the revenue estimate for the proposal due to behavioral changes. These distribution estimates are estimates of the burden imposed on taxpayers.[19] Second, it would have shown that the distribution of the increase in burden

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17. Notably, while the current-practice baseline is appropriate in the case of the SALT regulations as it reflects a new use of existing regulatory authority not explicitly contemplated by the congressional Joint Committee on Taxation during the legislative process, it is likely not appropriate to consider the regulation discretionary. Allowing the unrestricted use of the charitable contribution workarounds is contrary to statute and congressional intent, and thus Treasury and the IRS were—in an important sense—obligated to regulate.

18. We focus in this brief on the impact of regulations on federal revenues but impacts on state and local revenues should also be reported when they are quantitatively important. If analysts anticipate a large change in state and local revenues because of these regulations, such an effect would be appropriately estimated and reported in the analysis.

19. As noted throughout, treating a dollar in the hands of different people and the government as having the same social value embeds assumptions about the social value of government spending and the appropriate distribution of the tax burden. Thus, the economic analysis should stop at the point of estimating these impacts and should not draw conclusions about their value.

would be highly progressive, a distributional impact that policymakers may wish to incorporate into their decision-making process.[20]

Finally, Treasury should have estimated compliance costs for the proposed regulation. The net impact of the compliance costs would reflect the combined impact of the reduction in compliance costs due to the elimination of the charitable contributions workarounds and the increase in compliance costs due to use of other workarounds. (The use of other workarounds should also be reflected in the revenue and burden estimates.) However, in practice, quantification of these compliance cost changes would be of relatively limited importance as they likely are a fraction of the estimates for the revenue and distributive impacts above.

In contrast to many implementing regulations, where the reduction in compliance costs provides the primary justification for regulation, the change in compliance costs is largely irrelevant for the SALT charitable contribution regulations. The merits of this regulation are determined by the impacts on revenues and burden. Indeed, this proposed regulation is at the scale of major tax legislation in terms of its impact on those quantities.

At its core, the large revenue estimate for the regulation is the economic case for proposing it. Treasury, again correctly in our view, determined that it would be inappropriate and inconsistent with Congressional intent to allow the use of charitable contributions as a means of avoiding the limitation applied to state and local tax deductions in the 2017 Tax Act. Of course, raising this large quantity of revenue necessarily imposed substantial burden.

This analysis is starkly different from the analysis presented in the regulatory impact analysis (RIA) for the proposed regulation. The primary benefit identified in the RIA is a reduction in socially wasteful tax avoidance behavior and a corresponding reduction in complexity and paperwork burdens. A secondary benefit is more equal treatment of donations to different organizations. The primary costs identified are compliance costs associated with contributions that generate state tax credits that are still made after the regulations take effect.[21]

Judged relative to the approach that would result from a direct application of Circular A-4, the RIA is incomplete in one important way: it does not address behavioral responses resulting from higher effective marginal tax rates as a result of the loss of a de facto state and local tax deduction. Indeed, under this approach, in which any change in revenues is offset by a change in lump-sum taxes, the SALT charitable contribution regulation almost certainly reduces efficiency. The implicit question in such an analysis is whether an increase in the marginal tax rate for high-income taxpayers increases revenues at lower cost to those

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20. The incidence assumption used in this analysis should reflect state policy changes that affect the burden to the extent they are quantitatively important. The magnitude of these effects is highly uncertain, but they would likely reduce the progressivity of the regulation to the extent they exist.

21. A number of pre-existing state programs also generate state tax credits for charitable contributions, many of which would likely continue to exist even after the regulations take effect.

taxpayers than an equivalent lump-sum tax. The answer is almost certainly no notwithstanding the costs of using the charitable contributions workaround.

That the SALT charitable contribution regulation almost certainly has negative net benefits under a direct application of Circular A-4 is not a reason not to finalize the regulation. It is a reason to reject that approach as it does not provide useful guidance in evaluating tax regulations. Declaring widely supported regulations to have negative net benefits because they would reduce aggregate social welfare assuming a hypothetical use of funds and a specific normative stance on the appropriate distribution of the tax burden would undermine the credibility of the regulatory process and discourage high value regulations. Treasury should revise the regulatory impact analysis for the SALT charitable contribution regulation to focus on revenues, burden, and compliance costs.

Regulations under 199A

The 2017 Tax Act created a deduction for income derived from pass-through businesses in a new section 199A. Taxpayers may deduct 20 percent of qualifying income, subject to restrictions based on the wages paid by the business, the capital invested in the business, the type of business, and other factors. The ambiguities of the statutory language have led to substantial uncertainty about the application of the provision and a clear need for guidance from Treasury and the IRS. The agencies have stated their intent to provide multiple rounds of guidance on the application of the new section and proposed the first batch of regulations in August 2018.

Again, the appropriate framework for evaluating the proposed regulation is one of revenues, burden, and compliance costs.[22] However, as a regulation implementing the 2017 Tax Act, this analysis should rely on a post-statutory, post-regulation baseline. In other words, Treasury and the IRS should focus the analysis on the economic effects of their exercise of discretion, not the enactment of section 199A itself or the mere existence of implementing regulations. Using this framework would have allowed Treasury and the IRS to clarify the economic impacts of the proposed regulation in relation to the effects estimated by the congressional Joint Committee on Taxation during the legislative process and would have guided refinements to the regulation. In contrast, the analysis of the proposed regulation provides little insight into the economic effects of the regulation, and Treasury and the IRS missed opportunities to use the analysis to refine the regulation.

Consider the aggregation provision mentioned above. An alternative regulation under which businesses were not allowed to aggregate their operations for purposes of determin-

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22. Traditional methods of distribution analysis are less well-suited to evaluating the changes in burden discussed in this section than they are many other types of changes. This reflects both the nature of the issues implicated by 199A and the resulting behavior. The 199A regulations would thus be an example of a regulation that would require specialized methods to evaluate changes in burden. Nonetheless, as noted in the text, the tradeoff between revenues and burden remains the fundamental tradeoff facing regulators and the appropriate focus of the economic analysis.

ing the 199A deduction would increase revenues and increase burden. According to Treasury's analysis, in this alternative scenario businesses would engage in costly restructuring to avoid tax. Thus, an alternative regulation under which businesses were not allowed to aggregate would result in only a modest revenue gain and a relatively larger increase in burden. The implicit judgment in proposing the aggregation provision is that providing a reduction in tax via the aggregation rules offers an advantageous tradeoff between revenues and burden and thus this alternative is inferior to the proposed regulation.

An analysis of a regulatory alternative in which aggregation is not allowed using a framework focused on revenues, burden, and compliance costs makes clear what impacts Treasury and the IRS anticipate from this provision and provides guidance in refining the regulation. In developing regulations Treasury and the IRS should be looking for alternatives that improve the tradeoff between burden and revenues. Nonetheless, quantifying these impacts would be exceptionally difficult. Thus, for these types of regulations, it will often be the case that the revenues and burden frame motivates the conceptual exercise, but the analysis is ultimately limited to qualitative statements about the impacts of the regulation.

A similar reframing can be applied to the analysis of many other provisions of the proposed 199A regulation. For example, Treasury's analysis of several provisions (such as the rules for netting of gains and losses in 199A-1) can be understood as anticipating an increase in revenues and burden resulting from reduced avoidance, but in these cases Treasury and the IRS implicitly judge the tradeoff between revenues and burden as suggesting the proposal consistent with higher revenues is appropriate. Thus, alternatives in which the regulation did not include these provisions would reduce revenues and reduce burden, but the implicit judgment is that the reduction in burden would not justify the reduction in revenues.

In addition to reframing the current analysis, Treasury and the IRS should have used the economic analysis to evaluate other specific choices that were made in the proposed regulation relative to alternatives that were not explicitly discussed, again in terms of revenues and burden. Consider the definition of specified service trades or businesses, businesses the income from which does not qualify for the deduction.

The proposed definition includes a very narrow reading of the term "reputation or skill" and provided treatment of certain activities and occupations (e.g. banking and real estate brokers) that was broadly viewed as quite favorable. These choices are not discussed in the regulatory impact analysis, but they should be. In both cases, Treasury likely reduced revenues and reduced burden relative to alternatives that included a broader definition of reputation and skill or otherwise excluded more business activities from those eligible for the deduction. As always, whether the proposed definition is desirable as an economic matter depends on the relative change in revenues and burden. Given the number of businesses potentially covered by a broader reading of the term reputation or skill, this is likely one of the more quantitatively significant elements of the regulation. Thus, analysis of this choice should have been a key component of the regulatory analysis.

The use of the post-statutory, post-regulation baseline for implementing regulations reflects the fact that the economic analysis of such regulations is more important for selecting between regulatory alternatives than in determining whether or not to regulate. There was no plausible scenario in which Treasury and the IRS would not issue regulations under 199A, and the obligation to make clear what the tax law is (and the resulting reduction in compliance costs) form the case for doing so. Nonetheless, precisely because it would have been inappropriate for Treasury and the IRS not to regulate under these provisions, attempting to generate precise estimates of this reduction in compliance costs is not of substantial value to policymakers or the public.

In contrast, Treasury and the IRS could and should have used the regulatory impact analysis to evaluate the choice to treat income from banks as eligible for 199A, for example. How much revenue was lost as result of this choice? Which taxpayers experienced a reduction in burden and what was that reduction in burden?

Conclusion

The tools of economic analysis can be applied to proposed tax regulations to determine the likely effects of the regulations and to help identify and contextualize the tradeoffs involved. However, judging the merits of the regulation requires taking a normative stance on highly controversial issues: the value of revenues and the appropriate distribution of the tax burden. Rather than suggest that there exists an apolitical answer to these questions, the economic analysis of tax regulations should be structured to provide transparency into the relevant economic tradeoffs and thereby provide policymakers the information they need to make informed decisions. To that end, the Office of Management and Budget should issue new guidance specific to the case of tax regulations that directs Treasury and the IRS to focus the analysis on revenues and burden and not to make a conclusion about social benefits, social costs, or net benefits.

As noted at the outset, this brief focuses on how to conduct an economic analysis of tax regulations that provides useful information to regulators and the public. Unfortunately, the analysis for proposed regulations implementing provisions of the 2017 Tax Act has been of limited value in this regard. Should that not improve, it raises a more fundamental question of whether the review process should be continued. The review process increases the resources required to complete each regulatory project and delays the release of regulations. The experience to date suggests the review process itself may not pass a cost-benefit test. Absent improvements, a future administration may want to consider reverting to the more limited review of tax regulations that existed prior to the recent agreement between Treasury and the Office of Management and Budget.

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