INTERVIEW

Dr. Jane G. Gravelle

By Jasper L. Cummings, Jr. and Alan J.J. Swirski*

Dr. Jane G. Gravelle is Senior Specialist in Economic Policy with the Congressional Research Service of the Library of Congress. She has worked at the CRS since 1969. She is familiar to most tax professionals because over the years her reports have addressed the most important tax issues of the day. We previously interviewed Jane in 1999. The views stated below do not represent the views of the Congressional Research Service.

Q The use of "dynamic scoring" to estimate the revenue gains and losses of tax proposals has been in the news lately. Please summarize the recent changes in official rules concerning dynamic scoring of tax bills and tell us what effect you think the changes will have.

A What has happened recently is that the House rules have changed to require a point estimate to be included as a feedback effect in the official revenue scores for legislative proposals. Previously the Joint Committee on Taxation's estimates of the macroeconomic effects of proposals were advisory and they usually had a range of models and elasticities and effects. Now they have to choose a point estimate. On the one hand, a lot of people are concerned about incorporating these estimates into the official revenue estimates of bills because they might encourage revenue losing bills. On the other hand, because the JCT will have to make a decision about the point estimate, there will be less ability to cherry pick from their numbers anymore. I think the change might tend to make tax reform legislation a little more likely, but I think there are other issues that overwhelm that.

Q In our 1999 interview we did not talk about the taxation of foreign income, and yet today it seems to be the centerpiece of many proposals for major tax changes. How are proposals in the foreign area likely to fit into larger tax legislation and how important do you think it is to make dramatic changes in the taxation of foreign business income?

A I would say the system we have now is very imperfect, and also there ought to be a way to improve on it. Right now we have deferral and also these new companies with intangible assets apparently have been shifting a lot of their profits abroad and leaving them there. So there is this huge accumulated unrepatriated income that we have not taxed. I do not really think there is a big distortion in investment from what we have now, so it may not be that important whether we go to a system that currently taxes worldwide income or to a territorial system or something in between, like a lower tax on foreign source income. Most countries where business makes real physical investments have effective tax rates that are marginally similar to ours. I actually calculated some of those in a paper I wrote on international tax rate comparisons.

I think the real issue that is going on now with the taxation of foreign source income is that there is a lot of profit shifting going on. My report on tax havens showed the growth between 2004 and 2010 in the multinational profits in tax havens where holding companies are located (such as the Netherlands) and the growth is astonishing. When I looked in 2004, the Cayman Islands had multinational profits that were about 650% of Cayman Island GDP. Now it is over 2000%. So there has been a huge increase in the revenue estimates of deferral by the Treasury Department and by the Joint Committee on Taxation. As a result, I think income shifting is what now affects tax revenues more than shifts in real economic activity.

But the biggest tax expenditure in the foreign area right now is deferral. So if you were to eliminate deferral you would raise a lot of revenue which you could use for rate reduction, but there are a lot of companies opposed to that. I think the repatriation problem is less serious than a lot of people say it is. In fact there is a theory that says repatriation taxes and dividends really do not matter, that foreign income is kind of trapped abroad already one way or the other. But we could do some compromise—apply a lower rate to foreign income and get less revenue that way. If you go to a territorial tax system, you really are going to need some strong effective anti-abuse rules or it will make profit shifting even worse.

I think we could improve on the current system, but the choice of which way we go depends on a lot of factors. I mean if you were just standing aside and looking at maximizing U.S. welfare, you would say end deferral, tighten up on inversions, and collect that revenue. But, I am not sure that is the outcome that we are going to see. As I said, you can get rid of repatriation taxes by ending deferral, by moving to a territorial tax, or doing anything in between, such as a lower tax rate plus a requirement that you repatriate a certain portion of foreign income. There are a lot of ways to do an intermediate system.

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Q You have previously identified the 1970s as an era when a different kind of organized business interest group tax lobbying appeared, and it grew in following decades. Has tax lobbying changed since we last talked?

A I think if anything business lobbying for tax benefits has gotten worse. I mean, the impression I get here on Capitol Hill is that the large firms like Apple and Google are heavily lobbying in the international area because they want to be able to bring their profits back without paying taxes or paying as much tax. A recent example is the issue of the medical device tax. It is a tiny little tax, probably relatively unimportant. According to research I have done, it has very little effect on jobs simply because demand for medical devices is very inelastic—you are not going to give up your pacemaker because the price goes up 2%, or 2.3%. Yet there is this very heavy lobbying effect by these large medical device makers that is elevating this little tax of minor importance into a major one—one that was part of the bargaining chips when the government was closed in 2013.

So if anything, I think tax lobbying has gotten worse. It is very hard for members of Congress to really hear an analysis that is not somebody looking for their own private interest.

Q Does the CRS self-identify provisions to study in this regard or must the studies be requested? To the extent it selects its own subjects for study, how is that done?

A When I decide to do papers as opposed to responding to requests, I just look at what Congress is talking about. So that is why I wrote something on dynamic scoring and that is why I write a lot on international tax issues. How other people decide, I do not know, but that is how I decide. I try to write papers that are about the issues before Congress, which is my obligation here.

Q You previously predicted that a value added tax would be hard to enact and since then the interest in a VAT or "flat tax" seems to have abated. But at some point does not the classic income tax reform formula of broadening the base and lowering the rates approach a sort of consumption tax?

A Well, that is not actually where we are heading right now. Basically the corporate rate reductions that were in the Camp proposal or the discussion papers that Baucus' Senate Finance Committee put out are all trying to broaden the base to pay for a corporate rate reduction. The only pressure I see moving towards a consumption tax base, and it has yet to be determined where we go, is bonus depreciation. So bonus depreciation was enacted in 2008. It was supposed to be a short term stimulus, but somehow it got in with the extenders and it keeps being extended. It would tend towards a consumption base, but it is a big revenue loser if you make it permanent. In general the tax reform efforts that I have seen remain squarely within the income tax framework.

If there is a flatter income tax rate structure, in order to move in the direction of a consumption tax you would still need expensing of investments. We are talking about the opposite, slowing depreciation, and in the Camp bill capitalizing advertising and R&D. So that is really not moving towards a consumption tax.

Q In our 1999 interview you mentioned the problem of accommodating to a price adjustment if a VAT were adopted and cited a possible 12% fall in GDP after enactment of a VAT. However, this problem does not seem to be much discussed. Is the explanation that proponents of income tax cuts (and possibly consumption tax increases) are not so concerned about the "demand side" as they are about the "supply side"? Does supply side economics as such still have supporters?

A Well, certainly supply side economics has lots of supporters. I do not know why people ignore this very crucial aspect of enacting a significant VAT, whether the VAT replaces the income tax or is added to raise a lot of revenue. The VAT would have macroeconomic effects on the economy either in pushing up inflation or pushing down output. My guess is that if we really got to the point where it looked like something was going to happen, the macroeconomists would notice and say something. It is just we have not gotten that far. Up to now the VAT has mostly been an academic issue, and so far the academics do not pay much attention to the effects on demand, maybe because they are tax people rather than macroeconomists. I do not have a good answer to that. I still think that is a crucial issue with moving to a value added tax.

Q Most proponents of decreasing the income tax on capital say that it would increase "savings and investment." Aren't those two different things? Perhaps taxing consumption would encourage people to save, and perhaps flooding banks with savings might lower some interest rates and entice businesses to borrow and invest in plant and equipment; but we have low interest rates right now and such investment is not occurring (or maybe not fast enough). So what is the relationship between savings and investment?

A Well, certainly savings and investment would be the same in the long run in a closed economy, but not in an open economy where some of your savings can flow abroad and some of your investment can come from abroad.

I think what we are seeing right now, or have been seeing, is not a long run effect, but the effect of reduced demand on investment. If you have reduced demand and you have excess capital, even very low interest rates are not going to induce you to spend. I think that is

really a consequence of the fairly serious recession that we just went through.

In the long run, I also am not sure about savings response to tax rates because it is hard to really get good evidence, but we have not seen the kinds of changes in savings rates when we cut taxes or when the interest rates rise that we would expect to. It is maybe just that people do not respond to rates of return, maybe they have targets for saving, so that is a very uncertain area. You can have an increase in investment by cutting corporate taxes, but even those results are small. There is a small response to corporate tax rates because capital flows from abroad are limited because of investors' preferences and also the constraints of the production function that limit how much capital you can absorb without pushing down the rate of return enough to end additional flows.

Q In 1999 you predicted that the then recent capital gains rate reduction would lose more revenue than planned. Since then we have had further reductions and have extended the capital gains rate to dividends. Did those reductions lose more revenue than predicted?

A I really have not looked closely at capital gains since then and you cannot always tell just by looking at a time series how much revenue has changed. I still do not think that the realization elasticity is very high. I think it is low, so I really think when you cut the capital gains tax you lost revenue, definitely you lost it with the reduced taxation of dividends, which do not have that kind of realizations response. So I think those preferences lost revenue.

Q "Tax reform" is popular again. Does "tax reform" have an objective meaning or is it just the term we like to apply to the tax change we like today?

A Well, I guess I am more inclined to say that latter—that tax reform is defined very differently by very different people. I think economists would say tax reform is something that increases at least one of the goals of taxation without making others a lot worse: efficiency, that is eliminating distortions in the tax system, equity and fairness, at least maintaining the current distribution, and simplicity. Simplicity is sort of always there and often not paid much attention to. So that is how I would define a reform as opposed to just a change. You can have changes that worsen things.

Q Is there anything that you are currently working on that you can talk about and that you would like to comment on?

A Well, I do think the claims for big economic growth effects, or even big efficiency effects from tax reform, need to be considered very carefully. When the Joint Committee estimated the Camp bill, they used two models. One of the models they used was called an overlapping generations model. It is a model where individuals optimize over their lifetimes. They have perfect foreknowledge, perfect information, and they behave perfectly rationally. I doubt how well the model works to explain savings.

But they also added onto this a model that JCT obtained from John Diamond and George Zodrow at the Baker Institute at Rice University. That model introduces something very strange related to the Camp proposal that would impose lower tax rates on intangible investments which shift the ownership of intellectual property out of tax havens into the United States. There is some doubt about how much effect that might have since a zero rate is better than anything. But even if a tax change did prevent sending IP offshore, it would not change anything real. I mean, if you moved the rights to sell advertising for Google from Ireland back to the United States, that is not going to change anything Google does. If you move the area of the patents where Lipitor is held, that is not going to change how people make pills. They are not going to suddenly lose the formula. Or Apple is not going to lose access to technology for items made in Singapore or China because the patent is moved back to the United States. That does not make any sense. And yet, it was treated in this modeling as a type of capital that can be moved back to the United States.

That proposal is responsible for a good piece of the large effect on output that was found for the Camp bill. The Joint Committee's estimates found an increase in GDP for their own in-house model of 0.2% or 0.1% over the ten years. This other model found 1.5%. There are a lot of reasons things like that happen, but a significant piece of that, probably over a half of the difference between this model and the other one, is due to this treatment of intangibles which just does not make any sense to me. Apparently it does not make sense to other people. William McBride at the Tax Foundation made the same set of comments about that. So, we do have to be careful in revenue estimating to make sure that ideas are vetted and have gotten general approval and is not just some kind of new idea that has really been largely untested. I think the JCT has good people, and I think their job, which is very hard, has been made much harder. They are going to have to work hard at things like that and say just what is in a range of estimates. We have to decide what we think is a legitimate way to estimate these effects.

Q Which government organization makes "official" revenue estimates of tax proposals?

A Officially it is only the Joint Committee on Taxation. That is what only they do. I can comment on it, I can talk about it, but I am not responsible for it. Only they are responsible for it. The Treasury has not done anything like dynamic scoring recently, and they do not really have a role in scoring. I am sure the Treasury analysts and the JCT analysts talk to each other, but it is basically just the Joint Committee on Taxation that would determine all of that.

Q Is there anything else you would like to add?

A We really need to look at these extenders, including things like bonus depreciation, and make a final decision. When you have had something like the R&D credit that has been extended over and over again since 1981, it is time to say we have experimented with this enough to see if we want to keep it. I do think uncertainty in tax law is not good for taxpayers, so we should probably, maybe in the context of tax reform, make some decisions about that. I think we also may need legislation to deal with inversions regardless of what kind of tax reform we have because I do not think lowering the rate is enough. Going to 25% is not going to make you think zero does not look so good anymore. So those are the issues I think we are going to have to face—extenders and inversions. ■

Boxscore

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Submissions and Comments on Government Regulations, Administrative Rulings, Blanket Authority and ABA Policy*

TO	DATE	CODE SECTION	TITLE	COMMITTEE	CONTACT
Internal Revenue Service	3/2/15	877A	Comments on the Tax Status of Certain Expatriates	U.S. Activities of Foreigners and Tax Treaties Committee	Michael J. Miller
Internal Revenue Service	1/20/15	469	Comments on Material Participation by a Trust or Estate Under Internal Revenue Code Section 469	Fiduciary Income Tax Committee, S Corporations Committee	David A. Berek, Richard L. Drees, C. Wells Hall III, Laura D. Howell-Smith
Internal Revenue Service	1/9/15	856	Comments on Proposed Regulations Issued Under Section 856	Real Estate Committee	A. Cristina Arumi
Internal Revenue Service	10/17/14	871(m)	Comments on Proposed Regulations Issued Under Section 871(m)	U.S. Activities of Foreigners and Tax Treaties Committee, Financial Transactions Committee	Matthew Stevens
Internal Revenue Service	10/6/14	356(a)(2)	Comments Regarding the Sourcing of Earnings and Profits for Boot in Reorganizations	Corporate Tax Committee	Jasper L. Cummings, Jr.
Internal Revenue Service	9/2/14	752	Comments on Proposed Regulations on Recourse Liabilities of Partnerships and Related Parties	Partnerships and LLCs Committee	Erich P. Hahn, Martin D. Pollack

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