WRITTEN TESTIMONY SUBMITTED TO:
THE ARKANSAS TAX REFORM AND RELIEF TASK FORCE

Regarding Dynamic Scoring of Proposals by Regional Economic Models, Inc.

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Thank you for the opportunity to submit these written comments in response to the submission of dynamic scores for proposed Arkansas tax reforms by Regional Economic Models, Inc. My name is Lisa Christensen Gee and I am a Senior State Tax Policy Analyst for the Institute on Taxation and Economic Policy (ITEP), a nonprofit research group. ITEP's research focuses on federal and state tax policy issues with an emphasis on the goals of sustainability, transparency, and fairness. ITEP has testified before the Task Force on multiple occasions regarding its tax system, most recently testifying on issues of the relative regressivity of Arkansas' tax system compared to that of other states and on the topic of tax triggers. ITEP is submitting these written comments as we were unable to attend the Task Force meetings held this week in person.

My written comments today highlight the value and *significant limitations* of dynamic scoring so as to discourage overreliance on this information (which can lead to potentially costly mistakes) and to recommend how the information from dynamic scoring should be contextualized within the broader framework for evaluating the desirability of different tax policy reform proposals.

What is Dynamic Scoring?

Dynamic scoring is an approach to understanding the impact of changes in tax or spending policies that takes into account behavioral changes caused by these policy changes. In addition to illustrating the direct effects of a policy change, it seeks to capture the secondary and tertiary indirect effects as well.

By contrast, static analysis looks just at the immediate impact of a policy change on individuals and businesses given their current behavior (though some static estimates incorporate some elements of behavioral changes).

Dynamic scoring is most charitably thought of as an attempt to clearly show how fiscal policy changes will work in the real world over the long run.

Why Use Dynamic Scoring?

Tax changes are frequently enacted with macroeconomic goals in mind—such as growing employment or income. Dynamic scoring in theory provides policymakers some basis for gauging whether the chosen policy changes will have the intended results and for measuring how well those changes perform once enacted.

An Information Tool with Significant Limitations

Dynamic scoring offers policymakers one potentially useful tool to garner information about the possible macroeconomic tradeoffs between different tax and spending policies, but only if the *significant limits* of the tool are fully recognized and expectations are adjusted accordingly.

Dynamic scoring is a very imprecise tool and as such, generates a lot of uncertainty in its results. This uncertainty is rooted in the following:

1) *Dynamic scoring relies on intentionally reductionistic assumptions about the economy that do not mirror the real world.* For example, CGE models assume an economy in equilibrium, both before and after modeled policy changes. Simplifying assumptions—such as perfectly efficient markets with full information, prices that adjust until supply equals demand in all markets, and full employment—allow modeling to be done but also "bake into" the results baseline conditions that are not true to the actual economy or world we inhabit.

2) *Dynamic scoring—especially at the state level—relies on sparse data.* CGE models must quantify linkages between dozens of economic sectors. Even at the national level, these linkages are often "opaque and arbitrary approximations." Data on these linkages are often nonexistent at the state level. Cross-state issues add additional complications.

3) *Estimates of the macroeconomic effects of policy changes are highly uncertain*. Economists differ substantially on the size of macroeconomic feedbacks from reducing marginal income tax rates or other changes in taxes or spending. There is no consensus on the impact of tax changes on labor supply, savings, investment, or consumption. The research that finds a positive relationship between tax cuts and macroeconomic factors supports the finding that the effect is small.[i]

Additional Challenges of Dynamic Scoring for States

1) *Uncertain estimates of macroeconomic effects of tax policy changes are even smaller at the state level.* Any macroeconomic effects predicted at the state level are going to be similarly uncertain and even smaller for a few reasons:

    - In a balanced-budget environment, tax cuts require corresponding spending cuts and those spending cuts are often economically damaging (e.g., cutting workforce training programs, shorting infrastructure budgets, not keeping up with current services education budget).
    - State tax rates are comparatively low to begin with. Small changes in low tax rates don't yield big economic effects.
    - Even large state tax cuts with large estimated dynamic effects may amount to small values in comparison to general-fund revenues.

2) *Dynamic effects take years to show up*. State lawmakers are required to balance their budgets 1-2 years a time, making dynamic scoring an unhelpful budgeting tool for managing state tax revenues and budgets during the time period that tax policy changes are enacted. The uncertainty regarding the size of the effects and when they will occur mean the estimates are just too difficult to build into budgets in any meaningful way.

3) *Relying too heavily on dynamic scoring threatens the credibility of budget processes.* Given their uncertainty and susceptibility to manipulation, the use of dynamic scoring in revenue or spending estimates can raise suspicions that they are biased and politically motivated. Tax reform proponents frequently use dynamic scoring to make tax reform proposals seem less costly than they really are, paving the way for deeper tax rate cuts or various corporate tax breaks.

4) *Most dynamic scoring efforts at the state level have been discontinued because actual dynamic estimates are too imprecise and too uncertain to build into a state's budget in any meaningful way.* A

2015 report[ii] by Georgia State University's Center for State and Local Finance and the Fiscal Research Center surveyed state's experiences with dynamic scoring. Among the staff in at least 21 states surveyed, the overwhelming conclusion researchers found was that policymakers found the results and process disappointing:

> "Not only did tax cuts not pay for themselves (and no credible model shows that they do), but even very aggressive estimates of dynamic effects were too small and too uncertain to be a source of easy money that could be used to fill a budget gap."[iii]

Kansas Case Study[iv]

Kansas' recent experience with dynamic scoring underscores the perils of using these types of estimates for budgeting and revenue forecasting.

When scoring the impacts of 2012 tax changes in fiscal year 2015, the state's economist came up with a static estimate of $824 million loss. A pro-tax-cut firm, however, predicted a dynamic score of a $714 million loss, forecasting that $110 million (13.5 percent) of the lost revenue would be recovered due to dynamic effects.

What actually happened? State revenues trended below the state's static revenue estimates, meaning the tax cuts ended up being even more costly than the state had originally predicted (research shows that traditional estimates have a 3 percent margin of error). Had the state relied instead on the more optimistic revenue estimate provided by the dynamic scoring, it would have had an even larger budget gap to fill in subsequent years. The state was better served—as are all states—by relying on more conservative fiscal estimates when budgeting for tax policy changes.

Conclusion

It is commendable for Arkansas lawmakers to seek out the most complete picture in understanding the impacts of the various tax proposals they may ultimately recommend for enactment. The dynamic scores presented to the Task Force by REMI offer one illustration of the potential economic tradeoffs at play among different tax-policy choices under consideration, but given the inherent uncertainty and imprecision of these estimates, lawmakers should be cautious not to given them too much weight particularly as they think through how to pay for any potential tax cuts in upcoming fiscal years. To estimate the impact of tax cut proposals, lawmakers will be better served by relying on static revenue estimates.

Further, questions about the potential macroeconomic impacts of any tax policy reform should be considered within a broader framekwork of additional questions that highlight the other important tradeoffs at play and speak to the comparative desirability of any given proposed tax cut, including:

1) Is the timing right to cut taxes?
    a. Does the state have the resources it needs right now to adequately invest in its people and infrastructure?
    b. Is the state prepared to respond to looming federal budget cuts?

c. Is the state prepared for the next economic down turn?

2) What individuals and businesses would primarily benefit from the proposed tax cut?
   a. How have these taxpayers benefited from recent state and local tax cuts compared to other taxpayers at different income levels?
   b. How do the current tax burdens of these taxpayers compare to those of other taxpayers in the state?
   c. Are these the taxpayers most in need of relief?

ITEP continues to recommend to the Task Force that its recommended tax policy reforms:
- Avoid further erosion of the corporate income tax.
- Target tax cuts to those with higher combined state & local taxes relative to income (refundable EITC, increase standard deduction).
- If insistent on cutting taxes for top-income earners, moderate with elimination of costly loopholes (capital gains) and pair with refundable tax credits for low-income taxpayers.

Thank you for your time and consideration of these remarks.

Respectfully submitted,

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[i] See http://www.cbpp.org/research/academic-research-lacks-consensus-on-the-impact-of-state-tax-cuts-on-economic-growth
[ii] See https://cslf.gsu.edu/files/2015/04/Dynamic-Revenue-Analysis_April2015.pdf
[iii] See http://www.governing.com/gov-institute/voices/col-stat-disappointing-experience-dynamic-scoring.html
[iv] See http://www.governing.com/gov-institute/voices/col-stat-disappointing-experience-dynamic-scoring.html