Five Things an Economist Thinks Are Important in Analyzing the Domestic Production Deduction: What Accountants and Lawyers Should Know About Economists*

Abstract - This is one of a trio of papers intended to highlight the potential gains from increased collaboration between the economists, lawyers and accountants in the tax policy community. In particular, this paper provides the view of an economist serving as a revenue estimator. In that role, five important issues/concepts are described to aid lawyers and accountants to understand how economists go about analyzing tax policy issues.

INTRODUCTION

This paper provides the perspective of an economist to an ongoing dialogue regarding how economists, accountants and attorneys can learn from one another and, thus, improve their analysis of tax policy issues. To narrow and provide specifics for our National Tax Association Spring Symposium audience, the participants in this session focused on the domestic production activities deduction, which was enacted as a part of the American Jobs Creation Act of 2004.

I have elected to further restrict my discussion and provide the perspective of a revenue estimator. This perspective is distinctly different from that of many other economists, particularly most academic economists. By function, the revenue estimator is providing a very narrow analysis of the implication of a policy change—the annual revenue cost of a particular provision over the subsequent decade. Revenue estimation is also distinct in that this analysis typically must be completed in days or hours rather than over weeks or months. Often this analysis is occurring at the same time that the proposal and its legislative language are being finalized.1 While this is a very narrow form of economic analysis, it is one where lawyers, accountants and economists do collaborate.

* The views expressed in this paper are those of the author and should not be construed as reflecting the view of the Department of the Treasury.

1 For more details about revenue estimating at the Joint Committee on Taxation (JCT) or the Office of Tax Analysis, please see Xanthopoulos (2005).
on a repeated basis. Thus I believe that it is a good starting point for a dialogue regarding how to strengthen and broaden communication and collaboration across disciplines in the tax community.

While formally the issue at hand is the production deduction, I view this more as a parable about what economists, accountants and lawyers can learn from one another. The issues highlighted here are broadly applicable to any major tax policy proposal that might need analysis.

A Short History

In the summer of 2001, the World Trade Organization ruled in favor of the European Union (EU) and found the extraterritorial income provisions of the tax code (ETI) to be an illegal subsidy. This ruling was appealed by the U.S. and was upheld in January 2002. These rulings opened the door to over $4 billion dollars of trade sanctions by the EU. In response, the U.S. signaled its intention to repeal the provisions, but indicated that it would take some time and, as a result, the EU postponed the application of the allowable sanctions.

This set the stage for a policy debate that would take almost two years to resolve. The repeal of ETI would raise about $6 billion annually in tax revenue. The issue that Congress was faced with was determining what that revenue would be used for. Given the tax cuts for individuals enacted in 2001, there was pressure from the business community for a business/corporate tax cut. Through many twists and turns, it became clear that instead of a targeted tax break for exports, a broader subsidy for domestic manufacturing or production was preferred by Congress. For a more detailed history of ETI and proposed replacements, please see Brumbaugh (2004).

On October 22, 2004 President Bush signed into law the American Jobs Creation Act of 2004. Among other things, this bill repealed ETI provisions of the code and enacted Section 199: the Domestic Production Activities Deduction. While formally a deduction, this provision was designed to act like a tax rate cut for domestic production activities. Once fully phased in, a business whose activities all qualified for the deduction would effectively face a top tax rate of 31.85 percent. By structuring this as a deduction rather than a corporate tax rate cut, the benefits of the provision were made available to non-corporate taxpayers.

Calculation of Qualified Production Activities Deduction

This deduction faces two limitations. The steps below mimic the tax form (Form 8903):

- Domestic production gross receipts
- less Allocable cost of goods sold
- less Directly allocable deductions, expenses, or losses
- less Indirectly allocable deductions, expenses, or losses
- equals Qualified production activities income
- the lesser of Qualified production activities income or Taxable income
- times a percentage (three percent in 2005–2006, six percent in 2007–2009, and nine percent in 2010 and after)
- equals a tentative production activities deduction
- the lesser of the tentative deduction or 50 percent of W–2 wages
- equals the Section 199: Domestic Production Activities Deduction.

Technically we can agree about how the provision works; the calculation above is straightforward. The issue is that many of the concepts are new and the legislation leaves significant issues to be worked out via the regulatory process. In the regula-
tory process, including the determination of what is “qualified production activities,” what indirect costs can be allocated, what measure of wages are to be used for the W–2 wage limitation, and “shrink back” in the item by item test. The clarification of such issues in the regulatory process is typically left to lawyers and accountants at the Internal Revenue Service and the Treasury Department and often takes months or years to resolve. If economists are to effectively inform policymakers during the legislative process, as is the function of revenue estimators, then the collaboration of lawyers, accountants and economists will be needed to shed some light as to what the taxpayer will eventually face.

FIVE ISSUES IMPORTANT TO ECONOMISTS

A la David Letterman, my list of five issues will be presented in reverse order from least to most important. While these are principally intended to communicate to lawyers and accountants things that they should know about economists, they should also remind economists about our own peccadilloes. We should attempt to temper these a bit before we collaborate with those who do not have the propensity to repeatedly cite the law of the second best.

5. Efficiency

Economists spend years in graduate school learning what is efficient/ideal, how to measure the inefficiency, and how to make policy more efficient. The result of this training and our inherent interests that lead us to the profession in the first place is that most economists want to scream when confronted with policy like the “American Jobs Creation Act of 2004.” The provision runs against deeply held convictions of how tax policies should be designed. Our inclination is to suggest alternative provisions that might improve economic efficiency rather than detract from this goal. While it is self–evident that a provision like this can only be produced in the infamous sausage factory, it might take economists longer to get over it.

Thus, I make a plea to accountants and lawyers to bear with us. After we vent for a moment, we will be able to move on to analyze the provision at hand with minimal further grousing. As a reminder to economists, while our misgivings are well intentioned, we should not let the perfect be the enemy of the good. We should not forget that better analysis of politically achievable policy is valuable.

4. The Law of Large Numbers

A fundamental difference between the approaches of economists (especially empirical economists like revenue estimators) and accountants or lawyers is immediately apparent to anyone who sits around a table to discuss a policy provision. The lawyer’s comments include repeated citations of code sections that only other lawyers can keep track of. The accountants cite “FAS statements” that hold little meaning to the lawyers or the economists. What the lawyers and accountants have in common is a conceptual framework where they systematically construct an example and then apply relevant laws, regulations or principles to that particular set of facts and circumstances. This is in marked contrast to the economists who are often looking for behavioral responses that are common across taxpayers and are, thus, looking to generalize across taxpayers.

The lawyers and accountants excel at detailing how a particular taxpayer is impacted by any given set of laws, regulations or principles. Both accounting and law rely on the fact that any particular

---

2 See Gravelle (2005) for an economist’s view of the inefficiencies in this legislation.
set of facts and circumstances should be covered by the applicable rules. Thus, everyone lies on one side or the other of the rule and significant energy is devoted to assuring that the rules are robust to the most difficult cases. In contrast, economists typically try to avoid black and white rules in favor of shades of gray. The reliance on statistical analysis of the relevant relationships implies that economists want rich variance in circumstances while the approach of lawyers and accountants tend to leave a more binary description of the world.

As a revenue estimator at Treasury, I have been fortunate to work with a series of outstanding accountants and lawyers. They have always impressed me with their ability to provide detailed explanations of the impact of a tax provision on a particular taxpayer. In the case of Section 199, I have heard detailed explanations of the “Starbucks footnote.” In a stylized sense, rather than just telling me that someone is impacted by a provision, they can go into minute detail precisely describing the facts why that is the case. While impressive and often interesting, as a revenue estimator these descriptions have little value unless they can also tell me how that fits in with the population as a whole. Unless the revenue estimator knows where in the distribution that particular instance falls, one does not know how to use the data provided.

Further, I have come to believe that the accountants and lawyers I encounter at Treasury have a built–in bias due to sample selection. Because they are so highly skilled, while in private practice, they dealt with the most difficult issues/cases. Thus, when they draw on their personal experience, they are often drawing on cases that are in the tail of the distribution. The particular examples that lawyers and accountants can provide are important to understanding the workings of a given provision. One should be wary of assuming that these examples are typical and represent an average taxpayer for the purpose of a broad provision like Section 199.

3. Are Current/Observed Practices Relevant?

Economists like to focus on response to incentives (perhaps to a fault). A revenue estimator looking at the production deduction will focus on issues such as manipulating the timing of deductions, allocating of shared costs, applying the “shrink–back” rule, embedding additional services, and such. Because the economist’s strength is in analyzing/forecasting the response to a change in incentives, what tends to capture our attention is “discontinuities” in incentives. What we often need help with is better understanding the accounting implications and whether the firm can figure out their incentives. Often the language of accounting may make it difficult to communicate economic fundamentals to the market. Without the help of accountants, economists often overlook these issues and are then confused by the choices made by firms and the subsequent market reaction. Lawyers and accountants in the tax community are more likely to have first hand experience working with taxpayers. These experiences serve to remind them of the difficulties in determining the proper application of the tax law and, thus, assuring that choices are consistent with the opportunities provided. Economists need this reminder of the significant transaction costs that exist in the world and should not necessarily be surprised if we fail to observe behavioral responses even if economic fundamentals change and vice a versa.

2. Data

Economists typically want to bring the data to the question at hand. Revenue estimators, in particular, feel more confident if they can use their unique data resources to estimate a provision. Without question, the data accessible by Treasury and JCT provides opportunities to perform analysis that others cannot. But for any
given issue this is only an advantage if we know how to apply existing data to a new question or policy. Tax data reflect how a taxpayer complied with a given set of tax provisions; the production deduction provides a new set of incentives, which are significantly different than preceding law. In particular, a taxpayer’s activities have to be distinguished between foreign and domestic as well as “qualified production” versus other activities. While financial data typically has some line of business detail, tax data does not. Any large firm is going to have a mixture of qualified and non–qualified activities, but the only relevant indicator in the tax data is its industry code.

For this particular estimate, there was a significant debate as to whether this was closer to a targeted provision or a full rate cut. One’s view on this question is likely to influence the approach taken in constructing a revenue estimate. If you view this as a narrowly targeted provision, the logical way to proceed is to carefully go through the taxpaying population and select those businesses that conduct qualified activities. Meanwhile, if you view the provision as being more broadly applicable, with an impact more like a rate cut, you might proceed by taking the entire population and eliminating the unqualified activities. Ideally, these two approaches would yield the same estimate, but clearly in practice they will not. The distinction between qualified and non–qualified activities is not clear given existing data. Thus the difference between the estimates from the two methodologies is the significant gray area of activities where facts and circumstances will dictate the treatment.

1. What Will/Can IRS Do?

As is often the case, this provision left significant loose ends to be solved by the regulations. Thus, the legislative language is insufficient to accurately analyze the impact of the provision.

The revenue estimators have to estimate:

(a) What the regulations will be,
(b) What will IRS be able to enforce, and
(c) How taxpayers will respond to (a) and (b).

Economists may be good at estimating (c), but they are not necessarily in the best position to estimate (a) and (b). Of course, unless you have to estimate (c), one presumably has little incentive to investigate (a) and (b) prior to the enactment of the legislation.

Because so much was left to regulation in the provision, no one had a good idea of the specifics when the American Jobs Creation Bill was being considered. That said, the revenue estimator had to predict how the regulations would turn out and how IRS will audit the issue. It is always frustrating to the revenue estimator to ask an accountant or attorney “What will the regulations look like?” or “Can IRS enforce this?” and get the inevitable answer of “I don’t know.” This is the natural response given a lawyer’s or accountant’s deep involvement in the regulatory process. They might expect to spend a significant portion of their time over months or years working on this issue; thus, they are disinclined to predict the outcome off the cuff.

Unlike the other issues in this paper, this is more about function within the tax policy process than discipline. However, the solution is the same—better communication can aid all parties. Revenue estimators need to communicate that they are not asking for a pre–commitment in the regulatory process, but rather the best information possible from a party that is more knowledgeable than they are. On the other side, given that, revenue estimators should share their “fears” of potential abuses to assure that they receive prompt attention in the regulatory process.
CONCLUSION

This paper will be published almost two years after the enactment of the Domestic Production Activities Deduction. While this paper and others in this issue point out what could be gained from additional understanding and collaboration between economists, accountants and lawyers, it is worth noting that we still do not know much about the provision at hand. To recap the top-five list:

5. Efficiency—It remains self evident that this provision is economically inefficient.
4. Law of Large Numbers—It remains unclear what is the “typical” application.
3. Are Current Practices Relevant—It is unclear whether there are significant behavioral responses to this incentive.
2. Data—Existing data is not useful in analyzing the distinction among activities and we are still awaiting tax data from the first year that it was in effect.
1. What Will/Can IRS Do?—While the bulk of the regulations have been issued, it is clear that this is likely to be a contentious issue to audit.

Provisions like the Domestic Production Activities Deduction are inherently difficult to analyze and their implications, difficult to forecast. That said, there remain significant opportunities for increased collaboration between economists, lawyers and accountants to provide insight into the implications of provisions like the Domestic Production Activities Deduction. Via formal interactions, such as this National Tax Association symposium, as well as informal interactions, the tax community can strengthen cross-discipline understanding and collaboration.

Acknowledgments

The author would like to thank the other participants in the NTA Spring Symposium session where this paper was presented: Jay Mackie, Lil Mills, George Plesko, and Clarissa Potter. Hopefully others learn as much from them as I have.

REFERENCES

Brumbaugh, David L.

Gravelle, Jane G.

Xanthopoulos, Judy.