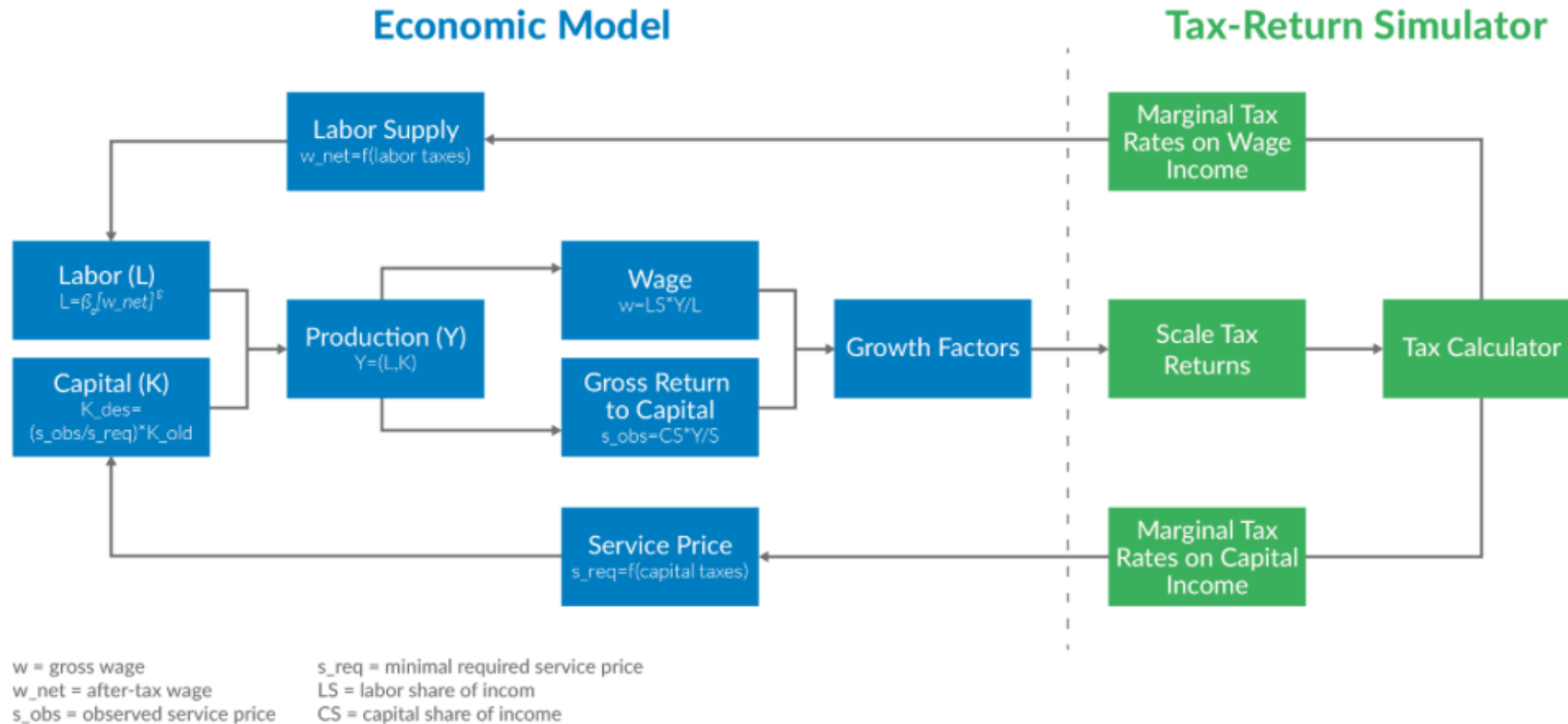


A (Short) Technical Overview of the TAG Model

Current Model

- Tax Foundation Taxes and Growth (TAG) model currently uses a neoclassical production function and a tax simulator to estimate the effects of changes in tax policy on long run output, within a small open economy framework



Tax Foundation Model Structure and Assumptions

Comparative Statics Model

- Assumes a market in long-run equilibrium.
- No adjustment path is calculated.

Open Economy

- Financial markets move capital freely across borders.
- Long-run supply of capital goods is highly elastic.

Deterministic

- Probability Ranges Not Modeled

A Neutral Federal Reserve

- The FED does not react to changes in the economy.
- The FED maintains a target inflation rate.

Technology does not change

- Total factor productivity is constant.
- Technological development does not correlate with growth/contraction.

Taxpayer Demographics

- The demographics of taxpayers do not change with growth/contraction.
- The Public Use Files from the IRS are scaled with growth/contraction

Model Assumptions: Stylized Facts

Labor's share of factor income is constant

- Historically, labor and capital have garnered roughly constant shares of economic output (after inflation and economic depreciation of capital).

Labor supply is relatively inelastic

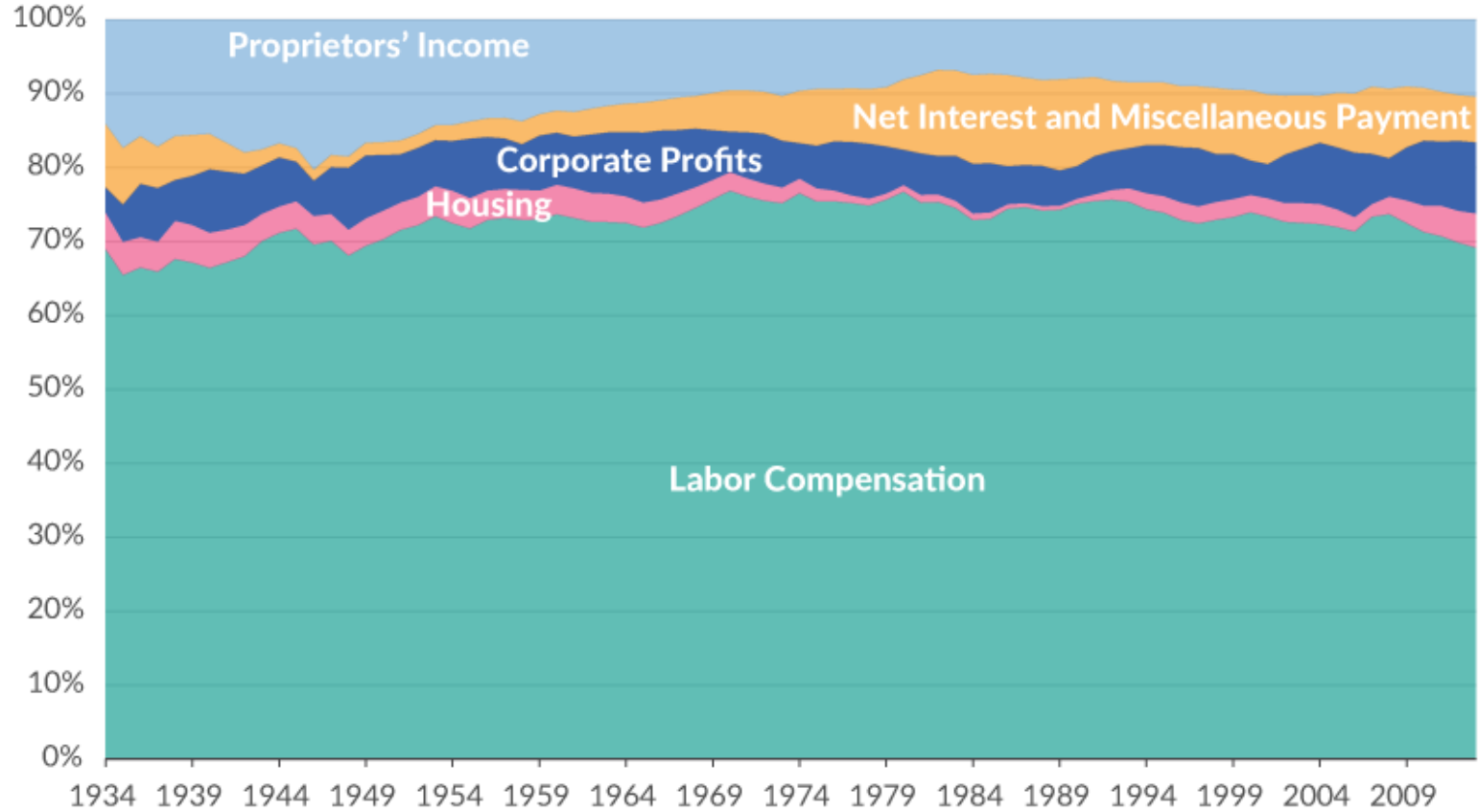
- Empirical studies have shown that primary pool of labor is virtually invariant to wage (elasticity of 0.1) and the second pool of labor more responsive (elasticity of close to 1).
- TAG model uses a 0.3 elasticity of labor with respect to wage.
- CBO estimates a wage elasticity for all earners of 0.19.

Long-run real after-tax rate of return to physical capital is constant

- Investors in a stable economy require a minimum of 3%-4% return to delay consumption. Data suggests this has been relatively constant over time.

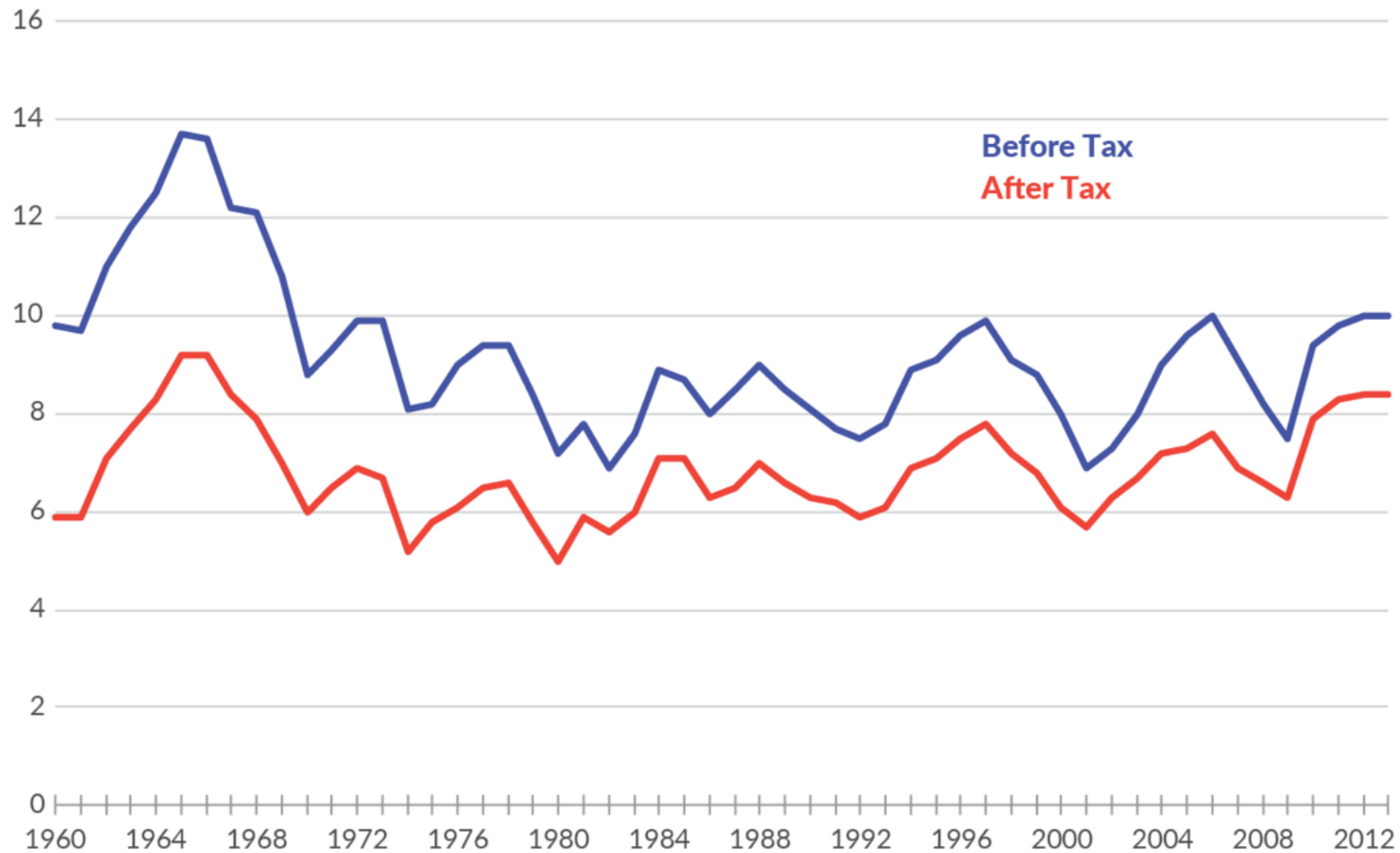
Labor Compensation Is Historically about 70 Percent of Net Income

Shares of Private Enterprise Net Income, 1934-2013



Source: BEA Table 1.10. Gross Domestic Income by Type of Income.

Rates of Return for Nonfinancial Corporations, 1960-2013



Source: BEA