UPDATED: Distributional Estimates for Several Variants of Option 1 of the Bowles-Simpson "Chairmen's Mark"

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ABSTRACT

Originally posted November 16, 2010. Updated on November 18, 2010 to include analyses in which only the income tax expenditures are eliminated but payroll tax expenditures remain and on November 24, 2010 to include an additional option that would retain 80 percent of the tax preferences for mortgage interest, employer-sponsored health insurance, and retirement saving.

We link below to distributional tables for tax year 2015 for the variant of the Bowles-Simpson "Chairmen's Mark" that would eliminate all tax expenditures except for the child credit and the earned income tax credit, eliminate the alternative minimum tax and the phase-outs of itemized deductions and personal exemptions, and replace the current six bracket individual tax rate schedule with a three bracket schedule with rates of 9 percent, 15 percent, and 24 percent (from "Co-Chairs' Proposal: Draft Document", November 2010, page 24, line 4 on table). The proposal would treat capital gains and dividends as ordinary income, use the chained CPI to index tax parameters, increase the Social Security wage base by 2 percent per year more than the growth in the average wage (making the wage base $140,000 in 2015), and phase in an increase in the federal excise tax on gasoline of 15 cents per gallon (13.5 cents per gallon on average in 2015). Finally, it would reduce the corporate tax rate to 26 percent and eliminate corporate tax expenditures.

Variant 2 (line 5 on the referenced table) would restructure tax expenditures for mortgage interest, health, and retirement benefits instead of eliminating them, retaining about 80 percent of their current benefits (the 80 percent variant). It would also replace the current individual rate schedule with a three bracket schedule, but the rates would be 12 percent, 20 percent, and 27 percent. It would also eliminate corporate tax expenditures, but would switch to a territorial system and set the corporate rate at 27 percent. Based on discussions with the Fiscal Commission staff, we simulated the following changes in tax preferences for mortgage interest, employer-sponsored health insurance, and retirement saving:

- The mortgage interest deduction would be repealed and replaced with a 15 percent refundable tax credit.
- The exclusion for employer-sponsored health insurance would be repealed and replaced with refundable credits of $1,058 for single coverage and $2,433 for family coverage.
- Tax preferences for retirement saving would be reduced:

-Limits on contributions to tax-qualified retirement saving plans, including employer-sponsored salary reduction plans and individual retirement accounts, would be reduced to 43 percent of their current limits.

-Income accrued within defined contribution accounts (interest, dividends, and realized capital gains) in excess of $6,330 per year would be taxable.

-Income accrued within defined benefit plans in excess of $177,000 per year would be taxable to the individual beneficiary.

TPC DISTRIBUTION METHODOLOGY

TPC's estimates include the effects of changes in the individual income tax, the wage base for Social Security payroll taxes, and the federal excise tax. The estimates assume that corporate receipts remain unchanged, with the elimination of corporate tax expenditures exactly offsetting the drop in the corporate rate, but we have not independently estimated the effect of the plan on corporate taxes.

Several types of income, including employer-sponsored health insurance, cafeteria plan benefits, and employer contributions to retirement saving plans, are currently exempt from both income and payroll taxes. As a result, a key design issue in proposals to reduce or eliminate income tax expenditures is whether such changes would also apply to payroll taxes.

After discussions with Fiscal Commission staff, we understand that the co-chairmen are proposing the narrower approach, in which the elimination of most tax expenditures affects income taxes but not payroll taxes. TPC originally analyzed a broader version in which the elimination of tax expenditures would also affect payroll tax receipts; in that case, our estimates include the effects of these additional payroll taxes, but do not take account of offsetting future Social Security benefits attributable to these additional taxes. We link to both sets of tables below.

TPC's estimates of this proposal include no behavioral responses. They also do not account for any effects of the elimination of tax expenditures on federal spending programs or on state spending or revenues. By encouraging more work effort and saving and reducing incentives to avoid tax, the lower marginal rates could increase reported taxable income and total receipts. But some of the other responses could increase the deficit. For example, a shift in insurance coverage from employer sponsored insurance to the new subsidized health exchanges in response to eliminating the tax exemption of employer-provided health insurance benefits could raise federal spending, offsetting some of the budgetary saving from taxing these benefits.

The estimates are presented against two baselines — the current policy baseline and the current law baseline. The current policy baseline assumes all the 2001 and 2003 tax cuts are extended, the AMT patch is extended with exemptions indexed to changes in the consumer price index (CPI), and estate tax provisions in effect in 2009 are extended. Under the current law baseline, all the 2001 and 2003 tax cuts expire, estate tax parameters are restored to 2001 levels (55% rate and $1 million exemption), and the AMT patch expired as scheduled at the end of 2009.

DISTRIBUTION RESULTS

The estimates differ greatly between the two baselines. If the tax expenditure provisions affect only income taxes, not payroll taxes, the variant of the Chairmen’s Mark that eliminates all tax expenditures would reduce after-tax income relative to current policy by about 2 or 3 percentage points, on average, in all quintiles in the income distribution (somewhat more in the second and top quintile and less in the others). But the largest drop in after-tax income would occur for taxpayers in the top 1 percent, and especially the top 0.1 percent, of the income distribution, making the tax system more progressive at the very high end. In contrast, when compared with current law, the Chairmen's Mark would reduce after-tax income in the bottom two quintiles of the income distribution and would raise after-tax income in the top three quintiles, making the system on average less progressive. The difference between the two estimates reflects the relatively large benefits that the top fifth of taxpayers received from the 2001 and 2003 tax cuts and would receive from extension of the AMT patch.

Assuming the elimination of certain tax expenditures applies to payroll taxes as well would result in a much larger overall tax increase. Relative to current policy, after-tax income would decline by an average of 3.9 percent rather than the 2.8 percent under the Chairmen's Mark. The overall pattern would not be markedly different, however. Each quintile would see an average reduction in after-tax income of about 3 or 4 percent, although the second quintile would be hit relatively harder. Compared with current law, this variant would raise taxes overall--after-tax income would fall by an average of 0.3 percent--while the Chairmen's Mark would reduce taxes and thus increase after-tax income by an average of 0.9 percent. The additional revenues in this variant come from payroll taxes, which are regressive, so the incremental reduction in after-tax income is largest in the middle quintiles. The additional burden is small in the top 1 percent because payroll taxes are a small share of the overall tax burden for those at the top of the income distribution.

Compared with current policy, the 80 percent variant would reduce after-tax income the most in the top quintile of the distribution, and especially for those with very highest incomes. After-tax income would decline by almost 8 percent for those in the top 1 percent of the income distribution and by over 11 percent for those in the top tenth of 1 percent.Taxpayers in the lowest quintile, in contrast, would on average receive a small net tax cut.

Compared with current law, taxpayers in all quintile would receive a net tax cut on average, with the largest increase in after-tax income going to taxpayers in the fourth quintile of the distribution.Taxes would still increase on average, however, for taxpayers in the top 1 percent of the income distribution, causing their after-tax incomes to decline about 2 percent. And the decline in after-tax income would be even larger (5 percent) for those in the top tenth of 1 percent of the distribution.

The relatively worse outcomes for very high income taxpayers under the 80 percent option, compared with eliminating all tax expenditures, occur because these taxpayers face higher marginal rates, but gain little as a share of their income from retention of preferences for mortgage interest, health insurance and retirement saving.The tax preferences worth the most to these groups--the preferences for capital gains and dividends – are eliminated under both the option that eliminates all tax expenditures and the 80 percent option.

TPC's distributional analyses in recent years have evaluated proposals relative to both the current policy and current law baselines. But in developing their proposal, the Fiscal Commission staff has also considered tax distributions relative to CBO's alternative fiscal scenario (AFS). Under the AFS, which is based on the pay-go rules adopted by the current (soon to be outgoing) Congress, it is assumed that the AMT patch and 2009 estate tax parameters are extended and that the 2001 and 2003 tax cuts are extended with the exception of those that benefit only joint filers with income of $250,000 or more ($200,000 for single filers). The AFS baseline approximates the current policy baseline for most taxpayers, but is closer to the current law baseline for high-income taxpayers.