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Distribution Estimates for Bipartisan Policy Center Tax Reform Proposal

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ABSTRACT

We link below to distribution tables for the tax reform proposal put forward by the Bipartisan Policy Center (BPC) Debt Reduction Task Force on November 17, 2010. We provide estimates for the plan as it would look in 2022, ten years after its proposed enactment, evaluated at 2018 income levels. We conduct the analysis for 2022 because certain elements of the plan phase in gradually over time.

The findings and conclusions contained within are those of the author and do not necessarily reflect positions or policies of the Tax Policy Center or its funders.

OVERVIEW OF THE BPC PROPOSAL

The BPC plan would be a radical overhaul of the current tax system. On the individual side, the plan would implement a two-rate structure: 15 percent on taxable income up to about \$100,000 for married couples (\$50,000 for singles); and 27 percent on income above those thresholds, which would be indexed for inflation after 2012, and eliminate the individual alternative minimum tax. To help pay for these tax rate cuts, the proposal would eliminate numerous individual tax expenditures, including credits and deductions for education expenses, the credit for child and dependent care, the exclusion from income of benefits under Section 125 cafeteria plans and the foreign earned income exclusion. Long-term capital gains and qualified dividends would be taxed as ordinary income, but the first \$1,000 of net long-term gains for married couples (\$500 for others and indexed for inflation) would be excluded from income. The proposal would cap, and then phase out over ten years, the exclusion from income of employer-sponsored health insurance benefits beginning in 2018. It would also limit combined employer and employee contributions to tax-deferred retirement accounts to the minimum of 20 percent of earnings or \$20,000, indexed for inflation.

The proposal would eliminate the itemized deductions for state and local income, sales and property taxes and replace charitable deductions and the home mortgage interest deduction with 15 percent refundable credits. The credit for mortgage interest would be allowed only on primary residences up to an un-indexed \$25,000 limit. Deductions would be retained for medical expenses in excess of 10 percent of adjusted gross income (AGI) and miscellaneous expenses in excess of 5 percent of AGI, both subject to a \$4,600 floor for married couples (\$2,300 for others), indexed for inflation after 2012.

Proposals that set a tax-exempt threshold and provide benefits to low income families and families with children would be substantially restructured and simplified. The standard deduction, personal exemptions, head of household filing status, the child tax credit, and the earned income tax credit would be eliminated. Instead, the BPC proposal would provide a refundable credit of \$1,600 (indexed for inflation after 2012) for each dependent and a refundable earnings credit equal to 21.3 percent of the first \$20,300 of earnings, indexed for inflation after 2012. The earnings credit would be on a per-worker basis and would be available to all eligible individuals under age 65 who could not be claimed as a dependent on someone else's tax return.

Taxation of Social Security beneficiaries would also be altered significantly. The proposal would include 100 percent of Social Security benefits in taxable income and eliminate the elderly credit. In place, the proposal would provide a non-refundable credit equal to 7.5 percent of Social Security benefits and a non-refundable credit for individuals age 65 or older equal to 15 percent of the current standard deduction, including the additional standard deduction for the elderly.

The BPC would enact a 6.5 percent (3 percent for 2012) broad-based consumption tax which they refer to as a “Debt Reduction Sales Tax”. It would also impose an excise tax in 2012 of 1 cent per ounce, indexed to inflation after 2018, on the manufacture and importation of sugar-sweetened beverages and raise the federal excise tax on alcoholic beverages to 25 cents per ounce. The new child credit and earnings credit would help offset the burden of these new taxes for low-income families. The BPC plan would retain 2009 estate tax law but would tax unrealized capital gains at death. On the corporate side, the proposal would reduce the corporate tax rate from 35 percent to 27 percent and would eliminate many tax expenditures including the domestic production deduction, the research and experimentation tax credit, and accelerated depreciation for rental housing. The proposal would leave the basic structure of international tax rules, including deferral and subpart F, untouched.

BPC would also provide a one-year payroll tax holiday in 2011 to help stimulate economic recovery. The effects of this proposal are not included in TPC’s distribution tables, which analyze tax policy as it would be in 2022.

TPC’S DISTRIBUTION METHODOLOGY

TPC’s distribution estimates include the effects of changes in the individual and corporate income tax, payroll taxes for Social Security and Medicare, excise taxes for alcohol and sweetened beverages, and the introduction of a broad-based consumption tax.

The estimates of individual income tax reforms include effects on both income and payroll tax receipts. Some of the proposals, including the elimination of the exemption for employer-sponsored health insurance, elimination of cafeteria plan benefits, and limiting the exemption of employer contributions to retirement saving plans, increase the amount of earnings subject to tax, thereby raising payroll tax receipts. 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. TPC’s distributional estimates do, however, include the effects of a BPC proposal to help restore long-run solvency to Social Security by phasing in gradually the share of earnings subject to Social Security payroll taxes, until it reaches 90 percent of earnings.

Following conventional practice, TPC’s distribution 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. The budgetary effects of estimated shifts to the new subsidized health exchanges are accounted for in BPC’s overall scoring, but are not counted in the TPC estimates shown here.

We present the estimates 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 and indexed for inflation, and the \$3.5 million exemption and 45-percent estate tax rate in effect in 2009 are extended. Under the current law baseline, all the 2001 and 2003 tax cuts expire, as does the AMT patch, and the estate tax exemption falls to \$1 million with a 55 percent top statutory rate.

DISTRIBUTION RESULTS

The pattern of the tax change is roughly similar against both baselines although the magnitude of the resulting changes obviously differs. Overall, the BPC plan is more progressive than either current law or current policy. Relative to current law, households in the bottom quintile would actually experience an increase in their after-tax incomes of 0.7 percent on average, or about \$100. Households in the middle of the income distribution would see a small tax increase, averaging 0.2 percent of after-tax income, whereas households in the top quintile would experience a tax increase equal to about 2.5 percent of income on average. At the very top of the distribution, the 130,000 households with cash income in excess of about \$3.2 million would see a tax increase equal to 4.6 percent of income or close to \$300,000 on average.

Relative to current policy that makes the 2001 and 2003 tax cuts permanent, the BPC plan essentially holds the bottom quintile harmless on average. Households in the middle fifth of the income distribution would experience a tax increase averaging 2.8 percent of income; the tax increase for the top quintile would average more than 7 percent of income. Those at the very top of the income distribution would be hit the hardest. Households in the top 0.1 percent would see their taxes increase by an average of 11 percent of income or more than \$700,000.

In recent years, TPC has chosen to conduct its distributional analyses relative to both the current policy and current law baselines. But in developing their proposal, the Bipartisan Policy Center staff measured the impact of their plan relative to CBO's alternative fiscal scenario (AFS). The AFS, which is based on the pay-go rules adopted by the current (soon to be outgoing) Congress, extends the AMT patch and 2009 estate tax law. It also extends the 2001 and 2003 tax cuts with the exception of those provisions 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.