

Options to Finance the Additional War Costs¹

Leonard E. Burman and Jeffrey Rohaly
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The President has requested an additional \$87 billion to finance the war and reconstruction costs in Iraq. Commentators and some members of Congress have expressed an interest in options to offset these additional costs so as not to add on to the burgeoning budget deficit, which CBO estimates to be \$480 billion in fiscal year 2004. This note considers four options to raise approximately enough revenue to finance the additional war costs. The estimates are approximate because they do not account for additional tax avoidance that higher rates might provoke, a significant factor in official revenue estimates.

Table 1. Revenue Gained from Options, in Billions of Dollars

Option	FY2003-2008²	FY2003-2013
1. Temporary surtax of 5.25% of positive income tax liability, 2003-2004	89	89
2. Increase top income tax rate from 35 to 37.5 percent, 2004-2010	59	93
3. New top income tax rate of 39.6 percent on income over \$1 million, 2004-2010	51	92
4. Temporarily restore pre-EGTRRA rates to top three brackets, 2004-2006	91	91

Options 1: Temporary War Surtax

The first option would simply increase the income tax bills of those who owe positive income tax by 5.25 percent in 2003 and 2004. A taxpayer who would owe \$1,000 in 2003 would pay an additional \$52.50 as a war surtax. Taxpayers who owe no tax or who receive refundable tax credits in excess of their tax liability would be unaffected by the surtax. An advantage of the surtax is that the timing of revenues would match fairly closely with the timing of the outlays, which are likely to be made in 2003 and 2004. If desired, the option could be modified so the tax is higher in 2003 to raise more of the revenue in the first year. If the credit rate were doubled, the tax liability could be

¹ Leonard Burman is Senior Fellow at the Urban Institute and codirector of the Tax Policy Center; Jeffrey Rohaly is Research Associate at the Urban Institute and director of modeling for the Tax Policy Center. We thank Joel Friedman, Bill Gale, Scott Keefer, Jeff Lemieux, and Peter Orszag for helpful comments and discussions. Views expressed are those of the authors and should not be attributed to the Urban Institute, its board, or its sponsors.

² Note that, following convention, all revenue estimates are calculated on a fiscal year basis, based on an estimate of when the tax receipts would be collected. Distributional estimates are based on tax liability (not tax receipts) in calendar year 2004.

assigned entirely to calendar year 2003 (although some collections would occur in 2004 when tax returns are filed).

Like all of the estimates in the table, this revenue estimate is “static,” meaning that it does not account for behavioral responses by taxpayers. The official revenue estimators for Congress and the Administration would assume that higher tax rates would lead to tax avoidance, and that the highest levels of tax avoidance would occur at the highest tax rates. Thus, the Joint Committee on Taxation—the official scorekeepers for the Congress—would likely score this estimate as producing less than \$89 billion.

The distribution of burdens from this option is progressive with income, because the income tax is progressive. The tax would represent 1.8 percent of taxable income for the 1 percent of tax units with the highest incomes, but virtually nil for the bottom 20 percent, and only 0.3 percent of income for the middle quintile. (See Table 2.) The top 1 percent would bear 34.8 percent of the burden, and 80 percent would be borne by the top 20 percent.

Table 2. Option 1
5.25 Percent Surtax:
Distribution of Income Tax Change by Percentiles, 2004¹

AGI Class ²	Percent of Tax Units with Tax Change	Percent Change in After-Tax Income ³	Percent of Total Income Tax Change	Average Tax Change (\$)	Average Income Tax Rate ⁴	
					Current Law	Proposal
Lowest Quintile	*	*	*	**	-10.5	-10.5
Second Quintile	45.3	-0.1	0.9	15	-5.4	-5.2
Middle Quintile	75.6	-0.3	4.9	80	3.8	4.1
Fourth Quintile	94.0	-0.5	13.7	222	8.1	8.6
Next 10 Percent	99.2	-0.6	13.2	429	10.0	10.5
Next 5 Percent	99.7	-0.8	11.7	755	12.6	13.2
Next 4 Percent	99.9	-1.1	20.7	1,673	17.1	18.0
Top 1 Percent	99.8	-1.8	34.8	11,273	25.1	26.4
All	62.9	-0.8	100.0	324	12.0	12.7

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0503-1).

* Less than 0.05 percent. ** Less than \$1 in absolute value.

(1) Calendar year. Baseline is current law. Surtax would be applied to income tax after refundable and nonrefundable credits, if positive.

(2) Tax units with negative AGI are excluded from the lowest quintile but are included in the totals. Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

(3) After-tax income is AGI less individual income tax net of refundable credits.

(4) Average income tax, net of refundable credits, as a percentage of average AGI.

Option 2. Increase Top Income Tax Rate to 37.5 Percent

The top income tax rate is currently set at 35 percent, although it was 38.6 percent in 2002 and 39.6 percent in 2000. This option would increase the top income tax rate, which applies to taxpayers with taxable incomes over \$311,950 in 2003, to 37.5 percent starting in 2004. The rate would return to 39.6 percent in 2011, as scheduled under current law. The proposal spreads out the costs of the war over 7 years. The option would raise \$59 billion through 2008 and \$91 billion over the 10-year budget window. (Again, the JCT would score this as raising less revenue due to behavioral responses.)

The option is highly progressive. Virtually all of the tax (99.9 percent) would be paid by the top 1 percent of households. (See Table 3.) However, the tax is a smaller share of income for the top 1 percent in 2004 than the 2-year across-the-board surtax (option 1), because it is spread over 7 years rather than two.

Table 3. Option 2
Raise Top Personal Income Tax Rate to 37.5 Percent:
Distribution of Income Tax Change by Percentiles, 2004¹

AGI Class ²	Percent of Tax Units with Tax Change	Percent Change in After-Tax Income ³	Percent of Total Income Tax Change	Average Tax Change (\$)	Average Income Tax Rate ⁴	
					Current Law	Proposal
Lowest Quintile	0.0	0.0	0.0	0	-10.5	-10.5
Second Quintile	0.0	0.0	0.0	0	-5.4	-5.4
Middle Quintile	0.0	0.0	0.0	0	3.8	3.8
Fourth Quintile	0.0	0.0	0.0	0	8.1	8.1
Next 10 Percent	0.0	0.0	0.0	0	10.0	10.0
Next 5 Percent	0.0	0.0	0.0	0	12.6	12.6
Next 4 Percent	0.2	*	0.1	1	17.1	17.1
Top 1 Percent	48.0	-1.2	99.9	7,672	25.1	26.0
All	0.5	-0.2	100.0	77	12.0	12.2

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0503-1).

* Less than 0.05 percent. ** Less than \$1 in absolute value.

(1) Calendar year. Baseline is current law. Under current law, the top rate is 35 percent.

(2) Tax units with negative AGI are excluded from the lowest quintile but are included in the totals. Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

(3) After-tax income is AGI less individual income tax net of refundable credits.

(4) Average income tax, net of refundable credits, as a percentage of average AGI.

Option 3. Restore 2001 Top Rate for Taxable Incomes over \$1 Million

The third option would create a new top tax bracket of 39.6 percent for those with very high taxable incomes—over \$1 million. The provision would expire after 2010, when rates return to their 2001 levels. The option would raise \$51 billion through 2008 and \$92 billion through 2013.

The distributional consequences look nearly identical by percentiles as Option 2 and are not shown separately. The only difference in the distributional table is that none of the tax would be borne by the lowest 99 percent of households. Of course, the tax would have different implications within the top 1 percent: 99.8 percent of the tax would be paid by the richest 1 in 1,000 households (see Appendix), whereas option 3 would raise taxes for virtually all families in the top 1 percent.

Option 4. Temporarily Restore Pre-EGTRRA Top Rates

The last option would temporarily restore the highest three tax rates that had been in effect in 2000 for long enough to finance the war costs. Rates would be raised from 35, 33, and 28 percent to 39.6, 36, and 31 percent respectively for tax years 2004 to 2006. The option would raise \$91 billion between fiscal years 2003 and 2008, and the same

amount over the budget window. It shares the advantage of option 1 of tying revenues more closely to the timing of the costs that will be incurred.

The option would be highly progressive. Virtually all of the revenue (99.6 percent) would be collected from the top 10 percent of households, and 98 percent would be assessed on the richest 5 percent. (See Table 4.) By the same token, the highest income one percent of taxpayers will pay significantly more tax as a share of income—an average of almost 3 percent—than under any of the other options. Moderately high income taxpayers (the rest of the top 10 percent) would also see a tax increase, although less than under option 1. Note that, as in option 1, the tax increase appears larger because the tax is spread over a relatively short period—three years in this case—rather than over 7 years in options 2 and 3.

Table 4. Option 4
Rollback Top Three Personal Income Tax Rates to 31, 36, and 39.6 Percent:
Distribution of Income Tax Change by Percentiles, 2004¹

AGI Class ²	Percent of Tax Units with Tax Change	Percent Change in After-Tax Income ³	Percent of Total Income Tax Change	Average Tax Change (\$)	Average Income Tax Rate ⁴	
					Current Law	Proposal
Lowest Quintile	0.0	0.0	0.0	0	-10.5	-10.5
Second Quintile	0.0	0.0	0.0	0	-5.4	-5.4
Middle Quintile	0.0	0.0	0.0	0	3.8	3.8
Fourth Quintile	*	*	*	**	8.1	8.1
Next 10 Percent	4.3	*	0.4	9	10.0	10.0
Next 5 Percent	9.1	-0.1	1.4	60	12.6	12.6
Next 4 Percent	54.3	-0.5	13.0	698	17.1	17.5
Top 1 Percent	77.1	-2.9	85.2	18,332	25.1	27.3
All	3.8	-0.5	100.0	215	12.0	12.5

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0503-1).

* Less than 0.05 percent. ** Less than \$1 in absolute value.

(1) Calendar year. Baseline is current law. Under current law, the top 3 rates are 28, 33, and 35 percent.

(2) Tax units with negative AGI are excluded from the lowest quintile but are included in the totals. Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

(3) After-tax income is AGI less individual income tax net of refundable credits.

(4) Average income tax, net of refundable credits, as a percentage of average AGI.

How Much of the Tax Cuts are Rolled Back?

While all of these options would raise taxes on some households relative to current law, the tax increases only represent a fraction of the tax cuts that were enacted in 2001 and accelerated in 2003. On average, households in 2004 owe almost \$1,300 less in income taxes than they would if the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) had not been enacted. (See Table 5.) The tax cuts are largest for those with high incomes, both in dollar terms and as a percentage of after-tax income. The top 1 percent of households are slated to receive an average tax cut of over \$30,000, or 5 percent of income, compared with an average tax cut of 3.1 percent of income.

People in every income class would still be paying lower income taxes after these options than they would pay under pre-EGTRRA law. Under option 1, the 2-year surtax, the

average tax cut would be 2.4 percent of income, compared with 3.1 percent under current law. This represents a 24.9 percent reduction in the tax cut, with the largest reduction in the highest income groups. Options 2 and 3, spread the tax out over more years, and thus would allow almost as large a tax cut in the aggregate as under current law—averaging about 3 percent of income. Overall, the war tax would represent less than 6 percent of the 2001 and 2003 tax cuts. Because these options target the tax to the top 1 percent, they are most affected. Nonetheless, the top 1 percent would still receive a larger net tax cut (after subtracting the war tax) as a percentage of income—3.7-3.8 percent—than any other income class.

Finally, option 4 would also take back more of the tax cut in the short term, because it would only be effective for three years. On average, families would get a net tax cut of 2.6 percent of income compared with pre-EGTRRA law. However, the shape of the distribution of net benefits changes. The top 1 percent of taxpayers would lose 60.1 percent of their tax cuts—much more than any other group—and the bottom four quintiles would be unaffected. As a result, the top 1 percent would receive a smaller net tax cut as a share of income than most other groups—although still more than the bottom two quintiles. In dollar terms, they would still receive the largest tax cuts, averaging over \$12,000.

Table 5. How Much of the 2001-2003 Tax Cuts Would be Rolled Back in 2004?¹

AGI Class ²	Average EGTRRA+ JGTRRA Tax Cut (\$)	Percent Change in After-Tax Income ³				
		Current Law	1. Temp. 5.25% surtax	2. Raise top rate to 37.5%	3. Add 39.6% bracket	4. Pre- EGTRRA top rates thru '06
Lowest Quintile	-3	0.1	0.1	0.1	0.1	0.1
Second Quintile	-242	1.7	1.6	1.7	1.7	1.7
Middle Quintile	-685	2.6	2.3	2.6	2.6	2.6
Fourth Quintile	-1,106	2.4	1.9	2.4	2.4	2.4
Next 10 Percent	-2,263	3.2	2.6	3.2	3.2	3.2
Next 5 Percent	-3,361	3.5	2.7	3.5	3.5	3.4
Next 4 Percent	-4,770	3.2	2.1	3.2	3.2	2.7
Top 1 Percent	-30,485	5.0	3.1	3.7	3.8	2.0
All	-1,298	3.1	2.4	3.0	3.0	2.6

AGI Class ²	Percent Reduction in Income Tax Cut				Average Net Tax Cut After Option (Dollars)			
	Option 1	Option 2	Option 3	Option 4	Option 1	Option 2	Option 3	Option 4
Lowest Quintile	0.1	0.0	0.0	0.0	3	3	3	3
Second Quintile	6.0	0.0	0.0	0.0	227	242	242	242
Middle Quintile	11.6	0.0	0.0	0.0	606	685	685	685
Fourth Quintile	20.1	0.0	0.0	0.0	884	1,106	1,106	1,106
Next 10 Percent	18.9	0.0	0.0	0.4	1,835	2,263	2,263	2,254
Next 5 Percent	22.5	0.0	0.0	1.8	2,606	3,361	3,361	3,302
Next 4 Percent	35.1	0.0	0.0	14.6	3,097	4,769	4,770	4,072
Top 1 Percent	37.0	25.2	24.3	60.1	19,212	22,814	23,066	12,155
All	24.9	5.9	5.7	16.6	974	1,221	1,224	1,083

(1) Calendar year. Baseline is pre-EGTRRA law. Includes provisions in EGTRRA and JGTRRA affecting the following: marginal tax rates; the 10-percent bracket; the child tax credit; the child and dependent care credit; the AMT; the standard deduction, 15-percent bracket, and EITC for married couples; tax rates on long-term capital gains and dividends. Excludes

(2) Tax units with negative AGI are excluded from the lowest quintile but are included in the totals. Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

(3) After-tax income is AGI less individual income tax net of refundable credits.

Appendix. Notes on Distributional Estimates and Supplemental Tables

Note that the distributional tables include our estimate of all nondependent tax filing units, including estimates for those who do not actually file income tax returns, in 2004. The income measure is adjusted gross income, as reported on tax returns or as imputed for nonfilers. See <http://www.taxpolicycenter.org/commentary/model.cfm> for a discussion of the Tax Policy Center's model and estimates.

The income cut-offs for the percentile breaks in tables 2-5 are in terms of 2002 income levels. They are shown in the following table.

Table A1.
AGI Breaks for
Distribution Tables, 2004¹
(AGI Measured in 2002 Dollars)

Second Quintile Begins at	7,130
Middle Quintile Begins at	19,436
Fourth Quintile Begins at	35,810
Next 10 Percent Begins at	65,833
Next 5 Percent Begins at	94,889
Next 4 Percent Begins at	130,109
Top 1 Percent Begins at	297,514

Source: Urban-Brookings Tax Policy Center
Microsimulation Model (version 0503-1)

(1) Calendar year. Income measure is adjusted gross income (AGI). Includes all filing and non-filing tax units, but excludes dependent filers.

Tables A2-A5 show the distribution of the four options by income.

Table A2. Option 1

5.25 Percent Surtax:

Distribution of Income Tax Change by AGI Class, 2004¹

AGI Class (thousands of 2002 dollars) ²	Tax Units ³		Percent with Tax Change	Percent Change in After-Tax Income ³	Percent of Total Income Tax Change	Average Tax Change (\$)	Average Income Tax Rate ⁴	
	Number (thousands)	Percent of Total					Current Law	Proposal
Less than 10	33,461	23.7	4.8	*	*	**	-9.9	-9.9
10-20	23,246	16.5	51.3	-0.1	1.0	19	-4.4	-4.3
20-30	18,563	13.2	71.7	-0.3	2.7	67	2.8	3.1
30-40	13,624	9.7	86.6	-0.4	3.7	125	6.1	6.5
40-50	10,550	7.5	93.3	-0.5	4.5	195	7.8	8.2
50-75	18,217	12.9	97.7	-0.5	12.1	302	8.9	9.4
75-100	9,955	7.1	99.4	-0.6	10.9	500	10.6	11.1
100-200	9,614	6.8	99.8	-0.9	21.8	1,036	14.3	15.1
200-500	2,299	1.6	99.8	-1.4	17.1	3,386	21.5	22.6
500-1,000	384	0.3	99.8	-1.8	8.0	9,443	25.5	26.8
More than 1,000	200	0.1	99.7	-1.8	18.2	41,349	25.8	27.1
All	141,030	100.0	62.9	-0.8	100.0	324	12.0	12.7

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0503-1).

* Less than 0.05 percent. ** Less than \$1 in absolute value.

(1) Calendar year. Baseline is current law. Surtax would be applied to income tax after nonrefundable and refundable credits, if positive.

(2) Tax units with negative AGI are excluded from the lowest income class but are included in the totals.

(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

(4) After-tax income is AGI less individual income tax net of refundable credits.

(5) Average income tax, net of refundable credits, as a percentage of average AGI.

Table A3. Option 2

Raise Top Personal Income Tax Rate to 37.5 Percent:

Distribution of Income Tax Change by AGI Class, 2004¹

AGI Class (thousands of 2002 dollars) ²	Tax Units ³		Percent with Tax Change	Percent Change in After-Tax Income ³	Percent of Total Income Tax Change	Average Tax Change (\$)	Average Income Tax Rate ⁴	
	Number (thousands)	Percent of Total					Current Law	Proposal
Less than 10	33,461	23.7	0.0	0.0	0.0	0	-9.9	-9.9
10-20	23,246	16.5	0.0	0.0	0.0	0	-4.4	-4.4
20-30	18,563	13.2	0.0	0.0	0.0	0	2.8	2.8
30-40	13,624	9.7	0.0	0.0	0.0	0	6.1	6.1
40-50	10,550	7.5	0.0	0.0	0.0	0	7.8	7.8
50-75	18,217	12.9	0.0	0.0	0.0	0	8.9	8.9
75-100	9,955	7.1	0.0	0.0	0.0	0	10.6	10.6
100-200	9,614	6.8	*	*	*	**	14.3	14.3
200-500	2,299	1.6	9.9	-0.1	3.8	179	21.5	21.5
500-1,000	384	0.3	75.6	-1.1	19.9	5,616	25.5	26.3
More than 1,000	200	0.1	81.3	-1.8	76.2	41,154	25.8	27.1
All	141,030	100.0	0.5	-0.2	100.0	77	12.0	12.2

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0503-1).

* Less than 0.05 percent. ** Less than \$1 in absolute value.

(1) Calendar year. Baseline is current law. Under current law, the top rate is 35 percent.

(2) Tax units with negative AGI are excluded from the lowest income class but are included in the totals.

(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

(4) After-tax income is AGI less individual income tax net of refundable credits.

(5) Average income tax, net of refundable credits, as a percentage of average AGI.

Table A4. Option 3
Top Bracket of 39.6 Percent on Taxable Income Over \$1,000,000:
Distribution of Income Tax Change by AGI Class, 2004¹

AGI Class (thousands of 2002 dollars) ²	Tax Units ²			Percent Change in After-Tax Income ³	Percent of Total Income Tax Change	Average Tax Change (\$)	Average Income Tax Rate ⁴	
	Number (thousands)	Percent of Total	Percent with Tax Change				Current Law	Proposal
Less than 10	33,461	23.7	0.0	0.0	0.0	0	-9.9	-9.9
10-20	23,246	16.5	0.0	0.0	0.0	0	-4.4	-4.4
20-30	18,563	13.2	0.0	0.0	0.0	0	2.8	2.8
30-40	13,624	9.7	0.0	0.0	0.0	0	6.1	6.1
40-50	10,550	7.5	0.0	0.0	0.0	0	7.8	7.8
50-75	18,217	12.9	0.0	0.0	0.0	0	8.9	8.9
75-100	9,955	7.1	0.0	0.0	0.0	0	10.6	10.6
100-200	9,614	6.8	0.0	0.0	0.0	0	14.3	14.3
200-500	2,299	1.6	0.0	0.0	0.0	0	21.5	21.5
500-1,000	384	0.3	1.1	*	0.2	64	25.5	25.5
More than 1,000	200	0.1	67.3	-2.3	99.8	52,052	25.8	27.5
All	141,030	100.0	0.1	-0.2	100.0	74	12.0	12.2

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0503-1).

* Less than 0.05 percent. ** Less than \$1 in absolute value.

(1) Calendar year. Baseline is current law. Top rate of 39.6 percent would apply to taxable income of more than \$1,000,000 for singles, married couples filing a joint return, and heads of household; the bracket threshold for married individuals filing a separate return would be \$500,000.

(2) Tax units with negative AGI are excluded from the lowest income class but are included in the totals.

(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

(4) After-tax income is AGI less individual income tax net of refundable credits.

(5) Average income tax, net of refundable credits, as a percentage of average AGI.

Table A5. Option 4
Rollback Top 3 Personal Income Tax Rates to 31, 36, and 39.6 Percent:
Distribution of Income Tax Change by AGI Class, 2004¹

AGI Class (thousands of 2002 dollars) ²	Tax Units ²			Percent Change in After-Tax Income ³	Percent of Total Income Tax Change	Average Tax Change (\$)	Average Income Tax Rate ⁴	
	Number (thousands)	Percent of Total	Percent with Tax Change				Current Law	Proposal
Less than 10	33,461	23.7	0.0	0.0	0.0	0	-9.9	-9.9
10-20	23,246	16.5	0.0	0.0	0.0	0	-4.4	-4.4
20-30	18,563	13.2	0.0	0.0	0.0	0	2.8	2.8
30-40	13,624	9.7	0.0	0.0	0.0	0	6.1	6.1
40-50	10,550	7.5	0.0	0.0	0.0	0	7.8	7.8
50-75	18,217	12.9	0.1	*	*	**	8.9	8.9
75-100	9,955	7.1	7.5	*	0.6	20	10.6	10.6
100-200	9,614	6.8	26.7	-0.2	6.7	212	14.3	14.5
200-500	2,299	1.6	68.4	-1.1	19.3	2,543	21.5	22.3
500-1,000	384	0.3	83.4	-2.9	19.6	15,495	25.5	27.7
More than 1,000	200	0.1	84.0	-3.6	53.7	81,256	25.8	28.5
All	141,030	100.0	3.8	-0.5	100.0	215	12.0	12.5

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0503-1).

* Less than 0.05 percent. ** Less than \$1 in absolute value.

(1) Calendar year. Baseline is current law. Under current law, the top 3 rates are 28, 33, and 35 percent.

(2) Tax units with negative AGI are excluded from the lowest income class but are included in the totals.

(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

(4) After-tax income is AGI less individual income tax net of refundable credits.

(5) Average income tax, net of refundable credits, as a percentage of average AGI.