Revenue and Distributional Effects Of the Thompson Tax Plan

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Republican presidential candidate and former Sen. Fred Thompson has announced a tax reform plan that permanently extends the 2001-2006 individual income tax cuts, permanently repeals the federal estate tax, repeals the individual alternative minimum tax at an unspecified future date while indexing the AMT exemption for inflation until that time, lowers the corporate tax rate to no more than 27 percent, permanently extends small business expensing, and shortens depreciation schedules. Also, the plan creates a second individual income tax system based on a proposal put forward by the Republican Study Committee (RSC). The RSC's alternative or "simplified tax system" would eliminate all deductions and credits in the current tax code and instead provide a much larger standard deduction. The simplified tax system would have just two tax rates: 10 percent and 25 percent. Taxpayers would have to make a largely irrevocable choice to join the new system at some point in the next 10 years. Taxpayers would then be allowed one additional switch between tax regimes at any point during their lifetime as well as a switch at the time of marriage, divorce, or a spouse's death.

This article considers how the individual income tax and estate tax provisions would affect federal revenues and the distribution of tax burden if they were enacted starting in 2009. The most striking feature of the plan is that it would represent, by far, the largest tax cut in history — much larger than the tax cuts enacted in 2001 or 1981. Over 10 years, individual income and estate taxes would fall by about $6 trillion to $7 trillion — or as much as 20 percent of overall revenues — before allowing for any behavioral responses. Accounting for the likelihood that lower tax rates cause taxpayers to report more income on their tax returns because they work harder, save more, and shelter less income from tax would reduce the revenue loss by about $1 trillion over 10 years, resulting in a cost of about $5 trillion to $6 trillion. The tax cuts increase sharply with income. The regressive nature of the cuts is more pronounced after 2010, when the 2001-2006 tax reductions expire under current law. In 2009 the cuts in the Thompson plan amount to 0.3 percent of income for the bottom quintile, 2.3 percent for the middle quintile, and 5.8 percent at the top. By 2011 the top quintile receives a tax cut equal to 9.5 percent of income, compared with 4.6 percent for the middle and 0.7 percent for the bottom quintile.

Individual Income and Estate Tax Provisions[1]

Extend the 2001-2006 income tax cuts. Most of the provisions of the 2001-2006 tax acts are set to expire at the end of 2010.[2] Thompson's plan would make these provisions — including lower marginal tax rates, reduced rates on capital gains and qualifying dividends, an increased and partially refundable child tax credit (CTC), and an increased standard deduction and other benefits for married couples — permanent.

Permanently repeal the estate tax. The 2001 tax act gradually phased in estate tax relief by raising the exemption level to $3.5 million by 2009 and reducing the top estate tax rate to 45 percent. The act then repealed the estate tax for 2010 only. Beginning in 2011, the estate tax is scheduled to return with a $1 million exemption and top statutory rate of 55 percent. Thompson's plan would make the one-year repeal of the estate tax permanent.

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[1]This section is based on the description of Thompson's plan found on his Web site, *available at* http://www.fred08.com/virtual/taxrelief.aspx. A nontechnical description of the RSC plan is available at http://www.house.gov/hensarling/rsc/doc/tpcactdetailedsummary.pdf. For modeling purposes we use the legislative text from the Government Printing Office, *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname= 110_cong_bills&docid=f:h3818ih.txt.pdf and the assumptions laid out in the next section of this report. We also thank Paul Teller of the RSC for discussing the details of the RSC's Taxpayer Choice Act with us.

[2]Provisions relating to select retirement savings incentives have already been made permanent by the Pension Protection Act of 2006 (P.L. 109-280).

Table 1. Major Individual Income and Estate Tax Components of Former Sen. Fred Thompson's Tax Plan: Static Impact on Individual Income and Estate Tax Liability and Revenue ($ billions), 2009-2018[1]

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2009-2018
Fiscal Year Revenue[2]											
Assuming tax units choose the system with less tax each year	-287.1	-404.6	-594.0	-720.4	-762.8	-809.2	-858.2	-910.8	-966.8	-1,025.4	-7,339
Assuming all tax units switch to the alternative tax system	-206.4	-293.0	-478.8	-601.7	-640.5	-683.6	-729.0	-777.5	-829.1	-883.8	-6,123
Calendar Year Liability											
Assuming tax units choose the system with less tax each year	-382.8	-411.9	-692.2	-732.5	-775.8	-823.1	-873.7	-926.9	-983.9	-1,043.4	-7,646
Assuming all tax units switch to the alternative tax system	-275.2	-298.9	-576.2	-612.8	-652.7	-696.8	-743.6	-792.5	-845.1	-900.8	-6,395

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-1) and TPC calculations.

[1]Proposal is effective Jan. 1, 2009. Baseline is current law. Proposal extends the provisions of the 2001-2006 tax cuts affecting marginal tax rates; the 10 percent bracket; the CTC; the child and dependent care credit; the standard deduction, 15 percent bracket, and earned income tax credit for married couples; tax rates on long-term capital gains and dividends; expansion of student loan interest deduction (excludes other education provisions); and estate tax exemption, rates, and state death tax credit. Proposal also repeals the individual AMT and allows taxpayers an election between the current tax system and an alternative tax system that denies adjustments to income, itemized deductions, and tax credits and that has a standard deduction of $12,500 ($25,000 for joint returns), personal exemptions of $3,500, and rates of 10 percent up to $50,000 ($100,000 for joint returns) and 25 percent above that level. Dollar values are presented in 2007 dollars and indexed for inflation. The preferential rates on capital gains and dividends are retained in the alternative tax. The alternative tax is modeled as described in H.R. 3818, with the exception that gross income is replaced by total income in the determination of the tax base. Estimates for 2018 are extrapolated from estimates for the years 2011 to 2017. Estimates are static and do not account for any potential microeconomic behavioral response. Official estimates from the Joint Committee on Taxation would likely show a smaller effect on revenue.

[2]Fiscal-year revenue numbers assume a 75-25 split for income tax provisions and a 0-100 split for estate tax provisions. The actual effect on receipts could differ.

Table 2. Major Individual Income and Estate Tax Components of Former Sen. Fred Thompson's Tax Plan Against a Baseline With the 2001-2006 Tax Cuts Extended and a Permanent AMT Patch: Static Impact on Individual Income and Estate Tax Liability and Revenue ($ billions), 2009-2018[1]

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2009-2018
Fiscal Year Revenue[2]											
Assuming tax units choose the system with less tax each year	-239.1	-331.9	-352.9	-373.9	-395.5	-419.6	-444.3	-469.5	-496.0	-524.5	-4,047
Assuming all tax units switch to the alternative tax system	-158.3	-220.3	-237.7	-255.2	-273.2	-294.1	-315.2	-336.2	-358.3	-382.9	-2,831
Calendar Year Liability											
Assuming tax units choose the system with less tax each year	-318.8	-336.3	-358.5	-379.1	-400.9	-425.8	-450.5	-475.9	-502.7	-531.8	-4,180
Assuming all tax units switch to the alternative tax system	-211.1	-223.4	-242.5	-259.5	-277.7	-299.5	-320.4	-341.5	-363.9	-389.3	-2,929

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-1) and TPC calculations.

[1]Proposal is effective Jan. 1, 2009. Baseline is current law plus the AMT patch in H.R. 3996 (allows personal nonrefundable credits against the AMT and increases the AMT exemption to $44,350 for single filers and $66,250 for joint filers), extension and indexation of the AMT patch in all future years, and extension of the provisions of the 2001-2006 tax cuts affecting marginal tax rates; the 10 percent bracket; the CTC; the child and dependent care credit; the standard deduction, 15 percent bracket, and earned income tax credit for married couples; tax rates on long-term capital gains and dividends; expansion of student loan interest deduction (excludes other education provisions); and estate tax exemption, rates, and state death tax credit. Proposal repeals the individual AMT and allows taxpayers an election between the current tax system and an alternative tax system that denies adjustments to income, itemized deductions, and tax credits and that has a standard deduction of $12,500 ($25,000 for joint returns), personal exemptions of $3,500, and rates of 10 percent up to $50,000 ($100,000 for joint returns) and 25 percent above that level. Dollar values are presented in 2007 dollars and indexed for inflation. The preferential rates on capital gains and dividends are retained in the alternative tax. The alternative tax is modeled as described in H.R. 3818, with the exception that gross income is replaced by total income in the determination of the tax base. Estimates for 2018 are extrapolated from estimates for the years 2011 to 2017. Estimates are static and do not account for any potential microeconomic behavioral response. Official estimates from the JCT would likely show a smaller effect on revenue.

[2]Fiscal-year revenue numbers assume a 75-25 split for income tax provisions and a 0-100 split for estate tax provisions. The actual effect on receipts could differ.

Provide relief from the AMT. Thompson's plan would permanently repeal the AMT but only at some future date as part of ''broader tax and spending reform.'' Until that time, the increased AMT exemption amount that expired at the end of 2006 would be extended and indexed annually for inflation.

Implement the RSC's simplified tax plan. Under the RSC plan, taxpayers would have the option of paying tax under the current income tax code or opting for an alternative system called the simplified tax. Taxpayers would have to make this choice to switch within the 10 years following enactment of the proposal. Once made, taxpayers would generally be allowed to switch only once more during their lifetime. However, switches between regimes would also be allowed at the time of marriage, divorce, or a spouse's death.

Under the simplified tax, all credits and most deductions would be eliminated, and the top tax rate would drop substantially. Taxable income would be equal to gross income — a taxpayer's income from all sources without regard to expenses or losses, including wages, gross income from self-employment, and capital gains — minus the standard deduction and personal exemptions. The standard deduction would more than double, to $25,000 for married couples filing a joint return and $12,500 for singles.[3] Exemptions for the taxpayer and qualified dependents would be $3,500 per person. There would be only two tax rates: 10 percent on the first $100,000 of taxable income for joint filers ($50,000 for singles), and 25 percent on any taxable income above that amount. The lower tax rates on capital gains and qualified dividends (a maximum of 15 percent) would still apply in the simplified tax. The tax bracket thresholds as well as the standard deduction and personal exemption amounts would be indexed annually for inflation. Under the simplified tax, all itemized deductions, such as those for home mortgage interest and state and local taxes, would be eliminated. Also, all nonrefundable and refundable credits, such as the CTC, education credits, and the earned income tax credit, would be eliminated.

Modeling Assumptions

Our revenue and distribution estimates for the Thompson plan include all the individual income and estate tax provisions described in the previous section. We do not include the corporate tax rate reductions or the changes to small business expensing and depreciation schedules.

The largest component of the revenue loss in the Thompson tax plan is the implementation of the RSC's simplified tax option. As introduced, the RSC's Taxpayer Choice Act is effective January 1, 2007. We assume that the Thompson tax plan would not be enacted until January 1, 2009, and would measure the revenue impact over the 2009-2018 budget window. Delaying enactment of the Thompson plan further and measuring the impact over a future period raises the 10-year cost of the plan, primarily because the cost of AMT and estate tax repeal rises significantly over time and the cost of extending the 2001-2006 tax cuts does not begin until 2011.

The campaign documentation for Thompson's plan for ''greater choice'' for taxpayers says that aspect of his overall tax plan is based on a proposal the RSC developed. The outline of Thompson's choice plan describes no differences from the RSC plan for a simplified tax system. Thus, we model that part of the Thompson plan as mirroring the RSC simplified tax plan as outlined in the RSC's legislation, with the exception that the tax base for the alternative tax is assumed to be total income rather than gross income.[4] As noted above, gross income is a taxpayer's income from all sources determined without regard to expenses or losses. As a result, a small-business owner would be required to include as income the portion of his gross receipts later paid out as salaries, investors could not offset capital gains with capital losses, and a partner could not deduct partnership losses from her income. We assume that the proposal did not really intend to exclude business owners, partnerships, and those with substantial capital gains and losses from the alternative regime. Total income allows deductions for expenses and losses, but excludes deductions not relating to the determination of income such as deductions for health savings accounts and IRAs.[5]

Finally, in our revenue estimates, we provide two options to show the impact of differing assumptions about how many taxpayers choose to switch to the simplified tax system. In the first option, we assume all taxpayers pay tax according to the system under which their liability for the current year would be lower. By allowing taxpayers to switch every year and assuming that all switching decisions are made on the basis of correct determinations of tax liability, this assumption probably overstates the revenue loss. In the second option, we assume that all individuals choose to switch permanently to the simplified tax beginning in 2009 even if their tax under the regular system would be lower. This assumption understates the revenue loss (and implies a significant tax increase for low-income families who would sacrifice refundable tax credits). Our distribution tables are based on the former assumption.

The Thompson plan promises to repeal the AMT only at some unspecified future date in combination with comprehensive tax and spending reform. However, once

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[3]The head of household filing status does not exist under the alternative system.

[4]We assume that the announced parameters of the Thompson plan, including tax bracket thresholds, the standard deduction, and personal exemptions, would be adjusted for inflation between now and the enactment date.

[5]Although dramatically reduced in size, income measurement problems would still remain using total income as the base instead of gross income. For example, alimony would be taxed as income for both the recipient of the payment and the person making the payment and employees would be taxed on jury duty pay forfeited to their employer.

Table 3. Major Individual Income and Estate Tax Components of Former Sen. Fred Thompson's Tax Plan: Impact on Individual Income and Estate Tax Revenue With Behavioral Response ($ billions), 2009-2018[1]

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2009-2018
Fiscal Year Revenue[2]											
Assuming tax units choose the system with less tax each year	-244.9	-346.2	-509.8	-624.2	-661.3	-701.7	-744.4	-790.1	-838.5	-889.4	-6,350
Assuming all tax units switch to the alternative tax system	-169.0	-241.4	-402.9	-514.3	-547.9	-585.5	-624.8	-666.9	-711.4	-758.8	-5,223
Calendar Year Liability											
Assuming tax units choose the system with less tax each year	-326.5	-352.7	-599.6	-635.1	-672.9	-714.2	-758.3	-804.5	-853.7	-905.5	-6,623
Assuming all tax units switch to the alternative tax system	-225.3	-246.7	-492.5	-524.1	-558.7	-597.2	-637.8	-680.3	-725.6	-774.1	-5,463

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-1) and TPC calculations.

[1]Proposal is effective Jan. 1, 2009. Baseline is current law. Proposal extends the provisions of the 2001-2006 tax cuts affecting marginal tax rates; the 10 percent bracket; the CTC; the child and dependent care credit; the standard deduction, 15 percent bracket, and EITC for married couples; tax rates on long-term capital gains and dividends; expansion of student loan interest deduction (excludes other education provisions); and estate tax exemption, rates, and state death tax credit. Proposal also repeals the individual AMT and allows taxpayers an election between the current tax system and an alternative tax system that denies adjustments to income, itemized deductions, and tax credits and that has a standard deduction of $12,500 ($25,000 for joint returns), personal exemptions of $3,500, and rates of 10 percent up to $50,000 ($100,000 for joint returns) and 25 percent above that level. Dollar values are presented in 2007 dollars and indexed for inflation. The preferential rates on capital gains and dividends are retained in the alternative tax. The alternative tax is modeled as described in H.R. 3818, with the exception that gross income is replaced by total income in the determination of the tax base. Estimates for 2018 are extrapolated from estimates for the years 2011 to 2017. Estimates incorporate an income elasticity (with respect to the net-of-tax rate) of 0.4.

[2]Fiscal-year revenue numbers assume a 75-25 split for income tax provisions and a 0-100 split for estate tax provisions. The actual effect on receipts could differ.

Table 4. Major Individual Income and Estate Tax Components of Former Sen. Fred Thompson's Tax Plan
Distribution of Federal Tax Change by Cash Income Level, 2009[1]
Detail Table

Cash Income Level (Thousands of 2006 Dollars)[2]	Percent of Tax Units[3]		Percent Change in After-Tax Income[4]	Share of Total Federal Tax Change	Average Federal Tax Change		Share of Federal Taxes		Average Federal Tax Rate[5]	
	With Tax Cut	With Tax Increase			Dollars	Percent	Change (% Points)	Under the Proposal	Change (% Points)	Under the Proposal
Less than 10	2.5	0.0	0.0	0.0	-2	-0.9	0.0	0.2	0.0	4.1
10-20	26.3	0.0	0.9	0.9	-129	-18.4	0.0	0.7	-0.8	3.6
20-30	43.2	0.0	1.5	2.0	-368	-14.7	0.0	2.2	-1.4	8.1
30-40	52.9	0.0	2.0	2.7	-639	-12.7	0.1	3.5	-1.7	11.9
40-50	69.2	0.1	2.7	3.6	-1,057	-13.4	0.1	4.3	-2.2	14.4
50-75	83.4	0.1	3.8	11.6	-2,016	-16.3	-0.1	11.2	-3.1	15.8
75-100	90.7	0.1	4.2	11.1	-3,046	-15.9	0.0	10.9	-3.3	17.4
100-200	96.0	0.2	6.1	31.9	-6,645	-19.4	-1.1	24.9	-4.6	19.2
200-500	97.7	0.1	6.3	18.5	-13,996	-17.0	-0.2	16.9	-4.6	22.5
500-1,000	96.9	0.1	5.1	5.6	-26,834	-13.4	0.2	6.8	-3.7	24.0
More than 1,000	94.7	0.1	5.6	12.3	-114,560	-11.2	1.0	18.3	-3.7	29.5
All	57.2	0.1	4.5	100.0	-2,485	-15.8	0.0	100.0	-3.5	18.6

Table 4. (Continued)

Baseline Distribution of Income and Federal Taxes by Cash Income Level, 2009[1]

Cash Income Level (Thousands of 2006 Dollars)[2]	Tax Units[3]		Average Income (Dollars)	Average Federal Tax Burden (Dollars)	Average After-Tax Income[4] (Dollars)	Average Federal Tax Rate[5]	Share of Pre-Tax Income	Share of Post-Tax Income	Share of Federal Taxes
	Number (Thousands)	Percent of Total					Percent of Total	Percent of Total	Percent of Total
Less than 10	17,677	11.6	5,908	245	5,663	4.2	1.0	1.2	0.2
10-20	25,125	16.5	15,917	700	15,217	4.4	3.7	4.5	0.7
20-30	20,689	13.6	26,341	2,496	23,845	9.5	5.0	5.8	2.2
30-40	15,800	10.4	37,089	5,054	32,035	13.6	5.4	6.0	3.3
40-50	12,740	8.4	47,763	7,917	39,846	16.6	5.6	6.0	4.2
50-75	21,849	14.3	65,664	12,384	53,279	18.9	13.2	13.8	11.3
75-100	13,775	9.0	92,210	19,119	73,091	20.7	11.7	11.9	11.0
100-200	18,217	11.9	143,638	34,255	109,383	23.9	24.1	23.5	26.0
200-500	4,999	3.3	303,901	82,418	221,482	27.1	14.0	13.1	17.1
500-1,000	789	0.5	722,111	200,095	522,015	27.7	5.2	4.9	6.6
More than 1,000	406	0.3	3,089,077	1,024,993	2,064,084	33.2	11.5	9.9	17.3
All	152,651	100.0	71,202	15,742	55,460	22.1	100.0	100.0	100.0

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-1).
Number of AMT taxpayers (millions). Baseline: 29.4 Proposal: 0.0

[1]Proposal is effective Jan. 1, 2009. Baseline is current law. Proposal extends the provisions of the 2001-2006 tax cuts affecting marginal tax rates; the 10 percent bracket; the CTC; the child and dependent care credit; the standard deduction, 15 percent bracket, and EITC for married couples; tax rates on long-term capital gains and dividends; expansion of student loan interest deduction (excludes other education provisions); and estate tax exemption, rates, and state death tax credit. Proposal also repeals the individual AMT and allows taxpayers an election between the current tax system and an alternative tax system that denies adjustments to income, itemized deductions, and tax credits and that has a standard deduction of $12,500 ($25,000 for joint returns), personal exemptions of $3,500, and rates of 10 percent up to $50,000 ($100,000 for joint returns) and 25 percent above that level. The preferential rates on capital gains and dividends are retained in the alternative tax. The alternative tax is modeled as described in H.R. 3818, with the exception that gross income is replaced by total income in the determination of the tax base. Dollar values are presented in 2007 dollars and indexed for inflation. Taxpayers are assumed to pay whichever tax is lower, the current tax or the simplified tax system.

[2]Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm.

[3]Includes both filing and non-filing units but excludes those that are dependents of other tax units.

[4]After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

[5]Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax) as a percentage of average cash income.

Table 5. Major Individual Income and Estate Tax Components of Former Sen. Fred Thompson's Tax Plan
Distribution of Federal Tax Change by Cash Income Percentile, 2009[1]
Detail Table

Cash Income Percentile[2,3]	Percent of Tax Units[4]		Percent Change in After-Tax Income[5]	Share of Total Federal Tax Change	Average Federal Tax Change		Share of Federal Taxes		Average Federal Tax Rate[6]	
	With Tax Cut	With Tax Increase			Dollars	Percent	Change (% Points)	Under the Proposal	Change (% Points)	Under the Proposal
Lowest Quintile	10.0	0.0	0.3	0.2	-25	-7.9	0.0	0.4	-0.3	3.3
Second Quintile	37.9	0.0	1.4	2.3	-284	-16.2	0.0	2.2	-1.3	6.5
Middle Quintile	58.3	0.0	2.3	6.2	-774	-13.0	0.3	7.8	-1.9	12.8
Fourth Quintile	84.7	0.1	3.9	17.7	-2,199	-16.2	-0.1	17.2	-3.1	16.2
Top Quintile	95.4	0.2	5.8	73.6	-9,138	-16.0	-0.2	72.2	-4.3	22.2
All	57.2	0.1	4.5	100.0	-2,485	-15.8	0.0	100.0	-3.5	18.6
Addendum										
80-90	93.7	0.2	4.9	17.2	-4,262	-17.2	-0.3	15.5	-3.8	18.4
90-95	96.6	0.2	6.7	16.4	-8,140	-20.8	-0.7	11.7	-5.1	19.4
95-99	97.8	0.1	6.4	20.3	-12,626	-17.5	-0.4	18.0	-4.7	22.1
Top 1 Percent	96.6	0.1	5.5	19.7	-48,933	-12.1	1.1	26.9	-3.8	27.4
Top 0.1 Percent	93.6	0.1	5.5	8.6	-212,838	-10.5	0.8	13.7	-3.6	30.9

Table 5. (Continued)

Baseline Distribution of Income and Federal Taxes by Cash Income Percentile, 2009[1]

Cash Income Percentile[2,3]	Tax Units[4]		Average Income (Dollars)	Average Federal Tax Burden (Dollars)	Average After-Tax Income[5] (Dollars)	Average Federal Tax Rate[6]	Share of Pre-Tax Income	Share of Post-Tax Income	Share of Federal Taxes
	Number (Thousands)	Percent of Total					Percent of Total	Percent of Total	Percent of Total
Lowest Quintile	29,944	19.6	8,899	319	8,580	3.6	2.5	3.0	0.4
Second Quintile	30,528	20.0	22,579	1,749	20,829	7.8	6.3	7.5	2.2
Middle Quintile	30,533	20.0	40,411	5,947	34,464	14.7	11.4	12.4	7.6
Fourth Quintile	30,532	20.0	70,425	13,586	56,839	19.3	19.8	20.5	17.3
Top Quintile	30,530	20.0	215,173	56,966	158,207	26.5	60.4	57.1	72.4
All	152,651	100.0	71,202	15,742	55,460	22.1	100.0	100.0	100.0
Addendum									
80-90	15,264	10.0	112,100	24,827	87,273	22.2	15.7	15.7	15.8
90-95	7,633	5.0	160,218	39,203	121,015	24.5	11.3	10.9	12.5
95-99	6,106	4.0	269,710	72,251	197,460	26.8	15.2	14.2	18.4
Top 1 Percent	1,527	1.0	1,302,421	405,989	896,433	31.2	18.3	16.2	25.8
Top 0.1 Percent	153	0.1	5,875,757	2,026,370	3,849,387	34.5	8.3	6.9	12.9

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-1).

Number of AMT Taxpayers (millions). Baseline: 29.4 Proposal: 0.0

[1]Proposal is effective Jan. 1, 2009. Baseline is current law. Proposal extends the provisions of the 2001-2006 tax cuts affecting marginal tax rates; the 10 percent bracket; the CTC; the child and dependent care credit; the standard deduction, 15 percent bracket, and EITC for married couples; tax rates on long-term capital gains and dividends; expansion of student loan interest deduction (excludes other education provisions); and estate tax exemption, rates, and state death tax credit. Proposal also repeals the individual AMT and allows taxpayers an election between the current tax system and an alternative tax system that denies adjustments to income, itemized deductions, and tax credits and that has a standard deduction of $12,500 ($25,000 for joint returns), personal exemptions of $3,500, and rates of 10 percent up to $50,000 ($100,000 for joint returns) and 25 percent above that level. The preferential rates on capital gains and dividends are retained in the alternative tax. The alternative tax is modeled as described in H.R. 3818, with the exception that gross income is replaced by total income in the determination of the tax base. Dollar values are presented in 2007 dollars and indexed for inflation. Taxpayers are assumed to pay whichever tax is lower, the current tax or the simplified tax system.

[2]Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm.

[3]The cash income percentile breaks used in this table are (in 2006 dollars): 20% ($14,769), 40% ($28,205), 60% ($49,076), 80% ($87,187), 90% ($128,408), 95% ($180,644), 99% ($430,237), 99.5% ($667,680), and 99.9% ($1,904,678).

[4]Includes both filing and non-filing units but excludes those that are dependents of other tax units.

[5]After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

[6]Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax) as a percentage of average cash income.

the simplified tax option is implemented, the difference in the revenue cost between full AMT repeal and extending the current AMT relief is relatively small compared with the cost of the entire plan (about $25 billion annually by the end of the budget window). Thus, we assume that the AMT is repealed for 2009 and thereafter.[6]

Effect on Federal Revenues

Assuming no behavioral response, implementation of Thompson's proposal would decrease federal revenues by $6 trillion to $7 trillion between 2009 and 2018 compared with current law (table 1). Against a baseline in which the 2001-2006 tax cuts are extended and a permanent AMT patch enacted, the plan would cost $3 trillion to $4 trillion (table 2). With a behavioral response, implementation of the proposal would reduce revenues by $5 trillion to $6 trillion (table 3).

The exact impact of the plan on federal revenues is uncertain because how taxpayers will choose between the alternatives is unclear. Tax returns include data for only a single year, but the taxpayer's decision about which plan to elect in principle requires predictions about income, expenses, and eligibility for tax credits for years into the future. Rare events such as large medical expenses or large casualty or theft losses for which deductions are allowed in the current tax code would make it relatively more attractive, but those events are often unpredictable. How taxpayers would incorporate the probability of those events in their decision to choose their tax regime is not clear. Also, the relative attractiveness of the two tax systems will change over the life cycle. Younger taxpayers tend to have lower incomes and may be eligible for tax credits, such as the refundable EITC, that are allowed under the regular tax but not the alternative. Later in life, they might expect their income to increase enough that they would no longer be eligible for the EITC and would thus benefit from the alternative system. While the opportunity to switch once for any reason and at marriage, divorce, or when a spouse dies may allow taxpayers to roughly obtain optimality over the life cycle, this approach would certainly be imperfect. On top of those informational limitations, taxpayers may simply defer making the switch out of ignorance or inertia, or they might miscalculate and choose the wrong option. In their revenue and distribution estimates, the RSC assumes that all taxpayers will choose it for its simplicity, but that assumption strains credulity for low-income families that might sacrifice $5,000 in refundable tax credits or high-income taxpayers who might forgo millions of dollars in foreign tax credits.

To reflect the range of uncertainty in our estimates, we calculate them under two different assumptions about behavior. One estimate allows taxpayers to choose the tax system in which they have the smallest liability each year and therefore results in the maximum possible revenue loss. This assumption probably overstates the revenue loss. A second estimate assumes that all taxpayers choose the alternative tax system. This option almost surely understates the true cost as the additional revenue raised depends crucially on the assumption that many taxpayers voluntarily pay much more tax than they have to, which seems unlikely. In fact, our results suggest that most taxpayers would face substantially different liabilities under the two tax systems and therefore would not find the choice between them a difficult one.

Official estimates of the revenue consequences of tax legislation produced by the Joint Committee on Taxation incorporate a microeconomic behavioral response. Those responses include changes in the form and timing of income received, changes in consumption patterns, and tax avoidance. Under conventional scoring rules, the JCT estimates assume that the baseline level of economic activity does not change as a result of tax changes. While taxes do affect the economy, the Thompson proposal is more likely to do harm than good in this regard. On one hand, tax rates would decline significantly, which might encourage people to work and save more, boosting the economy. On the other hand, unless the deficits are closed by draconian spending cuts, the proposal is likely to result in a huge increase in the national debt, which could have devastating effects on the economy over the long run (and would probably require large future tax increases as well as spending cuts to offset).

We estimate the behavioral response in terms of the elasticity of taxable income. The elasticity is the ratio of the percentage change in income resulting from tax legislation to the percentage change in the net-of-tax rate — that is, 1 minus the marginal tax rate, or the share of income that taxpayers get to keep after taxes. We assume an elasticity of 0.4 based on the work of Jon Gruber and Emmanuel Saez (2002) and Seth Giertz (2006). This means that if the tax rate fell from 35 percent to 25 percent, taxable income would increase by 6 percent. The net of tax rate increases from 65 percent to 75 percent, a 15 percent increase. That percentage multiplied by 0.4 generates a 6 percent increase in income.

In fact, the behavioral response to this tax change might well be smaller. Gruber and Saez found that approximately three-fifths of the responsiveness of taxable income to changes in the tax rate is the result of behavioral changes mediated through changes in itemized deductions and other base-narrowing activity. As a result, one might expect a reform such as Thompson's to show a smaller elasticity as the opportunity for such behavior is dramatically narrowed.

We estimate that the static cost of the Thompson plan is $7 trillion. Allowing a generous behavioral response decreases that cost to $6 trillion. Assuming that all taxpayers chose the new alternative tax system reduces the cost to $5 trillion, a lower bound on the revenue loss as discussed earlier.

The RSC says their plan is revenue neutral for the year 2007 against a baseline in which the AMT has already been repealed if all taxpayers choose the alternative tax system, resulting in federal revenues around 18.5 percent

(Text continued on p. 207.)

[6]The RSC plan proposes immediate and permanent repeal of the individual AMT, so our modeling is consistent with their proposal.

Table 6. Major Individual Income and Estate Tax Components of Former Sen. Fred Thompson's Tax Plan
Distribution of Federal Tax Change by Cash Income Level, 2011[1]
Detail Table

Cash Income Level (Thousands of 2006 Dollars)[2]	Percent of Tax Units[3]		Percent Change in After-Tax Income[4]	Share of Total Federal Tax Change	Average Federal Tax Change		Share of Federal Taxes		Average Federal Tax Rate[5]	
	With Tax Cut	With Tax Increase			Dollars	Percent	Change (% Points)	Under the Proposal	Change (% Points)	Under the Proposal
Less than 10	4.2	0.0	0.2	0.0	-9	-3.2	0.0	0.2	-0.1	4.4
10-20	44.5	2.2	1.9	1.1	-298	-34.1	-0.1	0.7	-1.8	3.5
20-30	74.7	0.9	3.7	2.8	-910	-29.2	-0.2	2.2	-3.3	8.0
30-40	84.3	0.5	4.3	3.3	-1,423	-23.7	0.0	3.3	-3.7	11.8
40-50	90.1	0.3	4.8	3.7	-1,960	-21.5	0.1	4.3	-3.9	14.3
50-75	97.3	0.1	6.3	11.0	-3,405	-23.9	0.0	11.1	-5.0	15.8
75-100	99.1	0.0	6.8	10.4	-5,060	-23.2	0.1	10.9	-5.2	17.4
100-200	99.4	0.1	8.6	26.9	-9,642	-25.1	-0.4	25.3	-6.4	19.1
200-500	99.6	0.1	8.8	16.1	-20,063	-22.5	0.3	17.5	-6.3	21.8
500-1,000	99.4	0.0	10.5	6.9	-55,247	-24.4	0.0	6.8	-7.3	22.7
More than 1,000	99.7	0.0	12.9	17.5	-273,883	-23.9	0.0	17.6	-8.4	26.7
All	73.9	0.6	7.6	100.0	-4,429	-24.0	0.0	100.0	-5.8	18.3

Table 6. (Continued)

Baseline Distribution of Income and Federal Taxes by Cash Income Level, 2011[1]

Cash Income Level (Thousands of 2006 Dollars)[2]	Tax Units[3]		Average Income (Dollars)	Average Federal Tax Burden (Dollars)	Average After-Tax Income[4] (Dollars)	Average Federal Tax Rate[5]	Share of Pre-Tax Income	Share of Post-Tax Income	Share of Federal Taxes
	Number (Thousands)	Percent of Total					Percent of Total	Percent of Total	Percent of Total
Less than 10	16,811	10.7	6,086	275	5,811	4.5	0.9	1.1	0.2
10-20	25,284	16.2	16,631	876	15,755	5.3	3.5	4.4	0.8
20-30	21,596	13.8	27,636	3,118	24,518	11.3	5.0	5.8	2.3
30-40	16,032	10.2	38,799	6,001	32,797	15.5	5.2	5.7	3.3
40-50	13,218	8.5	49,940	9,109	40,831	18.2	5.5	5.9	4.2
50-75	22,444	14.3	68,652	14,280	54,372	20.8	12.8	13.3	11.1
75-100	14,300	9.1	96,522	21,851	74,671	22.6	11.5	11.7	10.8
100-200	19,360	12.4	150,400	38,393	112,007	25.5	24.2	23.7	25.7
200-500	5,551	3.6	317,079	89,288	227,791	28.2	14.6	13.8	17.1
500-1,000	865	0.6	755,020	226,808	528,212	30.0	5.4	5.0	6.8
More than 1,000	443	0.3	3,272,093	1,148,541	2,123,552	35.1	12.0	10.3	17.6
All	156,502	100.0	77,021	18,484	58,537	24.0	100.0	100.0	100.0

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-1).
Number of AMT Taxpayers (millions). Baseline: 18.5 Proposal: 0.0

[1]Proposal is effective Jan. 1, 2009. Baseline is current law. Proposal extends the provisions of the 2001-2006 tax cuts affecting marginal tax rates; the 10 percent bracket; the CTC; the child and dependent care credit; the standard deduction, 15 percent bracket, and EITC for married couples; tax rates on long-term capital gains and dividends; expansion of student loan interest deduction (excludes other education provisions); and estate tax exemption, rates, and state death tax credit. Proposal also repeals the individual AMT and allows taxpayers an election between the current tax system and an alternative tax system that denies adjustments to income, itemized deductions, and tax credits and that has a standard deduction of $12,500 ($25,000 for joint returns), personal exemptions of $3,500, and rates of 10 percent up to $50,000 ($100,000 for joint returns) and 25 percent above that level. The preferential rates on capital gains and dividends are retained in the alternative tax. The alternative tax is modeled as described in H.R. 3818, with the exception that gross income is replaced by total income in the determination of the tax base. Dollar values are presented in 2007 dollars and indexed for inflation. Taxpayers are assumed to pay whichever tax is lower, the current tax or the simplified tax system.

[2]Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm.

[3]Includes both filing and non-filing units but excludes those that are dependents of other tax units.

[4]After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

[5] Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax) as a percentage of average cash income.

Table 7. Major Individual Income and Estate Tax Components of Former Sen. Fred Thompson's Tax Plan
Distribution of Federal Tax Change by Cash Income Percentile, 2011[1]
Detail Table

Cash Income Percentile[2,3]	Percent of Tax Units[4]		Percent Change in After-Tax Income[5]	Share of Total Federal Tax Change	Average Federal Tax Change		Share of Federal Taxes		Average Federal Tax Rate[6]	
	With Tax Cut	With Tax Increase			Dollars	Percent	Change (% Points)	Under the Proposal	Change (% Points)	Under the Proposal
Lowest Quintile	17.4	1.4	0.7	0.3	-69	-17.6	0.0	0.5	-0.7	3.3
Second Quintile	68.3	1.1	3.4	3.3	-740	-31.1	-0.2	2.3	-3.0	6.7
Middle Quintile	86.7	0.4	4.6	7.5	-1,649	-22.6	0.1	8.0	-3.8	13.0
Fourth Quintile	97.8	0.1	6.4	17.2	-3,802	-23.6	0.1	17.5	-5.0	16.3
Top Quintile	99.4	0.1	9.5	71.6	-15,851	-24.0	0.0	71.5	-6.8	21.5
All	73.9	0.6	7.6	100.0	-4,429	-24.0	0.0	100.0	-5.8	18.3
Addendum										
80-90	99.3	0.0	7.8	16.1	-7,114	-24.3	-0.1	15.7	-5.9	18.3
90-95	99.6	0.1	9.2	13.2	-11,675	-25.8	-0.3	12.0	-6.8	19.4
95-99	99.6	0.1	8.7	16.6	-18,386	-22.5	0.4	18.1	-6.3	21.7
Top 1 Percent	99.5	0.0	11.9	25.7	-113,962	-24.0	0.0	25.8	-8.0	25.3
Top 0.1 Percent	99.7	0.0	13.1	12.3	-545,298	-23.2	0.1	12.9	-8.4	27.8

Table 7. (Continued)

Baseline Distribution of Income and Federal Taxes by Cash Income Percentile, 2011[1]

Cash Income Percentile[2,3]	Tax Units[4]		Average Income (Dollars)	Average Federal Tax Burden (Dollars)	Average After-Tax Income[5] (Dollars)	Average Federal Tax Rate[6]	Share of Pre-Tax Income	Share of Post-Tax Income	Share of Federal Taxes
	Number (Thousands)	Percent of Total					Percent of Total	Percent of Total	Percent of Total
Lowest Quintile	30,704	19.6	9,721	392	9,329	4.0	2.5	3.1	0.4
Second Quintile	31,300	20.0	24,460	2,379	22,081	9.7	6.4	7.5	2.6
Middle Quintile	31,297	20.0	43,383	7,286	36,097	16.8	11.3	12.3	7.9
Fourth Quintile	31,305	20.0	75,537	16,125	59,412	21.4	19.6	20.3	17.5
Top Quintile	31,299	20.0	233,599	66,089	167,510	28.3	60.7	57.2	71.5
All	156,502	100.0	77,021	18,484	58,537	24.0	100.0	100.0	100.0
Addendum									
80-90	15,649	10.0	120,616	29,223	91,393	24.2	15.7	15.6	15.8
90-95	7,824	5.0	172,853	45,272	127,580	26.2	11.2	10.9	12.3
95-99	6,260	4.0	292,744	81,830	210,915	28.0	15.2	14.4	17.7
Top 1 Percent	1,565	1.0	1,430,531	475,852	954,679	33.3	18.6	16.3	25.7
Top 0.1 Percent	157	0.1	6,508,651	2,354,047	4,154,604	36.2	8.5	7.1	12.7

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-1).
Number of AMT Taxpayers (millions). Baseline: 18.5 Proposal: 0.0

[1]Proposal is effective Jan. 1, 2009. Baseline is current law. Proposal extends the provisions of the 2001-2006 tax cuts affecting marginal tax rates; the 10 percent bracket; the CTC; the child and dependent care credit; the standard deduction, 15 percent bracket, and EITC for married couples; tax rates on long-term capital gains and dividends; expansion of student loan interest deduction (excludes other education provisions); and estate tax exemption, rates, and state death tax credit. Proposal also repeals the individual AMT and allows taxpayers an election between the current tax system and an alternative tax system that denies adjustments to income, itemized deductions, and tax credits and that has a standard deduction of $12,500 ($25,000 for joint returns), personal exemptions of $3,500, and rates of 10 percent up to $50,000 ($100,000 for joint returns) and 25 percent above that level. The preferential rates on capital gains and dividends are retained in the alternative tax. The alternative tax is modeled as described in H.R. 3818, with the exception that gross income is replaced by total income in the determination of the tax base. Dollar values are presented in 2007 dollars and indexed for inflation. Taxpayers are assumed to pay whichever tax is lower, the current tax or the simplified tax system.

[2]Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm.

[3]The cash income percentile breaks used in this table are (in 2006 dollars): 20% ($15,384), 40% ($29,083), 60% ($50,348), 80% ($89,737), 90% ($132,504), 95% ($186,771), 99% ($447,567), 99.5% ($697,094), and 99.9% (1,996,728).

[4]Includes both filing and non-filing units but excludes those that are dependents of other tax units.

[5]After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

[6]Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax) as a percentage of average cash income.

of GDP. Our modeling with the same assumption and baseline finds that without taxing business expenses and individual losses the proposal falls short of this modest goal, losing approximately $150 billion and resulting in federal revenues of only 16.8 percent of GDP. Further, there is little reason to believe that people with substantially higher tax liability under the alternative will switch. Relaxing this assumption, revenues could drop to as little as 16 percent of GDP.

Between 2009 and 2018, we estimate that total federal revenues according to current law will be $37 trillion and individual income tax revenues will be $19 trillion. If enacted, Thompson's plan would reduce total federal revenues by 19 percent. Alternatively, the income tax cuts represent about 37 percent of individual income tax revenues over the period.

Effects on the Distribution of Tax Burdens

The Thompson tax plan is highly regressive. In 2009, households in the top 20 percent of the income distribution receive an average tax cut equal to 5.8 percent of income ($9,138), whereas those in the middle of the distribution receive an average cut of 2.3 percent of income ($774), and households in the bottom quintile receive an average cut of just 0.3 percent of income ($25) (table 5).[7] The group that benefits the most are taxpayers in the 90th to 95th percentiles of the income distribution. Taxpayers in that income range benefit greatly from AMT repeal as well as the drastically lower rates in the simplified tax system. Low-income taxpayers do not benefit from Thompson's plan because the simplified tax would eliminate refundable credits, such as the EITC and additional CTC, they receive under the current system. For most high-income taxpayers, the drastic reduction in the top statutory rate from 35 percent under the regular tax to 25 percent under the simplified tax, combined with the generous standard deduction under the new system, outweighs the loss of itemized deductions and credits that exist in the regular tax system.

Because the Thompson plan would permanently repeal the estate tax and extend the 2001-2006 individual income tax cuts set to expire at the end of 2010, it is even more regressive in future years when measured against current law. In 2011 the 157,000 households that represent the top 0.1 percent of income earners will see an average tax cut of 13.1 percent of income or $545,298 (table 7). Their average federal tax rate will fall from 36.2 percent under current law to 27.8 percent under the Thompson plan. In contrast, the bottom 20 percent of the income distribution will see an average tax cut of 0.7 percent of income or $69. Middle-income taxpayers receive an average cut equivalent to 4.6 percent of income or $1,649. Most of the benefits in the Thompson plan for lower- and moderate-income households in 2011 comes not from the simplified tax but from the extension of the 2001-2006 tax cuts, including the increased CTC, the 10 percent tax bracket, and increased standard deduction for married couples.

Finally, it should be noted that the long-run distribution of gains and losses depends on how the deficits are ultimately closed. If large deficits lead to massive cuts in entitlement spending and discretionary spending, low- and middle-income households could end up much worse off than they would have been had the tax cuts not been enacted. If, instead, the deficits lead to large future income tax rate increases, high-income people could end up being the losers. A third possibility is that some combination of spending cuts and tax increases result, making it impossible to predict who wins and who loses.[8]

A Revenue-Neutral Alternative?

Another option would be to increase the rates in the alternative tax and force taxpayers to use that system so that the cost was no greater than extending the tax cuts alone. This approach would require rates of 12.7 percent and 31.8 percent rather than rates of 10 percent and 25 percent and would be regressive. In 2009 taxpayers in the bottom quintile would see their after-tax income fall by 5.2 percent, taxpayers in the middle quintile would experience a 0.3 percent drop in income, and taxpayers in the top quintile would see their income fall by 0.1 percent. Taxpayers between the 60th and 95th percentiles come out ahead under this option.

Note also that the simple alternative tax would violate almost all of our international tax treaties because it would eliminate the foreign tax credit, which is designed to eliminate double taxation of income earned and subject to tax abroad. This flaw could be fixed by allowing the foreign tax credit, but that would raise the required tax rates further.

Other Issues

The Tax Policy Center has written extensively about the pointless complexity of the AMT and has provided scores of options for its revenue-neutral reform or repeal. The Thompson plan does eliminate the AMT, but it does not pay for the AMT's repeal. Also, it creates a second tax system, effectively an ''alternative maximum tax.'' Much of the complexity of the AMT revolves around the fact that it requires taxpayers to calculate their income tax twice: once under the regular system and once under the AMT rules. The alternative maximum tax in the Thompson plan would also require two calculations, although the rules of the alternative maximum tax are significantly simpler than those of the current AMT. But it also introduces complexity because of the generally irrevocable nature of the choice between systems. Taxpayers would have to determine whether the regular tax or the simplified tax would be better for them not just in the current year but also taking into account all future years. Taxpayers would need to factor in whether they ever plan to buy a house, have children, go to school, move to a different state, make more or less income, contribute to a retirement savings account, and so on. If taxpayers

[7]For our distribution estimates, we assume that households choose the system — the regular tax or the simplified tax — that results in the lowest amount of tax in the current year.

[8]For further discussion of the ultimate financing of revenue-lowering tax cuts, see Gale, Orszag, and Shapiro (2004).

forecast incorrectly, they could find themselves in future years locked into an alternative tax system in which they are paying more income tax than an identical individual who did not make a poor choice of system in a past year. Such a situation defies the generally accepted concept of horizontal equity in a tax regime. And it would make the tax system a significant source of risk regarding future income.

The proposal could also create enormous marriage penalties because of the provision that allows taxpayers to change their election on the occasion of marriage or divorce. For example, suppose a couple elects the simplified system when getting married, but then begins to earn substantial foreign-source income that is taxed abroad and eligible for the foreign tax credit under the regular income tax. They elect to switch back to the regular income tax. Suppose that at some future date they stop earning income abroad. They are now in the ''wrong'' tax system, but can no longer switch back to the alternative system as long as they stay married. Marriage could cost them thousands of dollars each year. However, the couple could immediately garner those savings by dissolving their marriage. In all likelihood the IRS would be required to issue regulations regarding sham nuptials and divorce proceedings.

Conclusions

The plan announced by Thompson would represent, by far, the largest tax cut in history. Over 10 years, individual income and estate taxes would fall by between $5 trillion and $7 trillion — or as much as 20 percent of overall revenues — depending on assumptions about how people respond. The tax cuts would be highly regressive and would become more so over time. By 2011 the top quintile would receive a tax cut equal to 9.5 percent of income, compared with 4.6 percent for those in the middle, and 0.7 percent for those at the bottom of the income scale.

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