Center on Budget and Policy Priorities

820 First Street NE, Suite 510
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

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PLAN FROM TOOMEY, OTHER REPUBLICANS NOT A FIRST STEP TOWARD BALANCED DEFICIT REDUCTION

Would Cut Taxes for Wealthy, Raise Taxes for Low- and Middle-Income Taxpayers, and Essentially Take Revenues Off the Table for Later Deficit Reduction

By Robert Greenstein and James R. Horney

Senator Pat Toomey and other Republicans on the Joint Select Committee on Deficit Reduction ("Supercommittee") portray their new offer to raise close to $300 billion in revenues (under a plan to reduce deficits by about $1.5 trillion over ten years) as a significant concession, and some observers have suggested it represents a welcome first step toward a balanced deficit reduction plan to put the budget on a sustainable path. But a closer examination of the proposal raises grave concerns and indicates that, in fact, it adds little balance.

It uses savings from closing tax loopholes and narrowing other tax expenditures mainly to set tax rates permanently at levels well below those of President Bush's tax cuts, and to make permanent *both* the highly preferential treatment of capital gains and dividend income under the Bush tax cuts *and* the temporary hollowing out of the estate tax for estates of the wealthiest one-quarter of 1 percent of Americans that Congress enacted in late 2010. Consequently, the proposal seems designed to make only a modest revenue contribution toward deficit reduction and then to *take revenues off the table for the larger rounds of deficit reduction that must follow*. Moreover, even while yielding modest savings, the revenue component would make the package *less* balanced by conferring large *new* tax cuts on the wealthiest Americans while forcing low- and middle-income Americans to bear most of the plan's budget cuts as well as its tax increases.

By permanently locking in tax rates well below the Bush levels, the plan would remove the potential to secure $800 billion in deficit reduction by letting the Bush tax cuts for households with incomes over $250,000 expire on schedule at the end of 2012, and it would remove the leverage that the scheduled expiration of these tax cuts provides to those who seek balanced deficit reduction with a substantial revenue contribution. It also would remove the potential to secure a substantial deficit reduction contribution from tax reform.

The various bipartisan groups that have crafted major deficit reduction proposals — the Bowles-Simpson commission, the Rivlin-Domenici task force, and the Senate's "Gang of Six" — all concluded that the most politically acceptable and economically efficient way to increase revenues substantially as part of a balanced package is through tax reform that cuts or eliminates many tax expenditures. While these commissions and groups used part of the savings from scaling back tax expenditures to reduce or hold down tax rates, they allocated very large portions of those savings to deficit reduction; all three of these bipartisan plans achieved $2 trillion or more in deficit reduction over the next ten years from revenues, relative to the current policy baseline that members of both parties on the Supercommittee are using. By contrast, the plan from Senator Toomey and his colleagues devotes the overwhelming bulk of savings from curbing tax expenditures to reducing tax rates and only a very small portion of savings — only $300 billion out of $3.5 trillion — to deficit reduction. If policymakers enact anything close to this plan, they will lose the opportunity to use tax reform to substantially reduce the deficit.

The Republican plan includes only $1.5 trillion in deficit reduction — an amount well short of what analysts generally agree is needed to stabilize the debt as a share of the economy in the coming decade. By eliminating the threat of the Bush tax cuts expiring (by locking in rates below the Bush levels) and enacting a tax reform that substantially reduces tax expenditures, the plan would remove these prime candidates for a significant revenue contribution for the major deficit reduction that policymakers will still have to enact. Indeed, the plan appears designed to heighten the chances that the substantially larger round (or rounds) of deficit reduction that must follow will focus almost entirely on spending cuts — which would force policymakers ultimately to adopt a series of severe program cuts that move substantially in the direction of the Ryan budget that the House passed in April.

As noted above, the Republican proposal would significantly shift tax burdens from high-income to lower- and middle-income taxpayers. High-income taxpayers would benefit enormously from the proposed cut in tax rates, while lower- and middle-income taxpayers would suffer disproportionately from the proposed reductions in tax expenditures, since the plan shields the main tax expenditure for the highest-income Americans — the highly preferential treatment of capital gains and dividend income. Preliminary estimates by the Joint Committee on Taxation of a plan similar to the Republican proposal indicate that taxpayers with incomes above $200,000 would get tax cuts significantly larger than the already-highly-lucrative tax cuts they will get if Congress extends all of the 2001 and 2003 Bush tax cuts.[1] The new tax cuts would be the largest for people with the highest incomes — those with incomes above $1 million would get a new tax cut of more than $30,000 a year, on average, on top of the tax cuts they would get from making all of the Bush tax cuts permanent. The Urban Institute-Brookings Tax Policy Center estimates that those households are receiving an average tax cut of $129,000 this year from the existing Bush tax cuts; thus, the total tax cut for these very well-off households could exceed $150,000 a year, on average, under the Republican plan.

Still more egregious, the Republican proposal would make permanent the temporary evisceration of the estate tax that Congress enacted at the end of 2010 as part of a deal between Republican leaders and President Obama. Compared to the already-generous cuts in the estate tax that were in place in 2009, this additional loosening would cut the estate tax *by more than $1 million apiece* on the estates of the wealthiest *one-quarter of 1 percent* of Americans. (These are the only estates affected, as smaller estates already are exempt from the tax under the 2009 estate-tax parameters.)

[1] The plan that JCT analyzed started with current policy (the 2001 and 2003 Bush tax are assumed to be permanent) and then reduced rates by roughly 15 percent. Under such a plan, the top rate would be 30 percent (instead of the 28 percent assumed in the Republican plan). The plan offset the cost of the rate cuts by reducing tax expenditures (the preferential treatment of income from capital gains and dividends was exempt from that reduction).

In contrast, taxpayers with incomes below $200,000 would see their tax bills *rise*, on average, compared to current policies. These additional taxes on lower- and middle-income Americans would come on top of the effects of the nearly $900 billion in spending cuts over ten years under the Republican plan, which would fall disproportionately on them because they are more dependent on Medicare, Medicaid, and other programs slated for cuts than are higher-income Americans.

The Republican proposal consequently is not one that seems appropriate even as a starting point for negotiations to produce a deficit-reduction plan that is fair and balanced.

The Republican Plan

The Republican proposal reportedly would:

- **Lock in individual income tax rates at levels well below those enacted as part of the Bush tax cuts in 2001 and 2003.** The top rate would not exceed 28 percent, which is nearly 30 percent lower than the 39.6 percent top rate under current law for 2013 and beyond, and is one-fifth lower than the 35 percent top tax rate that the Bush tax cuts established. There would be proportional reductions in the rates for other taxpayers, as well. These rate reductions would cost *more than $3 trillion* over ten years relative to a current-policy baseline that assumes continuation of the 2001 and 2003 Bush tax cuts and the loose estate tax rules enacted on a temporary basis in 2010. Compared to current law, under which the Bush tax cuts are slated to expire at the end of 2012, these rate reductions would cost *nearly $7 trillion*.

- **Increase revenues by about $290 billion over ten years relative to a current-policy baseline.** Relative to the baseline used by Bowles-Simpson, Rivlin-Domenici, and the Gang of Six — which assumed that the Bush tax cuts for upper-income taxpayers will expire as scheduled — the proposal would *shrink* revenues by about $500 billion. The proposal would reduce tax expenditures by about $3.5 trillion over ten years but then *use more than 90 percent of the savings* to offset the more-than-$3 trillion cost of reducing tax rates below the Bush tax-rate levels, as described above, producing a modest net revenue increase of $250 billion. The proposal would raise another $41 billion in revenues by using the chained-CPI to index parameters of the tax code.

  Republicans on the Supercommittee reportedly claim that their plan increases revenues by at least $500 billion, but that claim deserves little credence. Some $100 billion of that amount comes from assuming feedback effects from economic growth — so-called "dynamic scoring" — which is *not* used in standard estimates of the costs of proposed legislation, for good reason.[2] Another $100 billion comes from increases in Medicare premiums and other fees or charges that the plan incorrectly counts as revenue increases but that the federal budget shows, and CBO and OMB count, as spending reductions.

- **Cut spending by about $875 billion over ten years.** Approximately $635 billion would come from mandatory programs, more than half of this from Medicare and Medicaid (including

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[2] See Paul N. Van de Water, "Supercommittee Should Reject 'Dynamic Scoring': Estimates Are Uncertain and Subject to Manipulation," Center on Budget and Policy Priorities, October 18, 2011, http://www.cbpp.org/cms/index.cfm?fa=view&id=3598.

savings from increasing the Medicare eligibility age from 65 to 67), and about $160 billion from using the chained-CPI to determine cost-of-living adjustments for Social Security and other entitlement programs. The remaining $240 billion would come from cuts in discretionary programs on top of the cuts enacted in the Budget Control Act (BCA) in August. This $875 billion in cuts would disproportionately affect lower- and middle-income Americans, who depend more heavily on Medicare, Medicaid, and other mandatory and discretionary programs to ensure access to adequate health care, education, and other important services and benefits.

The plan's proponents describe the proposal as showing flexibility on the issue of revenues. But by locking in tax rates at very low levels and reducing tax expenditures dramatically, it appears designed to take significant revenue increases off the table for the inevitable future rounds of deficit reduction. (The plan's claimed $1.5 trillion in deficit reduction will not put the budget on a sustainable path — several trillion dollars of additional deficit reduction will be required to keep the debt from rising as a percentage of the gross domestic product in coming years and decades.)

To secure a significant revenue contribution in future deficit-reduction packages would require increasing tax rates or establishing a new revenue source such as a Value-Added Tax or other consumption tax. While any method of raising significant revenues is politically difficult, many lawmakers and experts have concluded that tax reform is likely to be a much more politically feasible means of securing the needed revenue than either raising rates or taxing consumption.

Taking the Bush tax cuts and tax expenditures, by far the two biggest potential revenue sources for deficit reduction, off the table for future deficit negotiations would greatly intensify pressure for severe cuts in Medicare, Medicaid, discretionary programs, and programs for the poor in coming deficit reduction rounds. Such additional cuts would almost certainly require changes in these programs that would undercut their ability to provide minimum levels of income and nutrition, and access to health care, for the nation's elderly and poor.

As noted, the Republican tax proposal also is highly regressive, shifting significant tax burdens from upper-income taxpayers to lower- and middle-income taxpayers. Details of the plan to reduce tax expenditures have not been provided, but proponents of the Republican plan have indicated they support an approach along the lines of a proposal by Harvard economist Martin Feldstein. Feldstein proposed to limit the use of certain tax expenditures (including the child credit, the mortgage interest deduction, and the exclusion of employer-provided health benefits) to no more than 2 percent of a taxpayer's Adjusted Gross Income (AGI).

The Feldstein proposal would disproportionately affect lower- and middle-income taxpayers for two reasons. First, it limits the tax expenditures that have a big effect on lower- and middle-income taxpayers while exempting and shielding the tax expenditure most important to higher-income taxpayers — the preferential treatment of income from capital gains and dividends. Second, since the limit is set as a percentage of AGI, it allows higher-income taxpayers to retain vastly higher dollar amounts of tax expenditures than lower-income taxpayers.

The Republican proposal also calls for changes in the corporate income tax. Proponents claim that these changes would be revenue neutral or even yield modest savings, but these claims may not be valid. A recent *Wall Street Journal* article indicated that the plan's corporate tax rate is between 25 and 28 percent, and just last week the Joint Tax Committee reported that it would be necessary to eliminate nearly all corporate tax expenditures — a virtual political impossibility — just to get to a

Feldstein Plan to Limit Tax Expenditures Would Have Regressive Impact

As noted, the tax-expenditure limitation in the new proposal reportedly may be based on a proposal by Martin Feldstein, although we do not know its precise details. Feldstein's estimates of his own plan show that:

- The proposal is regressive because it increases taxes as a percentage of AGI more for the lowest-income households than for high-income households.
- More than half of all of the revenue the proposal generates comes from limiting employer-sponsored health insurance (ESI), and middle-class families would provide the bulk of the revenue that comes from the ESI provision. Some 89 percent of the revenue generated by effectively taxing ESI would come from households with AGI below $200,000. In fact, a quarter of the *total* revenue that the *entire* Feldstein proposal generates comes from effectively taxing a portion of ESI for households below $75,000.
- Nearly three-fourths of the total revenue the Feldstein proposal raises — 71 percent — would come from people with incomes below $200,000.
- As an illustration of the equity problems the proposal creates, consider two taxpayers with different income levels but identical mortgages and the same amount of other tax preferences. Under Feldstein, the *high-income taxpayer gets to keep more of his mortgage interest deduction than the lower-income taxpayer is permitted to do.*

28 percent rate without *increasing* the deficit. If the corporate tax provisions are revenue neutral only because the plan's sponsors assume added revenues from "dynamic scoring," then the Republican proposal as a whole would consist of deficit-increasing corporate tax cuts and generous new high-income tax cuts, alongside sharp spending cuts and tax increases for low- and middle-income households.

Conclusion

Unfortunately, the Republican proposal does not represent a first step toward a balanced deficit-reduction plan that includes revenue increases and spending cuts and calls for somewhat larger sacrifices from those best able to bear the effects of tax increases and program cuts. In fact, from that last standpoint, the plan moves in the wrong direction and represents a step backward. The proposal couples a permanent reduction in high-end tax rates with a limitation on tax expenditures designed in a regressive manner as well as substantial reductions in Medicare, Medicaid, and other programs — steps that, in combination, would raise after-tax incomes at the top of the income scale while imposing hardship on millions of less-affluent Americans (and leaving many 65- and 66-year-olds uninsured if the Affordable Care Act's health insurance exchanges are unable to take effect and function adequately).

Moreover, the proposal would generate a level of revenues that is far below what Bowles-Simpson, the Gang of Six, and President Obama have proposed, and far below what is needed to avoid devastating budget cuts in the future that would move the country toward the policies of the

Ryan budget. The costs of any deal remotely similar to the new Republican proposal far outweigh the benefits of the modest deficit reduction it would produce.