

Growth, Distribution, and Tax Reform:
Thoughts on the Romney Proposal

by

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Abstract

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Governor Romney has proposed a personal income tax reform that would lower marginal tax rates and broaden the tax base. Critics of the proposal have argued that high-income taxpayers would receive a tax cut, and given that the proposal is meant to be revenue neutral, this would inevitably lead to increased taxes for families with low and moderate incomes. Because the Romney proposal does not specify in detail just what tax preferences might be eliminated or scaled back in order to broaden the tax base, much of the debate over it has focused on what provisions would be politically and administratively feasible.

While this discussion has been illuminating in some respects, something seems to be missing. Relatively little has been said about the possible effects of the Romney proposal on economic growth. This is curious because increasing growth is the motivation for the proposal in the first place.

In this paper, I analyze the Romney proposal taking into account the additional income that might be generated by economic growth. The main conclusion is that under plausible assumptions, a proposal along the lines suggested by Governor Romney can both be revenue neutral and keep the net tax burden on high-income individuals about the same. That is, an increase in the tax burden on lower and middle income individuals is not required in order to make the overall plan revenue neutral.

1. Introduction

One of the main elements of Governor Romney's program for increasing the growth of the U.S. economy is reform of the tax system. With respect to the personal income tax, the key elements of the Romney proposal are a reduction in all marginal tax rates by 20 percent, repeal of the alternative minimum tax, taxation of dividends and capital gains at a maximal rate of 15 percent, elimination of taxes on interest, dividends and capital gains for families whose incomes are under \$200,000, and broadening the tax base by reducing or eliminating various tax preferences. The Romney campaign has asserted that all this can be done in a way that raises the same amount of revenue as under the status quo ("revenue neutral") without raising the tax burden on taxpayers with low and moderate incomes.

In a recent paper that has garnered a lot of attention, Washington's Tax Policy Center (TPC) has challenged this assertion, arguing that it is mathematically impossible for the Romney proposal to achieve all these goals.¹ Specifically, the TPC argues that under the Romney proposal, high-income taxpayers would receive a tax cut, and given that the proposal is revenue neutral, this would inevitably lead to increased taxes for families with low and moderate incomes. The TPC paper has set off a spirited debate.² Because the Romney proposal does not specify in detail just what tax preferences might be eliminated or scaled back in order to broaden the tax base, much of the debate has focused on what provisions would be politically and administratively feasible.

While this debate has been illuminating in some respects, something seems to be missing. As far as I can tell, not much has been said about the possible effects of the Romney proposal on

¹ See Brown, Gale, and Looney [2012a].

² See, for example, the critique by Feldstein [2012] and Brown, Gale and Looney's [2012b] responses to their various critics.

economic growth. This is curious because increasing growth is the motivation for the proposal in the first place. In this paper, I analyze the Romney proposal taking into account the additional income that might be generated by economic growth.³ The main conclusion is that under plausible assumptions, a proposal along the lines suggested by Governor Romney can both be revenue neutral and keep the net tax burden on the upper income classes about the same. That is, an increase in the tax burden on lower and middle income individuals is not required in order to make the overall plan revenue neutral.

Another important issue seems to have gotten short shrift in the debate over the proposal. To assess the effects of moving from tax system X to tax system Y, one needs to know what X and Y are. In this case, X is the status quo, and Y is the Romney proposal. Much of the current controversy has arisen because the Romney proposal is not fully articulated, and therefore analysts can disagree about what kinds of tax preferences would be eliminated. That is, we don't know Y for sure. But X isn't clear either. That's because there is currently a contentious political debate over what the tax system in 2013 should look like. Republicans want the entire current policy, which includes across-the-board tax reductions enacted in 2001 and 2003, to continue into 2013, while Democrats want to revert to the pre-2001 law for high-income tax payers. The two parties are at an impasse, no one knows how the dispute will be resolved. In short, we do not know what the starting point (or "baseline") for this exercise should be, the 2012 law or the currently scheduled 2013 law. I therefore analyze the proposal two ways, once assuming that current law will continue into 2013 and hence be the baseline for reform, and once assuming that the provisions pertaining to high-income individuals will revert to their pre-2001

³ I do not consider modifications of the corporate tax or estate tax. The revenue effects of the estate tax are controversial. Indeed, some have argued that on net, it doesn't raise any revenue at all. But that debate is beyond the scope of this paper.

levels. It turns out that this aspect of the policy environment has a substantial effect on the conclusions.

2. Background

In order to explain my approach to analyzing the Romney plan, it is useful to begin by describing the tack taken by the TPC. As I understand it, the TPC model is based on a large set of publicly available tax returns (in electronic form and anonymized) provided by the Internal Revenue Service. When analyzing any change in the tax code, the TPC in effect plays H&R Block for every return, computing what the tax liability would be under the hypothetical new tax system. With such information for each taxpayer in hand, the TPC can compute the average change in taxes for each income group.

An important complication arises if taxes affect people's behavior. It's easy to think of examples: If taxes on wages go up, people might work less. If employers' purchases of health insurance for their employees become subject to taxation, employees might want less of their compensation in the form of generous health insurance policies and more in the form of cash. If the tax rate on dividends goes up, people might invest less in corporate stock. If these and a myriad other possible adjustments in behavior occur when the tax system is modified, then people's incomes will change. If one wants to compute people's tax liabilities under the new law, one should start with their actual incomes when the new law is in effect, accounting for behavioral responses.

The TPC analysts are well aware of this issue, and their model includes certain kinds of behavioral responses. Specifically, it allows for the possibility that in reaction to higher tax rates, people will rearrange their affairs so as to avoid some of the tax burden. For example, they

may increase their holdings of untaxed municipal bonds when the tax rate on interest income goes up, or they may take more of their compensation in the form of untaxed benefits when taxes on wages increase. The consequence of such avoidance activities is to reduce the amount of revenues collected when tax rates go up. The effect is symmetrical if tax rates go down; for example, if the tax rate on interest income is lowered, then taxpayers will shift their portfolios away from municipal bonds and toward bonds that pay taxable interest. This will reduce the revenue loss from any given reduction in tax rates. In the argot of tax revenue estimators, these changes are referred to as *micro-dynamic behavioral responses*.

At the same time, the TPC model assumes that regardless of the tax rate, people work the same amount, save the same amount, and invest the same amount. Thus, changes in the tax code have no effect on the amount of before-tax income.⁴ Because these so-called *macro-dynamic behavioral responses* are zero, no analysis of tax reform can ever show an increase or decrease in the total level of income in the economy. It follows that the revenue effects of any such changes are constrained to be zero.

What are we to make of this assumption? The first thing to note is that it is not idiosyncratic to the TPC. It is made, for example, by revenue estimators in the Treasury and the Congressional Joint Committee on Taxation.⁵ Thus, the TPC has not rigged its *modus operandi* in order to make the Romney proposal look bad. This observation, though, leaves unanswered the question of whether it is a sensible approach. My own view is that it provides an answer to an interesting question: If one wants to avoid the complications and uncertainties associated with the issue of how taxes affect economic growth, how does a tax reform change the amount of

⁴ The TPC analysts note that growth-induced changes in revenues could affect their estimates, but not be enough to affect the qualitative results. See Brown, Gale, and Looney [2012a].

⁵ See Cronin [1999] for a thorough discussion of the conventions used by the Treasury to estimate the distributional effects of tax policy.

revenue collected and its distribution across income groups? The assumption also provides a measure of consistency when estimating the revenue effects of hundreds of potential changes in the tax law considered by the Congress each year.

That said, one might want to incorporate macro-dynamic behavioral responses into the analysis for several reasons. First, when concerned citizens are looking at tables that purport to show the taxes that would be paid by various income groups under a given tax proposal, they might reasonably expect to see, well, the taxes that would be paid by various income groups under that proposal. Analyses that assume zero macro-dynamic behavioral responses don't meet that desideratum. Indeed, my highly unscientific survey of professional economists who aren't tax policy aficionados⁶ revealed that they were generally incredulous when I told them that the numbers being discussed in the press are based on calculations that explicitly rule out any changes in labor supply or saving behavior.⁷

Second, and relatedly, in the academic literature, it would not be considered exotic or even mildly controversial to include behavioral effects in analyses of tax policy. There is a long tradition of doing so.⁸ Indeed, my guess is that it would be challenging to publish a paper on the distribution of the tax burden in a first-rate academic journal if that paper assumed that no one's labor or savings behavior differed across various tax regimes.

Finally, it seems odd to assume away possible increases in incomes associated with a given tax reform proposal when its explicit goal is to enhance growth. This observation raises

⁶ "Tax policy aficionado" is to be preferred to "tax geek," the appellative used by my West Wing colleagues when I served on the Council of Economic Advisers.

⁷ In the early 1990s, Senator Phil Gramm, a Ph.D. economist, wanted to call attention to what he viewed as this critical flaw in the way that tax policies were analyzed. He asked the Joint Committee on Taxation to produce an estimate of the revenue consequences of a 100 % tax on income. Under JCT conventions, such a confiscatory tax would produce a huge revenue yield, because people would continue working even though their take home pay was zero.

⁸ See, for example, the papers cited in Feldstein [1983] and Altig et al. [2001]. Standard textbooks in Public Finance also spend a considerable amount of time discussing the possible impacts of taxation on labor supply and saving behavior. To pick a totally random example, see Rosen and Gayer [2009].

another reason that is given for excluding macro-dynamic effects—the impact of taxes on economic growth is uncertain. To be sure, there is a lot of disagreement on this issue among professional economists. But that is not sufficient cause to assume that the right answer is exactly zero. Rather, a more sensible approach is to consider alternative assumptions about how tax reform might affect the size of the economy, and see how they affect the substantive conclusions. As explained in the next section, this is the tack that I take.

3. The Framework

As already noted, the focus of the current controversy is on taxes that would be paid by high-income individuals under the Romney proposal. My goal is to see if there are plausible assumptions about behavior such that people in the upper tax brackets would pay about as much or more than they do under the status quo. I don't have a detailed tax simulation model of the kind used by professional tax revenue estimators. Instead, I rely on summary data from the IRS's *Statistics of Income (SOI)* for tax year 2009, the latest year for which such published data are available. Within each income bracket, the *SOI* provides data on total wages, dividends, taxable income, various deductions, tax liability, and so on. Without a detailed tax simulation model, I cannot compute how taxes would change on a household -by- household basis. On the other hand, there's something to be said for transparency. With this approach, I hope, it's relatively easy to see where the results are coming from, and to assess the implications of changing any assumptions that one thinks are implausible.

Here are the steps I follow:

Step 1. Calculate the amount of tax paid by the high income groups under the *status quo*.

As I mentioned above, this raises a question that, in a better world, wouldn't come up at all: Is

the “*status quo*” the law in effect in 2012, the law that is scheduled to go into effect in 2013, or something else that emerges from the political process? Because my office does not come equipped with a crystal ball, I do the analysis twice, once assuming that the current law with respect to high-income taxpayers will continue into 2013, and once assuming that it will revert to the pre-2001 situation. Another issue that has to be dealt with at the outset is how to define “high-income.” This is not a term of art. Some people would regard a family with an income of \$175,000 as being rich, while others would say that it is middle-class. Since who is “high-income” is in the eyes of the beholder, I again do the analysis twice, once for households with \$100,000 or more in income, and once only for households with \$200,000 or more.⁹

Step 2. Compute the amount of tax paid by high-income taxpayers under the Romney plan allowing for micro-dynamic behavioral effects, i.e., effects on the tax base that occur because people re-arrange their affairs (but not their labor supply or saving decisions) when tax rates change. As usual, there are differences among economists about the magnitude of these responses. My reading of the literature is that for high-income individuals, this response is substantial. I assume that for every hundred dollars that the government might expect to lose by reducing tax rates on this group, revenues fall by only about \$89 because of decreases in various avoidance activities.¹⁰ This is toward the low end of responses that have been estimated by economists.

The tax calculation requires an assessment of how taxable income would be affected by the reduction or elimination of various tax preferences. For each income class, the *SOI* provides

⁹ About 12.4 percent of all returns have incomes above \$100,000, and 2.8 percent have incomes over \$200,000.

¹⁰ Don't read this footnote unless you are an economist. Seriously, you'll find it impenetrable. Okay, I warned you. Here goes: The literature surveyed by Viard [2009] suggests that for high-income individuals, a reasonable estimate of the elasticity of taxable income with respect to one minus the tax rate is 0.4. To be on the conservative side, I assume a value of 0.25. Some research suggests that the responsiveness of high-income taxpayers may well be much higher. For example, Heim [2008] reports an elasticity exceeding one for high-income taxpayers.

detailed data for the major deductions (home mortgage interest, charitable giving, medical expenses, and state and local taxes). It also reports tax-exempt interest on state and local bonds. Information on the size of the health care exclusion by income class is not reported in the *SOI*; I base my estimates on information reported in Gruber [2011]. Estimates for the amount of inside build-up are taken from Gale and Looney [2012b]. (For the uninitiated, “inside build-up” is not what the dental technician tries to scare you about when admonishing you to floss every night before you go to bed. Rather, it refers to the cash value increase for certain life insurance policies.) To find the increase in tax liability associated with removing each kind of deduction, I multiply it by the applicable average effective marginal tax rate under the Romney proposal.¹¹ Thus, for example, if an individual is in the 28 percent tax bracket, then eliminating a \$100 deduction would increase his tax liability by \$28.

As I mentioned earlier, there is major controversy about the political and economic feasibility of eliminating various tax preferences, or, indeed, whether they would even end up in the final version of Governor Romney’s tax reform proposal. Hence, I report the revenue pick-up from the elimination of various groups of deductions separately, so that readers who are skeptical about whether some of the preferences might be eliminated can assess the revenue consequences themselves.

Step 3. Increase wage and capital income in order to take into account the macro-dynamic behavioral effects of the Romney proposal, that is, the effects on the size of the economy. Then multiply the increases in before-tax income by the applicable marginal tax rates. This immediately raises the question of how much the proposal would increase growth.

¹¹ Under the status quo, many individuals cannot deduct all of their state and local taxes because some of this deduction is eliminated under the Alternative Minimum Tax. Hence, in order to be conservative, when considering the revenue gain from eliminating the deduction of state and local taxes, I only include half the reported state and local taxes.

Although both economic theory and historical experience suggest that a tax system with lower marginal rates and a broader base would enhance growth, there is considerable controversy with respect to the quantitative impact. Put another way, the honest answer is that no one knows for sure.¹² Economic behavior is very complicated, and let's face it, economic forecasters haven't exactly covered themselves in glory during the past few years. But, as I emphasized above, it by no means follows that a zero response is the right answer. Given the uncertainty that attaches to these types of estimates, it makes sense to see how the results would differ assuming several different values for the growth-induced increase in incomes. I therefore include estimates for 3, 5, and 7 percentage points.

The 5 percent figure is consistent with Diamond's [2012] analysis, which is the only paper I have seen that embeds the Romney plan in a modern growth model. Diamond's computations are based on the assumption that the baseline is the law that will apply if the 2001/2003 tax changes are allowed to lapse, at least for high-income taxpayers. I refer to this as the "2013 law." The 2013 law embodies considerably higher tax rates than the 2012 law, so it is likely that the reform-induced increases in growth would be less with the 2012 than the 2013 baseline. That's because the more efficient the starting point, the lower are the incremental benefits of introducing a tax system with lower rates and a broader base. Therefore, my guess is that the growth effects using the 2012 baseline are lower than Diamond's estimate; 3 percentage points seems a reasonable figure.

¹² The following careful studies provide examples of how the growth effects of tax reform can depend on a variety of assumptions: Altig et al. [2001], Diamond [2012], and Mankiw and Weinzierl [2005]. Mankiw and Weinzierl's main conclusion is that "the dynamic response of the economy to tax changes is too large to be ignored. In almost all cases, tax cuts are partly self-financing. This is especially true for cuts in capital income taxes" (p. 19).

4. Results

The results are summarized in the table below. To begin, consider the first bank of numbers, which shows the outcome if the starting point is current policy, the “2012 law.” The first row shows the results for everyone whose income is \$100,000 or greater, and the second shows the figures for everyone whose income is \$200,000 or greater. Reading across the first row, the first figure, 679.4, tells us that under current policy, the revenue collected from taxpayers with incomes of \$100,000 or more is \$679.4 billion.¹³ The next entry indicates that the rate cuts in the Romney proposal would reduce revenue from taxpayers in this group by about \$158 billion, if there were no changes in behavior whatsoever. The next entry shows that if we account for a modest micro-dynamic behavioral response, this reduction in revenue becomes about \$143.9 billion.¹⁴ The next four entries show the revenue gain from base broadening, with separate entries for itemized deductions plus tax exempt interest, the exclusion of employer-provided health insurance, and inside build-up. The total is about \$200 billion.

The last three entries in the first row show the additional tax revenue due to economic growth under three scenarios. As just noted, I think that for the 2012 law baseline, the low end of the range in the table, 3 percentage points, seems a reasonable figure. This is associated with a \$25 billion dollar increase in revenues.

Now let’s sum things up. For the over \$100,000 group, the reduction in revenue because of rate cuts is about \$144 billion; the increase in revenue due to base broadening is \$200 billion; and with a 3 percentage point growth assumption, the additional revenue from a rise in incomes is \$25 billion.¹⁵ The net impact is a positive \$81 billion. That is, under these assumptions,

¹³ More precisely, this is tax liability before credits.

¹⁴ I use four significant digits to impress you with the scientific precision of the estimates.

¹⁵ This \$25 billion figure is 15.9 percent of the revenue loss if there were no changes in behavior at all, \$157 billion. Interestingly, this is quite close to Mankiw and Weinzierl’s [2005, Table 1] estimates of the same ratio.

taxpayers with incomes of \$100,000 or more would pay \$81 billion more in taxes. The second row shows analogous computations for taxpayers with incomes of \$200,000 or more. Again assuming a 3 percent growth rate, members of this group would pay about \$29 billion (or 6.5 percent of current revenues) more in taxes. The implication is that \$29 billion less of revenue from base broadening would be necessary in order to keep the taxes levied upon these high-income individuals about the same.

We next turn to the estimates using the 2013 law baseline, for which I think the 5 percent growth assumption is more appropriate. For taxpayers with incomes of \$100,000 and above, the net change in taxes is \$25.8 billion. For taxpayers with incomes of \$200,000 and above, the net change is now negative, \$28.1 billion (about 5.5 percent less than baseline revenues of \$509 billion). It seems fair to say that if the scheduled tax increases for 2013 actually went into effect *and* the definition of “high income” excludes people with 6-digit incomes below \$200,000, then under the Romney proposal, maintaining an approximately constant tax burden on high-income individuals would be more challenging. But I imagine that doing so would not be mathematically impossible.

5. Concluding Thoughts

One additional message emerges from the table: the revenues due to higher rates of economic growth are of the same order of magnitude as the revenues generated by certain important categories of base broadening. But the recent debate has been more occupied with the arcana of tax preferences and how they are allocated across income classes than with the impact of economic growth. To be sure, the extent to which a program of tax reform (and regulatory reform) would actually increase growth is controversial. But that doesn't mean it should be

ignored; rather, it should be debated. Economic growth should take center stage in the ongoing national conversation over tax policy.

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Revenue Consequences of the Romney Tax Reform

	Current tax liability	Revenue effect of lower tax rates		Revenue raised from base broadening				Additional tax revenue from rise in incomes due to higher incomes		
		Without "micro" behavior	With "micro" behavior 1/	Itemized deductions plus tax exempt interest 2/	Health exclusion	Inside buildup	Total	3%	5%	7%
Relative to 2012 law										
Over \$100K	679.4	-157.7	-143.9	112.5	72.5	15.2	200.3	24.9	41.5	58.1
Over \$200K	447.6	-89.5	-80.7	57.4	23.1	14.4	94.9	14.7	24.5	34.3
Relative to 2013 law										
Over \$100K	745.7	-245.0	-216.0	112.5	72.5	15.2	200.3	24.9	41.5	58.1
Over \$200K	509.1	-170.1	-147.5	57.4	23.1	14.4	94.9	14.7	24.5	34.3

1/ Calculation assumes a taxable income elasticity of 0.25.

2/ Includes medical expense deduction, charitable deduction, home mortgage deduction, state and local taxes paid deduction plus tax-exempt interest.

Note: All amounts are for fiscal years, in billions, and 2009 income levels.