Tax Policy Center

Urban Institute and Brookings Institution

Preliminary Revenue Estimate and Distributional Analysis of the Tax Provisions in *A Roadmap for America's Future Act of 2010*

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The Roadmap for America's Future Act of 2010 is a detailed reform package that overhauls Social Security, Medicare, Medicaid, and the U.S. federal tax system. In a January 27, 2010, report, the Congressional Budget Office (CBO) analyzed the spending provisions of the plan. This paper presents the Tax Policy Center's estimates of the revenue and distributional impact of the Roadmap's tax provisions.
A guide to TPC tables related to the act is available at http://www.taxpolicycenter.org/taxtopics/Ryan_Tax_Reform_Tables.cfm.

Summary of Key Tax Provisions[1]

Create an alternative simplified income tax system. The Roadmap would create an alternative federal income tax system, with a broader tax base and a lower, two-rate tax structure. It would eliminate all current deductions and credits[2] and exempt income from interest, dividends, and capital gains from the individual tax. Flow-through business income (i.e., income from sole proprietorships, partnerships, and S corporations) would only be taxed to the extent that it represents wage income. Taxpayers could choose to calculate their tax liability under either the current tax system or the simplified tax system. They would have to make their election within the first 10 years and could change tax systems one additional time or whenever they experience a "major life event (death, divorce, or marriage)."

Eliminate the estate tax. Consistent with no longer taxing investment income, the plan would repeal the estate tax for taxpayers in the alternative system. Because capital gains would not be taxed, the basis of inherited assets would no longer be an issue. The estate tax would continue for taxpayers who opt to remain liable for the current income tax.

Repeal the alternative minimum tax (AMT). The Roadmap would eliminate the alternative minimum tax entirely for all taxpayers regardless of which income tax option they choose.

Replace the income and payroll tax exclusion for employer-sponsored health insurance with a refundable credit. The Roadmap would repeal the exclusion for employer-provided health insurance (ESI) for both individual income and payroll tax purposes for all taxpayers. Instead, it would offer a refundable tax credit initially equal to $2,300 for individual filers and $5,700 for joint filers and families. The credit would be indexed by the average growth rate of the consumer price index (CPI) and the medical care component of the CPI.

Replace the corporate income tax with an 8.5 percent business consumption tax (BCT). The Roadmap would repeal the corporate income tax and impose an 8.5 percent BCT, a value-added tax (VAT) calculated using the subtraction method, on all businesses (C corporations, S corporations, partnerships, and sole proprietors). Businesses could immediately expense all investment and deduct the cost of employee health insurance. They could not deduct wages and other compensation.

Methodology

TPC estimated the revenue and distributional effects of the Roadmap using the Urban-Brookings Tax Policy Center microsimulation model. Details regarding the assumptions and additional information used in modeling the Roadmap plan are outlined below.

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[1] Descriptions of the proposal come from http://www.roadmap.republicans.budget.house.gov/, as well as email and phone communications with the minority staff of the House Budget Committee. The CBO letter is available at http://www.cbo.gov/doc.cfm?index=11048&type=1.

[2] Health savings accounts (HSAs) would remain in the alternative system. Contributions to HSAs would be excluded from tax.

TPC Model Assumptions:

- *ESI exclusion.* Estimates assume no change in coverage over time and that premiums grow at rates consistent with CBO current-law projections.[3]
- *Tax-advantaged savings plans.* Taxpayers who opt into the simplified income tax system could no longer contribute to IRAs, 401(k)s, or other tax-deferred savings plans that involve up-front deductions. They would, however, continue to pay tax on distributions from existing tax-advantaged accounts.
- *Taxation of flow-through business income.* Under the alternative tax system, only wage income from flow-through businesses would be subject to the individual income tax; any additional profits would be treated as dividends. TPC assumed that wage income for sole proprietorships and partnerships equals 80 percent of the net positive gain reported and that all flow-through income from S corporations (and other schedule E income) is dividend income.[4]
- *Taxpayer choice.* We estimate the effect on revenue under two separate assumptions: (i) tax units choose the system that minimizes their total tax liability and (ii) all tax units opt into the simplified system.

Other Estimates/Assumptions:

- *Business consumption tax (BCT).* The base of a broad subtraction-method VAT with expensing and border adjustments equals the total amount of household plus government consumption. Household consumption expenditures (excluding only imputed rent and financial services provided without payment) average approximately 58 percent of gross domestic product (GDP). Government consumption expenditures average 18 percent of GDP. With a 15 percent noncompliance rate and a 20 percent direct revenue offset, an 8.5 percent VAT would raise approximately 4.25 percent of GDP per year.
- *Refundable health care insurance tax credit.* According to the CBO report on the Roadmap, the cost of the health care tax credit would equal 2 percent of GDP in 2011. Since the credit would grow more slowly than GDP, the cost would gradually fall over time. Additionally, CBO estimates that 65 percent of the cost would show up as lower tax revenues while 35 percent would count as outlays. Based on those CBO estimates, TPC projects that the credit would reduce federal receipts by 1.3 percent of GDP in 2011.
- *Other revenue sources.* We use the revenue forecast from the CBO's January 2010 *Budget and Economic Outlook* for the amount of revenue generated from other sources (i.e., excise taxes, customs, and transfers from the Federal Reserve).

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[3] See http://www.cbo.gov/ftpdocs/107xx/doc10731/Average_Premiums_in_2009.pdf.

[4] Under current law, S corporations are required to provide "reasonable compensation" for shareholder employees.

Revenue Estimate

We calculate the revenue impact of the Roadmap in a manner that makes it comparable with the figures provided by Congressman Ryan's staff for the CBO report.[5] In particular, we estimate total gross federal receipts as a percentage of GDP. That differs slightly from TPC's normal methodology in that it counts negative tax liability as an increase in outlays, not a decrease in (net) tax revenue.

Federal revenues under the Roadmap would decline substantially as a percentage of GDP. Assuming taxpayers choose their preferred tax system, revenue would average 16.1 percent of GDP between fiscal years 2011 and 2015, rising to 16.6 percent by 2020, compared with 20.2 percent under CBO's January 2010 baseline. The fall in revenue would result primarily from the lower individual income tax rates and the exemption of capital income. If all taxpayers opted for the alternative system, revenues would increase to 16.8 percent by 2020.

We have confined our revenue estimate to the 10-year budget window ending with fiscal year 2020. However, at least two mechanical effects would affect the revenue estimate over a longer horizon. First, real bracket creep—the increase in effective marginal tax rates resulting from an increase in real wages over time—would increase revenues over time. Second, reduced taxable distributions from retirement accounts would lower revenues over time.

Distributional Analysis

The distributional analysis examines the impact of the Roadmap on tax burdens for calendar year 2014. We present the results against both current-law and current-policy baselines. The current-law baseline assumes that the 2001 and 2003 individual income tax cuts expire in 2011 as scheduled, Congress does not continue to adjust AMT parameters, and the estate tax reverts to its pre-2001 level. The current-policy baseline assumes that Congress makes the 2001 and 2003 individual income tax cuts permanent, indexes the parameters of the AMT for inflation, and maintains the estate tax at its 2009 level.

The incidence assumptions underlying the distributional estimates include (i) workers pay the individual income tax and both the employee and employer components of the payroll tax; (ii) taxpayers pay the corporate income tax (in the baseline) in proportion to their share of capital income; and (iii) taxpayers incur the cost of the BCT in proportion to their income from all sources, both taxable and nontaxable.

The Roadmap's tax provisions would be highly regressive compared with the current tax system. Relative to current law—and assuming that taxpayers choose their preferred tax system—the Roadmap would reduce taxes for most people, but the largest reductions would go to those with the highest incomes. After-tax income would rise by 1.5 percent for households in the bottom quintile (the 20 percent with the lowest incomes) but change

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[5] CBO assumed that the revenue path under the Roadmap would follow CBO's alternative fiscal baseline until 2029, after which it would remain at 19 percent of GDP.

little for the next two quintiles and go up just 0.6 percent for the fourth quintile. In sharp contrast, the top quintile would see their after-tax income jump 11 percent. Within that group, the top 1 percent would gain an average of 26 percent and the top 0.1 percent a whopping 36 percent. The share of total taxes paid by the bottom 80 percent would rise from 35 percent to 42 percent, while the share paid by the top 1 percent would fall by nearly half from 25 percent to 13.5 percent.

Taxpayers at the top of the income distribution gain most because they get the bulk of capital income, which the Roadmap would exempt from taxation. The change in average tax rates reflects that situation. While average rates would change little among the bottom 80 percent, they would fall dramatically at the top. For example, the average tax rate for the top 0.1 percent would plummet from 30 percent under current law to just 11 percent under the Roadmap.

Behavioral Responses and Other Sources of Uncertainty

The Roadmap would dramatically and fundamentally change the U.S. tax system. Although all revenue estimates contain some degree of uncertainty, that effect is magnified for large reforms such as the one considered here. We therefore provide only static estimates; we ignore any changes in income, either through a change in actual earnings or through a change in the reporting of income for tax purposes, resulting from the change in tax rates. Below we summarize the reason for this decision and discuss some potential sources of uncertainty in our analysis.

Dynamic versus static estimates. The Tax Policy Center typically incorporates a microdynamic response into its revenue estimates, based on a large economics literature that has examined the change in reported income in response to tax changes.[6] All else equal, we would expect the reduction in marginal tax rates under the Roadmap to increase taxable income. However, other aspects of the reform complicate using estimates based on previous (much smaller) tax changes. The BCT adds a layer of tax that would lower the after-tax value of work and thus at least partially offset any real labor supply response. In addition, the Roadmap's elimination of exclusions, deductions, and credits would remove another important source of income change. Most important, exempting capital income gives taxpayers a large incentive to reclassify income into these nontaxable forms. The combination of these and other factors make it difficult to quantify the magnitude of the behavioral response. It is likely, however, that behavioral change would lead to lower revenues.

Noncompliance among flow-through businesses. The Roadmap creates large incentives for taxpayers to reclassify wage income as capital income. Small business owners (i.e., sole proprietors and partnerships) would have the greatest opportunity to do that, simply

[6] An excellent review of the theory and evidence on how taxable income changes with respect to changing tax rates can be found in Saez, Slemrod, and Giertz, "The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review," Working Paper 15012 (Cambridge, MA: National Bureau of Economic Research, 2009).

by claiming lower salaries and therefore higher (untaxed) profits.[7] For simplicity, we have assumed that wages would equal 80 percent of net income currently reported by these entities.[8] This assumption likely understates wages for low-profit businesses and overstates wages for high-profit businesses. Actual reported wages would depend importantly on IRS rules and enforcement.

Revenue from the 8.5 percent BCT. Our estimate that the BCT would collect revenue equal to 4.25 percent of GDP relies on three specific assumptions: (i) the tax base includes nearly all private domestic and government consumption; (ii) noncompliance would occur at a 15 percent rate; and (iii) the tax would cause factor incomes to fall, which in turn would reduce revenues by 20 percent.[9] However, the estimate involves substantial uncertainty. Further, adding exemptions for education, health care, or government expenditures would result in lower revenue.

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[7] A recent GAO report discusses noncompliance issues associated with enforcing the "reasonable compensation" requirement among S corporations. It is available at http://www.gao.gov/new.items/d10195.pdf.

[8] The 80 percent figure is based on the aggregate ratio of labor compensation to total output for the U.S. corporate sector.

[9] The 15 percent noncompliance rate is in the range of estimates for the U.S. individual tax system and other value-added taxes around the globe.