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Tax Policy Center's Skewed Analysis of Governor Romney's Tax Plan

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Abstract
The Tax Policy Center (TPC) recently released a report that erroneously concludes that Governor Mitt Romney's tax reform plan would necessarily cut taxes for the rich and raise them for middle-income and low-income taxpayers. However, despite the authors' claims, their analysis is far from definitive. Instead, their conclusion is the result of a series of carefully made choices. These choices, not the underlying nature of the Romney plan, cause them to arrive at their selected result. This finding is harming the debate on tax reform.

This paper, in its entirety, can be found at **http://report.heritage.org/bg2735**

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The economy is in a prolonged slump and will continue to perform below its potential unless Washington implements significantly better economic policies. Tax reform is one policy improvement that could accelerate the recovery.

There is broad agreement that the tax code unduly restrains the economy and that tax reform could reduce or remove some of these restraints, freeing the economy to grow faster. Proper tax reform would:

- Improve economic performance by lowering marginal tax rates and making other growth-oriented changes;
- Enact a new tax code that raises the same amount of revenue as the previous tax code (revenue neutrality);
- Broaden the tax base to achieve revenue neutrality; and
- Maintain the current distribution of the tax burden across all income levels (distributional neutrality).

The Tax Policy Center (TPC) conducted an analysis of Governor Mitt Romney's tax reform plan. Governor

KEY POINTS

- The Tax Policy Center (TPC) recently released an erroneous report on Governor Romney's tax reform plan, claiming that it would cut taxes for the rich and raise taxes on middle-income and low-income taxpayers.
- The authors argue that their conclusion is definitive, but in fact their choices in framing their analysis, not the details of the Romney plan, determined their conclusion.
- The authors chose to examine only the impact of revenue-neutral pro-growth policy changes on the tax distribution. They could have chosen to analyze all aspects of the plan, including the requirement that it be distributionally neutral.
- The authors also chose which tax preferences lawmakers would close to make Governor Romney's plan revenue neutral.
- If they had made other choices, the authors would have reached a much different result.

Romney's plan follows all four requirements of tax reform. However, the report's authors conspicuously chose to ignore the requirement for distributional neutrality. The results of their analysis have garnered much attention because they erroneously claim that the plan would necessarily cut taxes for the rich, whom their report defines as those with incomes over $200,000, and raise taxes on middle-income and low-income taxpayers (all other taxpayers).

The authors' assumptions largely determine the report's conclusions. The carefully chosen assumptions underlying TPC's analysis misrepresent the outcome of Governor Romney's plan and misrepresent the results of pro-growth tax reform in general.

THE CAREFULLY CHOSEN ASSUMPTIONS UNDERLYING TPC'S ANALYSIS MISREPRESENT THE OUTCOME OF GOVERNOR ROMNEY'S PLAN AND MISREPRESENT THE RESULTS OF PRO-GROWTH TAX REFORM IN GENERAL.

TPC Analysis Is Not Definitive

Governor Romney's tax reform plan makes growth-enhancing changes in taxes. These changes include reducing all marginal income tax rates by 20 percent—for instance, the top rate would fall from 35 percent today to 28 percent—and eliminating the alternative minimum tax, the death tax, and the tax bias against savings and investment for taxpayers with incomes below $200,000. His plan would offset the revenue loss from those changes by broadening the tax base in unspecified ways.

In their analysis, the authors of the TPC report first calculated the revenue reduction from these pro-growth policy changes. They estimated that these changes would reduce revenue by $360 billion in 2015.[1] They then chose a combination of deductions, credits, exemptions, and exclusions ("tax preferences") that Governor Romney's plan would eliminate to broaden the tax base to generate the revenue necessary to make his plan revenue neutral.

In choosing which tax preferences to close, the authors started with a list of about 60 "tax expenditures" that apply to individual taxpayers.[2] They then ruled some of the tax preferences to be "on the table" and others to be "off the table." For example, the earned income tax credit, the child tax credit, and the mortgage interest deduction stayed on the table, but—most important—they removed the exclusion of interest on life insurance savings and the exclusion of interest from municipal bonds, among others. They then used the revenue raised from eliminating the selected policies to offset the $360 billion revenue loss from the pro-growth policy changes.

The authors applied the revenue gained from closing the tax preferences by starting with the highest income levels and then working down the income scale. For instance, when they exhausted the revenue gained from closing tax preferences for the top-income classification, they then moved to the next highest income group and so on until they had fully disbursed all of the revenue necessary to achieve revenue neutrality. They then determined how these changes would affect the distribution of the tax burden.

Their report concludes that these changes would "provide large tax cuts to high-income households, and increase the tax burdens on middle- and/or lower-income taxpayers"[3] because closing the specific tax preferences that the authors had chosen did not recapture enough revenue to make Romney's plan revenue neutral. They therefore distributed the remaining revenue from closing tax preferences to middle-income and low-income taxpayers. Under their analysis, the tax increases from closing those tax preferences more than offset the tax reduction for these families that comes from the pro-growth policy changes.

The report frames its eye-catching finding as being the only possible outcome for Governor Romney's plan. It says categorically:

> [M]aintaining revenue neutrality *mathematically necessitates* a shift in the tax burden of at least $86 billion away from high-income taxpayers onto lower- and middle-income taxpayers....
>
> Specifically, *it is not possible* to design a revenue-neutral plan that does not reduce average tax burdens and the share of taxes paid by high-income taxpayers under the conditions described

1. Samuel Brown, William Gale, and Adam Looney, "On the Distributional Effects of Base-Broadening Income Tax Reform," Urban–Brookings Tax Policy Center, August 1, 2012, p. 5, http://www.taxpolicycenter.org/UploadedPDF/1001628-Base-Broadening-Tax-Reform.pdf (accessed August 13, 2012).
2. For full list, see ibid., p. 20.
3. Ibid., p. 2.

> above, even when we try to make the plan as progressive as possible.[4]

The Tax Policy Center's assertion that their results are the last word on Governor Romney's plan is inaccurate. In fact, their finding is only one of many possible outcomes that analysts could reach given the limited data available about his plan. The authors have since released a statement that slightly walks back the finality of their conclusions.[5]

THE TAX POLICY CENTER'S ASSERTION THAT THEIR RESULTS ARE THE LAST WORD ON GOVERNOR ROMNEY'S PLAN IS INACCURATE.

Framing the Romney Plan

The TPC report's conclusion resulted from a series of decisions and assumptions that frame the analysis in a carefully chosen manner. The authors' choices and assumptions, not the underlying nature of the Romney plan, led to their selected result.

They first chose to disregard that Governor Romney's plan makes pro-growth policy changes while maintaining *both* revenue and distributional neutrality. The authors' modeling process ignored the distributional neutrality requirement and instead modeled one way that the pro-growth policy changes and revenue neutrality could affect the tax distribution.

The authors could have chosen to model the plan to capture its pro-growth policy changes *and* the revenue and distributional requirements. If they had done so, their analysis would have looked at various intricacies of instituting the tax reform plan. For instance, a more thorough analysis of the plan could address the difficulty of lowering rates by 20 percent while making the reform revenue neutral. Analysis on this ground would have vastly different implications for the current debate.

Authors' Assumptions Produced Their Conclusion

After first basing their analysis on assumptions that are in line with a hot-button tax issue (tax distribution), the authors made additional assumptions about tax preferences by placing some "on the table" and moving others "off the table." These assumptions led them further down a path of their own choosing, despite writing in their report "nor do we make assumptions regarding what those components might be."[6] These components are the tax preferences that they decided the Romney plan would close. Without making these assumptions about which tax preferences it closed, they could not conduct their analysis.

To lower marginal income tax rates and make other pro-growth changes in a revenue-neutral manner, all tax reform plans must reduce or eliminate tax preferences to offset the revenue lost from these pro-growth improvements. The authors' analysis models how eliminating specific tax preferences, as identified by the authors, would affect the distribution of the tax burden in their revenue-neutral model of the Romney plan's pro-growth policy changes.

The authors chose which tax preferences to keep based on their assumption that neither the next Congress nor a President Romney would propose changing these provisions. Eliminating the provisions they ruled out would certainly be politically difficult, and eliminating certain provisions could harm the tax base, but until lawmakers actually decide which tax preferences are on the table, there is no way to know for sure what those will actually be. To date, Governor Romney has not ruled out any tax preferences from elimination.

By preemptively ruling out these policies, the authors skewed their results. High-income taxpayers tend to benefit most from several of the policies that they ruled out, especially the exclusion of interest on life insurance savings and the exclusion of interest from municipal bonds. Their decision not to consider elimination of these policies is a major reason why they wrongly concluded that the Romney plan would necessitate a tax increase on middle-income and low-income taxpayers.

Incorrectly Ruling Out "Step-Up"

The authors also made a considerable error in ruling one policy out of bounds. They assume that the Romney plan would not change the step-up in basis of capital gains at death. This critical error significantly biases the report's results.

All proper tax reform plans should eliminate the death tax, as the Romney plan does. Under current law, heirs of taxable estates inherit assets after paying the death

4. Ibid., p. 5 (emphasis added).
5. Samuel Brown, William Gale, and Adam Looney, "Implications of Governor Romney's Tax Proposals: FAQS and Responses," Urban–Brookings Tax Policy Center, August 16, 2012, http://www.taxpolicycenter.org/UploadedPDF/1001631-FAQ-Romney-plan.pdf (accessed August 21, 2012).
6. Brown et al., "On the Distributional Effects of Base-Broadening Income Tax Reform," p. 2.

tax. When they sell those assets later, they calculate their capital gains tax by subtracting the asset's value at the time they inherited it rather than the price that the original owner paid. This is known as "step-up" basis. This makes sense because the heir already paid the death tax on the asset. Using the initial owner's basis would make the double taxation of the death tax even worse than it already is.

However, keeping step-up in place after eliminating the death tax would mean that some of the value of inherited assets escapes taxation. There is no economic justification for keeping it in place after death tax repeal. Plans that properly repeal the death tax typically employ a system, after repeal, whereby heirs pay capital gains tax when they sell inherited assets using as the basis the price paid by the person from whom they inherited the asset. This is called "carry-over" basis.[7]

Different Assumptions, Different Results

The authors assume that Governor Romney's plan would raise taxes on middle-income and low-income taxpayers by $86 billion, which would result from closing certain tax preferences on these taxpayers. However, if they had instead eliminated certain tax preferences that tilt toward high incomes that they originally ruled off the table, such as the exclusions of interest on life insurance savings and municipal bond interest, a minimum of $45 billion of the $86 billion would fall on high-income taxpayers, according to their follow-up analysis.[8]

If they fixed their step-up error, a large portion of the remaining $41 billion would also shift from middle-income and low-income taxpayers to high-income taxpayers, moving the Romney plan even closer to distributional neutrality.

The Office of Management and Budget estimates that step-up will reduce tax revenue by $24 billion in 2013.[9] Assuming that assets inherited after death follow the same distribution as long-term capital gains as reported by the IRS in 2009, 78 percent of that $24 billion, or $19 billion, would count as offsets for incomes over $200,000.[10]

In total, fixing the step-up error and putting the exclusions of interest on life insurance savings and municipal bond interest back on the table would shift at least $64 billion of the $86 billion tax increase (about 75 percent) that the report assumes would fall on middle-income and low-income taxpayers to high-income taxpayers.

In addition, this amount is decidedly conservative. Strong evidence suggests that the authors significantly underestimated the $45 billion that would be transferred up from middle-income and low-income taxpayers by eliminating the exclusions of interest on life insurance savings and municipal bond interest.[11] Furthermore, the $19 billion tax reduction for step-up in 2013 would likely be even higher in 2015, the year the report uses for its analysis.

Even assuming the $45 billion estimate is accurate and assuming step-up would not grow in value, there are several ways to close that remaining gap of $22 billion. For example, choosing tax preferences other than the ones the authors chose and combining them with other policy changes that they did not consider in their analysis could close the gap. These could include phasing out personal exemptions for high-income taxpayers or capping their itemized deductions. Some of these options might not be sound policy, but they would easily raise enough revenue from taxpayers earning more than $200,000 to close the $22 billion gap. In fact, President Obama's fiscal year 2013 budget includes a cap on itemized deductions for incomes over $250,000 that would raise considerably more than $22 billion.[12]

Making these changes in the authors' assumptions would undo their headline-grabbing conclusion that Governor Romney's tax reform plan would cut taxes on the rich and

7. Curtis S. Dubay, "The Economic Case Against the Death Tax," Heritage Foundation *Backgrounder* No. 2440, July 20, 2010, http://www.heritage.org/research/reports/2010/07/the-economic-case-against-the-death-tax.
8. Brown et al., "Implications of Governor Romney's Tax Proposals," p. 9.
9. U.S. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2013: Analytical Perspectives* (Washington: U.S. Government Printing Office, 2012), p. 261, http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/spec.pdf (accessed August 13, 2012).
10. Internal Revenue Service, SOI Tax Stats—Individual Statistical Tables by Size of Adjusted Gross Income: Individual Income Tax Returns Filed and Sources of Income, 2009 Tax Year, Table 1.1, http://www.irs.gov/file_source/pub/irs-soi/09in11si.xls (accessed August 24, 2012).
11. Matt Jensen, "The Tax Policy Center Updates Its Romney Plan Analysis," American Enterprise Institute, August 17, 2012, http://www.aei-ideas.org/2012/08/the-tax-policy-center-updates-its-romney-plan-analysis/ (accessed August 23, 2012).
12. U.S. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2013* (Washington,: U.S. Government Printing Office, 2012), p. 220, Table S-9, http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/budget.pdf (September 17, 2012).

raise taxes on middle-income and low-income taxpayers. Instead, with these changes in place, their analysis would show that the Romney plan makes growth-promoting policy changes in a revenue-neutral manner and does not raise taxes on middle-income and low-income taxpayers.

WITH THESE CHANGES IN PLACE, THEIR ANALYSIS WOULD SHOW THAT THE ROMNEY PLAN MAKES GROWTH-PROMOTING POLICY CHANGES IN A REVENUE-NEUTRAL MANNER AND DOES NOT RAISE TAXES ON MIDDLE-INCOME AND LOW-INCOME TAXPAYERS.

Dynamic Modeling Makes Distributional Neutrality Easier to Achieve

The changes suggested above would negate the findings of the TPC analysis on a mostly static basis. The authors account for taxpayers shifting income from nontaxable to taxable forms because of reduced rates. However, they did not account for the increased economic growth that the Romney plan would generate by increasing incentives to work, save, invest, and take on risk. In fact, they did not conduct this type of dynamic analysis because they entirely discount the beneficial effects of pro-growth policy changes. They even suggest that revenue-neutral tax reform plans like Governor Romney's plan could negatively affect growth.[13]

However, strong evidence indicates that the Romney plan would have a robust beneficial effect on economic growth.[14] A dynamic analysis that more accurately accounted for these growth effects would show a much smaller loss in net revenue from the plan's pro-growth policy changes, therefore requiring a smaller offset by closing tax preferences. Such a dynamic analysis indicates that the plan's pro-growth policy changes could generate between $24.9 billion and $58.1 billion in additional revenue just from taxpayers with incomes above $100,000.[15] This would make it easier for lawmakers to maintain distributional neutrality by specifically targeting the tax preferences that they still need to close on higher-income taxpayers.

Far Off the Mark

The Tax Policy Center is the industry standard for producing high-quality tax data that are integral to tax policy debates. However, in this TPC report, the authors' choices and assumptions lead them to a carefully chosen result that is misleading and biased. This hinders the debate on tax reform because lawmakers and the public need accurate information to make good decisions.

At best, this TPC analysis confirms that tax reform will require political leaders to make difficult decisions. This is self-evident. If tax reform were easy, Washington would have reformed the current 26-year-old code long ago.

To provide a more thorough analysis of Governor Romney's plan, the authors should show other ways to frame their analysis—including one that fully captures all of the plan's aims—to give a more detailed account of the issues his plan presents. They should also show the various ways that his plan could be revenue and distributionally neutral. Using dynamic analysis to evaluate the plan would further inform the public about the Romney plan because it would show its benefits, not just its costs.

An analysis on these grounds would move the debate forward rather than weigh it down with flawed results.

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13. Brown et al., "On the Distributional Effects of Base-Broadening Income Tax Reform," p. 14.
14. Martin Feldstein, "Romney's Tax Plan Can Raise Revenue," *The Wall Street Journal*, August 28, 2012, http://online.wsj.com/article/SB10000872396390444327204577617421727000592.html (September 10, 2012).
15. Harvey S. Rosen, "Growth, Distribution, and Tax Reform: Thoughts on the Romney Proposal," Princeton University, Griswold Center for Economic Policy Studies, *Working Paper* No. 228, September 2012, http://www.princeton.edu/ceps/workingpapers/228rosen.pdf (September 10, 2012).