Taxes under Obama and McCain

WILLIAM G. GALE AND BENJAMIN H. HARRIS

A good tax system raises the revenues needed to finance government spending in a manner that is as simple, equitable, stable, and conducive to economic growth as possible. Virtually no one thinks the current system is very good. It is not surprising, then, that tax policy has been a major issue in the Presidential election campaign, with both candidates proposing extensive changes.

The candidates take very different approaches to tax policy. The main differences are two: first, McCain's plans would reduce revenues by significantly more than Obama's; and second, McCain's would be substantially less progressive, especially among very high-income taxpayers, which is a fancy way of saying that Obama's claim that McCain's plan gives big tax cuts to the wealthy is spot on.

From the standpoint of growth or simplicity, both plans disappoint. It is hard to believe that either set of changes would have significant growth effects on the economy. Neither simplifies the tax code.

The biggest failure of their plans stems from a failure of our political system. Tax cuts appear to buy votes, but long-term projections of sacrosanct programs like Social Security and Medicare make clear that more, not less, revenue is required. Reality cannot be avoided forever, though we have avoided it for another election cycle. On this score, Obama fares less poorly than McCain as he doesn't cut taxes as much.

THE PLANS

Senator McCain would permanently extend all of the income tax cuts enacted by President Bush. Senator Obama extends almost all of the income tax cuts except those that apply to high-income households: he would raise the top two income tax rates, currently 33 and 35 percent, to their Clinton-era levels of 36 and 39.6 percent; restrict the value of exemptions and deductions for high-income households; and raise the top tax rate on dividends and capital gains to 20 percent from 15 percent. Both candidates would limit but not repeal the alternative minimum tax (AMT).

Neither candidate would let the estate tax expire. McCain would set a 15 percent tax rate

William G. Gale is Vice President and Director, Economic Studies, at the Brookings Institution and co-Director of the Urban-Brookings Tax Policy Center. Benjamin H. Harris is a Senior Research Associate at Brookings.

Table 1: Increase in National Debt by 2018 ($ trillions)

	Obama	McCain
CBO forecast	2.3	2.3
Candidates' increases	3.6	5.1
Total increase in national debt	5.9	7.4

on estates above $5 million; Obama a 45 percent rate on estates above $3.5 million.

McCain would cut the top corporate tax rate from 35 percent to 25 percent and allow businesses to expense equipment investment under certain circumstances.

Both candidates support automatic enrollment in individual retirement accounts (IRAs), a plan that would make saving for retirement the default option for workers.

On health care, Senator McCain would replace the current exclusion from income tax for health insurance provided by an employer with an individual-level refundable tax credit of $2,500 for singles and $5,000 for family coverage. Unlike the current exclusion, the credit would be available for both privately purchased and employer-provided insurance. Obama would provide a refundable tax credit to low-income families without access to employer-sponsored or public health insurance who buy insurance in a new insurance exchange. Both candidates also propose additional non-tax provisions for health care.

EFFECTS ON THE FEDERAL BUDGET

What are the fiscal effects of these changes? According to the estimates of the Tax Policy Center, compared to current law, Obama would cut taxes by $2.9 trillion over the 2009–2018 period. McCain would reduce taxes by nearly $4.2 trillion. These projections assume the 2001 and 2003 tax cuts expire in 2010 and that the AMT exemption is extended permanently at 2008 (nominal) levels. Including interest costs, Obama's plan would boost the debt by $3.6 trillion by 2018, McCain's by $5.1 trillion. These figures are on top of the $2.3 trillion increase that the Congressional Budget Office forecasts for the next decade.

Both candidates, however, prefer to compare their plans to an alternative baseline that extends the 2001 and 2003 tax cuts and indexes the AMT for inflation. This alternative baseline would collect nearly $3.6 trillion less than under current law over the coming decade. Against this alternative baseline, Obama would raise revenues by about $600 billion, while McCain would reduce revenues by $600 billion.

EFFECTS ON FAMILIES

Relative to the candidates' preferred baseline, the Obama plan would reduce taxes for low- and moderate-income families, but raise them significantly for high-bracket taxpayers. By 2012, middle-income taxpayers earning between roughly $40,000 and $70,000 would see their after-tax income rise by about five percent or nearly $2,200 annually. Those in the top one percent, with incomes in excess of approximately $600,000, would face a $19,000 average tax increase—a 1.5 percent reduction in after-tax income. McCain would lift after-tax incomes an average of about three percent, or $1,400 annually, for middle-income taxpayers by 2012. But, in sharp contrast to Obama, he would cut taxes

Table 2: Average Size of Tax Cut or Increase, by 2012

	Obama	McCain
Middle income families: $40,000 to $70,000	$2,200 tax cut	$1,400 tax cut
Top 1 percent: $600,000 and above	$19,000 tax increase	$125,000 tax cut

for those in the top one percent by more than $125,000, raising their after-tax income an average 9.5 percent.

These projections are built on descriptions of the candidates' plans provided by senior campaign staff. It is also possible to estimate the projected costs based upon what candidates have actually said on the campaign trail. Those promises paint a quite different picture with McCain's tax cuts increasing in magnitude and Obama's net tax cut decreasing. For instance, one version of McCain's proposal to create an optional simplified individual income tax system would increase the cost of his plan by more than $1 trillion over ten years. McCain has provided few details for his plan, but TPC projected the costs of a similar proposal made by the Republican Study Committee.

Obama has proposed raising the payroll tax for those earning over $250,000. Again, he has not provided details, but TPC assumes this would be a two percent income tax surcharge on adjusted gross income above $250,000 for couples and $200,000 for others and an additional two percent payroll tax for employers on each worker's earnings above those levels. Such a plan would increase taxes on high-income workers by nearly $400 billion over the next decade.

TPC estimates that McCain's health care proposals would reduce the number of uninsured by two million by 2018, at a ten-year cost of $1.3 trillion. Obama's reforms would take 34 million people off of uninsured status by 2018 at a ten-year cost of $1.6 trillion. Other analysts have produced significantly different estimates. The Lewin Group, for example, estimates that McCain's health plan will reduce the number of uninsured by 21 million by 2010 and will cost $2.0 trillion over a decade, compared to a reduction of 27 million uninsured and a net federal cost of $1.2 trillion for Obama.

The effects on economic growth are harder to gauge, but some rough calculations suggest the difference in effects may not be very large. Under Obama's plan, 61 percent of tax payers would see lower effective marginal tax rates (MTRs) and 15 percent would see higher MTRs. Under McCain's proposals, 20 percent of taxpayers would see lower marginal tax rates and one percent would see higher MTRs. McCain's MTR cuts are concentrated in the top 40 percent of the income distribution, while Obama's are sizable in every income quintile. The effects of the tax changes on small businesses have been vastly exaggerated in the public debate. The growth effects will be determined not only by the effects on marginal tax rates, but also the impact on national saving. McCain's proposals would increase public borrowing by $1.5 trillion more than Obama and therefore would exert more of a drain on national saving.

DISCUSSION

There are some good ideas presented in the various proposals. Return-free filing and automatic retirement saving are two choice ideas. And it is worth noting that both candidates have now endorsed taxes on carbon emissions, assuming that cap-and-trade with auctioned permits is the equivalent of a tax. Although McCain would give away some of the permits, and the key details still need to be worked out for either candidate, this represents a major shift in policy, and could bring in significant revenues.

McCain's proposal to restructure the employer deduction for health insurance expenditures into a fixed, refundable credit at the individual level is noteworthy on several dimensions. First, it is essentially a mandate to purchase health insurance, with the cost of violating the mandate equal to the value of refundable credit. Second, open-ended tax deductions are expensive, regressive, hidden spending programs. Converting them to fixed, refundable credits could greatly reduce the revenue loss, significantly reorient the distributional consequences and make taxes substantially simpler. This approach could be applied to many other deductions in the system.

What's perhaps more remarkable than the emerging new ideas is the set of issues that are not being discussed at all. One dog that's not barking is the AMT (alternative minimum tax), which will increase the inequity and complexity of the tax system. Tax filers pay the AMT when their AMT liability exceeds their regular income tax liability. Designed in the late 1960s and strengthened in 1986, the AMT operates parallel to the regular tax system and was originally intended to capture tax on excessive sheltering activity. The tax has evolved, however, so that it does not tax many shelters but does tax a variety of other things—like having children, being married, or paying state taxes—that most people do not consider shelters. Moreover, the number of taxpayers facing the AMT is slated to grow exponentially, from about 4 million in 2007 to about 33 million by 2010, because the AMT is not indexed for inflation and because some temporary AMT tax cuts are about to expire. Both candidates suggest "patches" for this, but shy away from more fundamental solutions.

Perhaps less obviously, both candidates have endorsed a baseline that assumes all of the Bush tax cuts are made permanent. Adoption of this baseline is no minor matter and it colors several issues. First, in every year since 2001, the Administration has requested that the tax cuts be made permanent and in every year Congress has refused to do so. So both candidates have adopted a baseline that no Congress has ever supported. Second, the loss in revenues from making the tax cuts permanent (even after adjusting for plausible feedback) would be enormous—equal to several times the resources needed to repair Social Security. As a result, the required spending reductions to pay for the tax cuts would be enormous, too. For example, if certain key programs were off-limits as ways of paying for the tax cuts—Social Security, Medicare, Medicaid because they need to be cut anyway to achieve long-term fiscal balance, defense and homeland security because we are still fighting the war on terrorism, and net interest because federal defaults would be a bad idea—all other federal spending would have to be cut by about half to pay for making the tax cuts permanent. In short, some very big fiscal choices are being swept under the rug by both candidates by virtue of adopting a baseline that assumes the tax cuts are permanent.

Third, the ability to enact fundamental tax reform—discussion of which has been absent in the campaign—is closely linked to the baseline issue. The expiration of the Bush tax cuts in 2010, coupled with the use of a current-law baseline (such as the one CBO follows) would create an ideal—once in a lifetime—situation to undertake fundamental reform, for two reasons. It would give lawmakers several hundred billion dollars per year to "play with;" that is, to offer as transition relief to taxpayers who would be adversely affected by reform. And, it would create the potential for a bi-partisan reform plan, because it would allow the majority of Republican lawmakers who have signed the "no new taxes pledge" to support a reform plan that represents a tax cut relative to the current-law baseline but a tax increase relative to the candidates' baseline.

Finally, using the candidates' baseline makes even harder an issue that may not require immediate action but should nevertheless help frame the current debate—the expected increase in government spending over the next several decades. Since 1950, tax revenues have hovered between 16 and 20 percent of GDP. Under current projections, however, government spending as a share of GDP will rise from 20 percent in 2007 to 22 percent of GDP by 2030 and 28 percent of GDP by 2050. The increase will be fueled by increased spending for Medicare and Medicaid, and to some extent Social Security. Unless political leaders are willing to enact truly massive cuts in the health programs, they will have to come to terms with the need for an increase in revenues to well above 20 percent of GDP.

It is, of course, not surprising from a political perspective that the candidates do not want to discuss the need for future tax increases. Nevertheless, the candidates' choice of baseline and the continual drumbeat and competition regarding who has the bigger tax cut will make it even harder to explain in the future why tax increases are needed. In addition, the need for higher revenue (in the absence of spending cuts) makes it even more important to make the current system as efficient and equitable as possible.

CONCLUSION

A more sensible set of structural reforms would aim to combine the fiscal responsibility and progressivity of the Clinton years, without the complexities of targeted subsidies, and the lower marginal tax rates of the Bush years, but with attention given to revenue levels, the growth of the AMT, and loopholes in the taxation of capital income. How could a system like this be created? Broaden the tax base by reducing and restructuring tax expenditures and use the revenues to hold rates down and eliminate the AMT. Neither candidate follows this approach, but it may be a helpful alternative to keep in mind.

The new President will face a variety of daunting economic issues, including tax policy. The breadth and severity of the financial crisis and economic downturn could well derail previous proposals, which were written in better times. Likewise, a fairly massive stimulus package may take political priority over more structural and longer-lasting tax changes. Still, while the new President may not be able to follow his original plan, the candidates offer a real choice on the structure of tax policy and the level of tax revenues.

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