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Would the Romney Tax Plan Necessarily Reduce After-Tax Incomes for the Middle Class?

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Introduction

In August, the Urban-Brookings Tax Policy Center (TPC) released a report[1] claiming to show that Mitt Romney's tax reform plan would necessarily raise taxes on middle-class taxpayers and reduce their after-tax incomes, while giving a significant tax cut to high-income taxpayers. This conclusion is based on a distributional analysis that assumes Romney's revenue-neutral tax reform plan, which includes an across-the-board 20 percent cut in marginal income tax rates and an elimination of the alternative minimum tax (AMT), would require a significant reduction in most tax expenditures, including most notably the child tax credit, mortgage interest deduction, state and local tax deduction, and the exclusion of employer-provided health insurance.

This TPC study showing Romney's tax plan as "raising taxes on the middle-class yet cutting taxes for the rich" has generated quite a bit of attention. Some economists such as Martin Feldstein[2] and Harvey Rosen[3] have taken issue with the study, arguing that Romney's tax plan would not necessarily require raising taxes on the middle class.

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[1] Samuel Brown, William Gale, & Adam Looney, *On the Distributional Effects of Base-broadening Income Tax Reform*, Urban-Brookings Tax Policy Center, Aug. 1, 2012, http://www.taxpolicycenter.org/UploadedPDF/1001628-Base-Broadening-Tax-Reform.pdf.
[2] Martin Feldstein, *Romney's Tax Plan Can Raise Revenue*, WALL STREET JOURNAL, Aug. 28, 2012, http://online.wsj.com/article/SB10000872396390444327204577617421727000592.html.
[3] Harvey Rosen, *Growth, Distribution, and Tax Reform: Thoughts on the Romney Proposal* (Working Paper No. 228, Princeton University, Sept. 2012), http://www.princeton.edu/ceps/workingpapers/228rosen.pdf.

One shortcoming of the TPC paper pointed out by Rosen is its "static" nature, meaning it fails to account for any income growth effects from the tax reform plan. Most economists would agree that revenue-neutral tax reform like that pushed by Romney would reduce economic distortions in the tax code and thereby increase economic efficiency and incomes by some degree over the long-term. Furthermore, unlike tax cuts that require debate over the economic effects of their financing, revenue-neutral tax reform does not need financing. In fact, if the plan was revenue-neutral on a static basis, it would likely raise revenue because it increases the size of the overall income tax base in the long-run.

The TPC study, which assumes no change in pre-tax incomes, claims that Romney's plan would decrease the after-tax incomes of tax units earning between $75,000 and $100,000 by an average of $884, or 1.2 percent, while increasing the after-tax incomes of those earning more than $1 million by $87,000, or 4.1 percent. For all tax units earning less than $200,000, TPC estimates the average after-tax income would fall by $539 and a rather significant $2,041 for tax units with children in that income range. These are the numbers that Obama's campaign has been hitting Romney with in television ads.

However, if one assumes that the Romney plan increases the size of the income tax base, then depending on the magnitude of such a dynamic effect, the supposed after-tax income decrease of low-and-middle-income groups may not be necessary, or at least not as large. The accompanying table walks through four such scenarios, showing the average change in after-tax incomes by income cohort under varying assumptions about the growth effects of Romney's plan. The scenarios are as follows: 0.5 percent growth in across-the-board pre-tax incomes, a 1 percent growth, a 1.5 percent growth, and a 2 percent growth. This analysis differs from that of Feldstein and Rosen in that it directly uses Tax Policy Center's figures and assumes that all of the other assumptions that the Tax Policy Center report made regarding Romney's plan are true, despite the fact that the Romney campaign disputes some of those assumptions.[4]

For a detailed step-by-step discussion of this study's methodology and the difference between after-tax income and economic welfare, see the accompanying working paper: *Methodology of Dynamic Adjustment to Tax Policy Center Analysis of Romney Plan*.

[4] See the Romney campaign's response to the study at http://www.mittromney.com/news/press/2012/08/romney-campaign-glaring-gaps-invalidate-tax-analysis. Also, the Heritage Foundation released a report showing that if those disputable assumptions are removed, Romney's plan becomes both revenue neutral and very close to distributionally neutral on a static basis. A posting on the Washington Post's Wonkblog quotes disagreement with the Heritage Foundation's claims on capital gains at death. The blog post also provides a useful resource for the many studies that have looked at the Romney tax plan. *See* Dylan Matthews, *Wonkblog's comprehensive guide to the debate over Romney's tax plan*, WASHINGTON POST WONKBLOG, Sept. 27, 2012, http://www.washingtonpost.com/blogs/ezra-klein/wp/2012/09/27/wonkblogs-comprehensive-guide-to-the-debate-over-romneys-tax-plan. For the Heritage Foundation study, *see* Curtis Dubay, *Tax Policy Center's Skewed Analysis of Governor Romney's Tax Plan*, Heritage Foundation, Sept. 25, 2012, http://www.heritage.org/research/reports/2012/09/tax-policy-centers-skewed-analysis-of-governor-romneys-tax-plan.

What the Numbers Show

As the table below shows, if the Romney plan was to cause an across-the-board 1 percent growth in pre-tax incomes, then the low-and-middle-income groups would no longer face a decrease in after-tax incomes as a result of his plan. The change in after-tax income would be relatively modest for low-and-middle-income earners at less than $100 per return, but it would nonetheless constitute an increase in after-tax income.

Average Change in After-tax Income from Romney Revenue-Neutral Tax Reform Plan ($ per tax unit)

Cash Income Group	Static TPC Estimate (0%)	0.5% Increase in Pre-Tax Incomes	1.0% Increase in Pre-Tax Incomes	1.5% Increase in Pre-Tax Incomes	2.0% Increase in Pre-Tax Incomes
$0-$30,000	-183	-82	20	121	223
$30,000-$50,000	-431	-198	35	269	502
$50,000-$75,000	-641	-302	36	375	714
$75,000-$100,000	-884	-418	48	514	979
$100,000-$200,000	-1,339	-624	91	806	1,521
$200,000-$500,000	1,808	3,274	4,740	6,206	7,672
$500,000-$1,000,000	17,136	20,517	23,898	27,279	30,660
$1,000,000 +	87,117	100,454	113,792	127,129	140,466
All Tax Units	0	404	808	1,213	1,617

Note: Figures in the Tax Policy Center report are for tax year 2015; baseline is current policy.
Sources: Tax Policy Center, and Author Calculations

The results do indicate, however, that anything less than a 1 percent growth rate would result in a decrease in after-tax income for low-and-middle-income groups. On the other hand, if incomes are assumed to grow faster than 1 percent, then lower-and-middle-income earners would see a fairly sizable increase in after-tax income. In the case of a 2 percent growth rate, this increase would range from $223 for those earning less than $30,000 to $1,521 for those earning between $100,000 and $200,000.[5]

There are two primary reasons for the difference between the TPC static numbers and the dynamic numbers shown in the table. First, higher pre-tax incomes increase tax revenue, other things being equal, thereby reducing the amount of base broadening that would be necessary to finance the 20 percent rate reduction that Romney has proposed. If pre-tax incomes were to grow by 1 percent (across the board) as a result of

[5] It should be pointed out that while these figures are averages for the income groups as a whole, effects vary across types of tax returns, such as married versus single, those with children versus those without children, and those who are homeowners versus those who are renters.

Romney's plan, this dynamic effect would be $28 billion. Second and more simply, higher pre-tax incomes increase after-tax incomes. That is, if Romney's plan increases economic efficiency and thereby overall pre-tax incomes, then that obviously will increase after-tax incomes.[6]

Conclusion

Overall, this analysis shows that if one assumes a 1 percent dynamic income growth effect under Romney's plan (as interpreted by the Tax Policy Center), then low-and-middle income earners would experience a slight increase in after-tax income as opposed to a decrease. A more modest growth of less than 1 percent would imply a decrease in after-tax income for low-and-middle-income earners, but a more robust growth of more than 1 percent would imply a substantive increase in after-tax income.

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About the Tax Foundation
The Tax Foundation is a 501(c)(3) non-partisan, non-profit research institution founded in 1937 to educate the public on tax policy. Based in Washington, D.C., our economic and policy analysis is guided by the principles of sound tax policy: simplicity, neutrality, transparency, and stability.

[6] It should be noted that an increase in pre-tax income is not necessarily the same as an increase in economic well-being. If middle-class taxpayers respond to the higher after-tax wage rates by working more, they are obviously better off on net (via revealed preference), but the income increase does not fully reflect an increase in well-being because they most likely had to give up some leisure in order to earn that additional income. On a similar point, it should be noted generally that a more accurate distributional analysis would be one that is done on the basis of the net welfare effect for each group, including gains from the elimination of deadweight loss. Because this is not a simple task, changes in tax burden or after-tax income are typically used as substitutes for changes in welfare.