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Martin Feldstein: Romney's Tax Plan Can Raise Revenue

By MARTIN FELDSTEIN

Mitt Romney's plan to cut taxes and offset the resulting revenue loss by limiting tax breaks has been attacked as "mathematically impossible." He would reduce all individual income-tax rates by 20%, eliminate the Alternative Minimum Tax and the estate tax, and limit tax deductions and loopholes that allow high-income taxpayers to reduce their tax payments. All this, say critics, would require a large tax increase on the middle-class to avoid raising the deficit.

Careful analysis shows this is not the case.

The critics' claims are based on calculations by the Tax Policy Center (a project of the Brookings Institution and the Urban Institute), which used a computer model to forecast personal tax revenue and Alternative Minimum Tax liabilities of taxpayers at each income level in 2015. Such forecasts are inevitably speculative.

To avoid the resulting uncertainties, I decided to analyze the Romney plan using the most recent IRS data, which is based on tax returns for 2009 and published in the current issue of the IRS quarterly publication. (Although 2009 was a low-income year because of the recession, using that year is preferable to looking back to some earlier period.)

Consider first the cost of the 20% reduction in all tax rates. The income-tax revenue in 2009 before all tax credits was $953 billion. Of this, $49 billion was from taxing dividends and capital gains at reduced rates that would not be subject to further reductions. So the 20% reduction applies to $904 billion and would produce what Washington tax analysts call a "static" revenue loss—that is, the revenue loss if the lower rates didn't cause taxpayers to change their behavior—of $181 billion.

But past experience shows that taxpayers do respond to lower marginal tax rates by acting in ways that increase their taxable incomes: increasing work effort, receiving more of their compensation in the form of taxable cash rather than untaxed fringe benefits, and spending less of their income on tax-favored forms of consumption that are deducted or excluded in calculating taxable income. More specifically, history shows that a tax cut that raises the after-tax share of earnings that an individual keeps by 10% raises taxable income by about 5%. This implies that the revenue loss from the 20% tax cut would be $148 billion, not $181 billion.

Eliminating the Alternative Minimum Tax in 2009 would have reduced revenue by an additional $23 billion. Eliminating the tax on interest, dividends and capital gains for married couples with

incomes below $200,000, and for single taxpayers with incomes below $100,000, would cost an additional $10 billion to $15 billion. This brings the total cost of the Romney income tax cuts to $186 billion at 2009 levels.

The key question raised by the Romney plan's critics is whether this revenue loss can be offset by broadening the tax base of high-income individuals. It is impossible to calculate the exact effects of the future reforms since Gov. Romney hasn't specified what he would do. But refuting the Tax Policy Center's assertions doesn't require that. It only requires knowing if enough revenue could be raised from high-income taxpayers to cover the $186 billion cost.

The IRS data show that taxpayers with adjusted gross incomes over $100,000 (the top 21% of all taxpayers) made itemized deductions totaling $636 billion in 2009. Those high-income taxpayers paid marginal tax rates of 25% to 35%, with most $200,000-plus earners paying marginal rates of 33% or 35%.

And what do we get when we apply a 30% marginal tax rate to the $636 billion in itemized deductions? Extra revenue of $191 billion—more than enough to offset the revenue losses from the individual income tax cuts proposed by Gov. Romney.

This does not mean eliminating all deductions. My preference would be to retain all deductions but to limit their total tax benefit to a moderate percentage of each taxpayer's adjusted gross income.

Additional revenue could be raised from high-income taxpayers by limiting the use of the "preferences" identified for the Alternative Minimum Tax (such as excess oil depletion allowances) or the broader list of all official individual "tax expenditures" (such as tax credits for energy efficiency improvements in homes), among other credits and exclusions. None of this base-broadening would require taxing capital gains or making other changes that would reduce the incentives for saving and investment.

What of the estate tax? Eliminating it would cost $21 billion of revenue in 2009 terms, an amount easily offset by other base-broadening changes. More importantly, eliminating the estate tax could be a revenue gainer in the longer term. That's because its current high rates induce high-wealth individuals to bequeath most of their money to foundations, universities and other tax-exempt institutions where the future investment earnings are untaxed. If the estate tax were abolished, more of those funds would go to children and grandchildren, who in turn would generate higher income taxes for generations.

Since broadening the tax base would produce enough revenue to pay for cutting everyone's tax rates, it is clear that the proposed Romney cuts wouldn't require any middle-class tax increase, nor would they produce a net windfall for high-income taxpayers. The Tax Policy Center and others are wrong to claim otherwise.

The Romney plan can reduce the current tax system's distortions, increasing national income in the short run and economic growth in the years ahead. That was the key to the very successful

Reagan tax cuts of 1986. It was also the tax-reform strategy embraced by the bipartisan Bowles-Simpson commission in 2010. And it could put the economy back on the right track in 2013.

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