



A Preliminary Analysis of the 2008 Presidential Candidates' Tax Plans

The Tax Policy Center*

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Tax and fiscal policy will loom large in the next president's domestic policy agenda. Nearly all of the tax cuts enacted since 2001 expire at the end of 2010. The individual alternative minimum tax (AMT) threatens to ensnare tens of millions of Americans in a web of pointless complexity and higher taxes, but a permanent fix palatable to both political parties has proven elusive. And large projected increases in spending on Social Security, Medicare, and Medicaid will put unprecedented demands on federal government revenue sources in the coming decades.

Fundamental reform of our tax system is one way to resolve these problems, but because reform creates both winners and losers, the leading presidential candidates have not addressed it seriously. Nonetheless, both candidates have proposed major changes to the nation's tax laws. Senator McCain would permanently extend the 2001 and 2003 tax cuts, increase deductions for taxpayers supporting dependents, reduce the corporate income tax rate, and allow immediate deductions for the cost of certain short-lived capital equipment. Senator Obama would permanently extend certain provisions of the 2001 and 2003 tax cuts primarily affecting taxpayers with incomes under \$250,000; increase the maximum rate on capital gains and qualified dividends; and enact new and expanded targeted tax breaks for workers, retirees, homeowners, savers, students, and new farmers. Senator McCain proposes to extend permanently the AMT "patch" that has prevented most individuals and families with incomes below \$200,000 from being affected by the tax, and in our interpretation of his proposal, Senator Obama would do the same. Each candidate would also increase the estate tax exemption and reduce the estate tax rate compared with current law in 2011 and beyond, although Senator McCain would cut the tax much more than Senator Obama. Finally, each candidate promises to broaden the tax base and reduce corporate loopholes. McCain lists eight breaks for oil companies as targets but, other than that, is short on details for his pledge to eliminate "corporate welfare." Obama identifies a variety of steps, including basis reporting for capital gains, taxing carried interest as ordinary income, and enacting sanctions on international tax havens that don't cooperate with enforcement efforts, but he would also need additional as-yet-unspecified policies to achieve his revenue target for base broadening.

Although both candidates have at times stressed fiscal responsibility, their specific non-health tax proposals would reduce tax revenues by \$3.7 trillion (McCain) and \$2.7 trillion (Obama) over the next 10 years, or approximately 10 and 7 percent of the revenues scheduled for collection under current law, respectively. Furthermore, as in the case of President Bush's tax cuts, the true cost of McCain's policies may be masked by phase-ins and sunsets (scheduled expiration dates) that reduce the estimated revenue costs. If his policies were fully phased in and permanent, the ten-year cost would rise to \$4.1 trillion, or about 11 percent of total revenues. Both candidates argue that their proposals should be scored against a "current policy" baseline instead of current law. Such a baseline assumes that the 2001 and 2003 tax cuts would be extended and the AMT patch made permanent. Against current policy, Senator Obama's proposals would raise \$700 billion, an increase of 2 percent, and Senator McCain's proposals lose \$600 billion, a decrease of roughly 2 percent. Senator McCain has stressed that deficits should be closed by spending cuts, but policies he identifies, such as limiting earmarks, would offset only part of the revenue losses attributable to his tax plan. As noted, both candidates may be overoptimistic in their revenue targets for closing tax loopholes—Obama probably more than McCain.

The two candidates' plans would have sharply different distributional effects. Senator McCain's tax cuts would primarily benefit those with very high incomes, almost all of whom would receive large tax cuts that would, on average, raise their after-tax incomes by more than twice the average for all households. Many fewer households at the bottom of the income distribution would get tax cuts and those whose taxes fall would, on average, see their after-tax income rise much less. In marked contrast, Senator Obama offers much larger tax breaks to low- and middle-income taxpayers and would increase taxes on high-income taxpayers. The largest tax cuts, as a share of income, would go to those at the bottom of the income distribution, while taxpayers with the highest income would see their taxes rise.

The impact of the tax code on economic activity under each candidate's policies would differ in several important ways. With Senator McCain's proposed policies enacted, the top marginal rates (35 percent on individual income and 25 percent on corporate income) would be significantly lower than under Senator Obama's plan (39.6 and 35 percent, respectively). McCain's reduced individual and corporate rates would improve economic efficiency and increase domestic investment, but the larger deficits he would incur to do so would reduce and could completely offset any positive effect. In contrast, Senator Obama's proposed new tax credits could encourage desirable behavior, particularly if the childless EITC and payroll tax rebate encourage additional labor supply among childless low-income individuals. However, he would also direct new subsidies at an already favored group—seniors—and an already favored activity—borrowing for housing—which could probably be better directed elsewhere.

Both candidates have proposed to change the tax treatment of health insurance in important ways. This analysis does not address those proposals, but we expect to evaluate both plans soon.

Section I of the report describes how we obtained information about the candidates' tax plans and how we performed our modeling and analysis. In section II, we outline the major tax proposals put forth, and in section III, we discuss the implications of their policies for the revenue raised and taxpayer economic activity. Section IV looks at their effect on the distribution of the tax burden.

I. How we did our analysis

One of the challenges facing anyone who wants to estimate the effects of candidates' tax plans is that no one—not even inside the campaigns—knows exactly what the proposals are. Stump speeches and campaign white papers are often short on the technical details needed to analyze the proposals fully. In addition, the candidates' plans are often works-in-progress that change during the course of a campaign.

However, it is important for the public to understand as much as possible how a candidate's tax proposals will affect them, their neighbors, and the broader economy. Thus, we have filled in the blanks, making assumptions about key missing details. Some of the details have been validated by campaigns, but some have not. Key details will likely change as the campaign continues, and we will update our analysis when we learn about revisions, modifications, or corrections. The details of the policies we model are clearly specified in the descriptions that follow.

One particular area of uncertainty is with respect to the health proposals. Senator Obama has not specified whether he will implement his subsidies for health insurance as a tax credit or direct spending program, while Senator McCain has said that his proposal is a tax credit. To allow an apples-to-apples comparison, we will compare both McCain's and Obama's health plans as if they were tax credits, but will do so outside our main analysis of the proposals (and do not include the health plans in this preliminary analysis).

In estimating the revenue and distributional effects of tax policies, we must specify a baseline—that is, a set of tax laws that are the yardstick for comparison. What the right baseline should be is not obvious. Congressional scorekeepers use a current law baseline, in which the tax cuts expire as scheduled after 2010 and nothing is done about the AMT. The administration uses a baseline in which it assumes all of the president's tax proposals are enacted, including permanent extension of the tax cuts, but only a temporary fix for the AMT. We estimate the cost of the plans against two baselines: current law (as described above) and extended law, in which the Bush tax cuts are extended and the AMT patch is extended.

We also estimate revenue as a share of GDP, which is independent of baseline, for each plan. This measure gives an indication of the level of government that could be sustained under each candidate's tax plans over the long term. Historically, tax revenues have averaged about 18 percent of GDP. (The president's fiscal 2009 budget projects receipts of 18.8 percent of GDP in 2013.) Senator McCain's proposals, if fully phased in by the end of his first term, would reduce revenues to about 17.6 percent of GDP, while Senator Obama's proposals would cut revenues less—to about 18.5 percent of GDP.

II. Description of the plans

In this section, we outline the two candidates' proposed tax plans. As noted, we sometimes had to make assumptions to model the proposals. We assume that all proposals would take effect January 1, 2009, unless the campaign has specified an alternative schedule. Of course, the legislative process might delay the effective date for some proposals (as well as make other changes). Table 1 summarizes the major elements of each plan.

A. Senator McCain's Plan

Extension of the 2001 and 2003 tax cuts. Almost all of the tax cuts enacted during the past eight years are set to expire at the end of 2010. (The major exception is the Pension Protection Act of 2006, which permanently expanded tax-favored retirement savings accounts and the saver's credit.) The sunset means that in 2011 the 10 percent tax bracket will disappear; the 28, 33, and 35 percent tax rates will increase to 31, 36, and 39.6 percent, respectively; the capital gains rates will increase from 0 and 15 percent to 8 or 10 and 18 or 20 percent (with the lower rate applying to long-held assets); the child credit will shrink to \$500 per child and be nonrefundable for most taxpayers; the top of the 15-percent bracket and the standard deduction for married couples will no longer be set to double the amounts for single filers; the top estate tax rate will increase to 55 percent and the exemption will decline to \$1 million; and numerous other provisions will revert to their previous form or expire completely. Senator McCain has proposed

making the 2001 and 2003 tax cuts permanent (except for the estate tax, which he would modify as described below).

Extension and indexation of the 2007 AMT patch. Individuals must compute their taxes under both the regular tax and the alternative minimum tax. If the alternative minimum tax exceeds the regular tax, taxpayers must pay the higher amount. The AMT requires taxpayers to add a number of preference items (including personal exemptions and certain deductions) to their taxable income, but they may deduct a special AMT exemption. Since 2001, the AMT exemption has been temporarily increased for a year or two at a time to prevent large numbers of taxpayers from becoming subject to the tax. In 2007, the exemption was \$66,250 for joint returns and \$44,350 for singles and heads of household. But, in 2008, the AMT exemption is set to return to its 2000 level—\$45,000 for couples and \$33,750 for singles and heads of household—and the number of taxpayers subject to the AMT is projected to increase from 3.5 million in 2007 to 26.5 million in 2008.

Senator McCain proposes to extend and increase the higher AMT exemption amounts set in 2007 and allow individuals to claim personal nonrefundable credits against the AMT. The 2001 tax cuts, which Senator McCain has said he would make permanent, allowed refundable credits against the AMT. Between 2009 and 2013, the AMT exemption amount would be indexed for inflation. After 2013 the exemption would be increased by inflation plus 5 percent until the joint exemption reaches \$143,000 at which point the rate of increase will revert to inflation only.

Although Senator McCain does not plan to repeal the individual AMT, he would allow taxpayers to avoid it by electing to be taxed under an optional alternative tax system (see box 1).

Dependent exemption increase. Taxpayers may claim exemptions for themselves, their spouses (on joint returns), and each dependent (usually children, but also certain other relatives and household members supported by the taxpayer). The exemption is \$3,500 in 2008 and is indexed for inflation going forward. Senator McCain has proposed increasing the dependent exemption—but not the personal exemption for taxpayers themselves—by \$500 each year beginning in 2010 until it reaches \$7,000 in 2016, after which it would again be indexed for inflation.¹ Because current law indexes the exemption for inflation, the proposed \$7,000 exemption in 2016 will not be twice its level scheduled under current law but only two-thirds higher. (We project that the personal exemption will be \$4,200 in 2016 under current law.)

Married couples filing a joint return reporting adjusted gross income of \$50,000 or less would be eligible for the \$7,000 exemption immediately (in 2009). The higher exemption phases out at a rate of \$100 for each \$1,000 (or fraction thereof) in excess of \$50,000, but not below the level set by the unrestricted phase in available for all taxpayers. For married couples, the \$7,000 threshold would not change until 2017 (that is, it would not be indexed for inflation in the interim). Thus, although this provision is sometimes described as a doubling of the personal exemption, that is true only in the first year, and then only for lower-income married couples.

¹ Our analysis assumes the projected current-law exemption of \$3,600 in 2009 with subsequent increases to \$4,000 in 2010 and then \$500 each year through 2016.

Summary of the Major Provisions of the McCain and Obama Tax Plans

| | John McCain | Barack Obama |
|---------------------------|---|---|
| 2001/2003 Tax Cuts | Make permanent all provisions other than estate tax repeal | Make permanent select provisions, including child credit expansions; 10, 15, 25, and 28 percent rates; changes to tax implications of marriage |
| Estate Tax | Make permanent estate tax with \$5 million exemption and 15 percent rate | Make permanent estate tax with \$3.5 million exemption and 45 percent rate |
| AMT | Extend and index 2007 AMT patch, further increase exemption by 5 percent in excess of inflation after 2013 (temporarily) | Extend and index 2007 AMT patch |
| New Tax Cuts | <p>Increase the dependent exemption by two-thirds (phased in)</p> <p>Reduce the maximum corporate income tax rate from 35 percent to 25 percent (phased in)</p> <p>Allow first-year deduction of 3- and 5-year equipment and deny interest deduction (expires)</p> <p>Convert R&D credit to 10 percent of wages incurred for R&D, make permanent</p> <p>Suspend federal gas tax for summer 2008</p> | <p>Refundable "Making Work Pay Credit" of 6.2 percent of up to a maximum of \$8,100 of earnings</p> <p>Refundable "Universal Mortgage Credit" of 10 percent of mortgage interest for nonitemizers</p> <p>Eliminate income tax for seniors making less than \$50,000 per year</p> <p>Extend childless EITC phase-in range, increase phase-out threshold</p> <p>Increase EITC phase-in rate to 45 percent for families with three or more children</p> <p>Increase to \$5,000 the add-on to EITC phase-out threshold for married filers</p> <p>Make CDCTC refundable and increase maximum credit rate to 50 percent.</p> <p>Make saver's credit refundable and change formula to 50 percent match up to \$1,000 of contributions</p> <p>Make permanent R&D credit and renewable energy production tax credit</p> <p>Mandate automatic 401(k)s and automatic IRAs</p> <p>Increase Hope credit: 100% match rate up to \$4,000</p> |
| Health | Replace exclusion from income for employer sponsored insurance with refundable credit of \$2,500 for individuals and \$5,000 for families | Income-related subsidies for health insurance |
| Tax Increases | <p>Repeal domestic production activities deduction</p> <p>Eliminate oil and gas loopholes</p> <p>Unspecified corporate base broadeners</p> | <p>Increase maximum capital gains rate to 25 percent</p> <p>Tax carried interest as ordinary income</p> <p>Eliminate oil and gas loopholes</p> <p>Tax publicly traded financial parts. as C corps.</p> <p>Codify economic substance doctrine</p> <p>Reallocate multinational tax deductions</p> <p>Require information reporting of basis for gains</p> |
| Simplification | Create optional alternative tax with two rates and larger standard deduction and exemptions | Provide taxpayers with simple returns the option of pre-filled tax forms to verify and sign. |

Permanent estate tax cuts. Current law reduces the estate tax in 2009 and eliminates it entirely in 2010, but only for that one year. Expiration of the 2001 tax cuts in 2011 will return the estate tax exemption to \$1 million and the top estate tax rate to 55 percent. Senator McCain has called

for permanent reduction of the tax in 2010 by increasing the estate tax exemption from its scheduled 2009 level of \$3.5 million to \$5 million and reducing the tax rate from 45 percent to 15 percent. We assume the exemption remains specified in nominal terms (i.e., is not automatically adjusted for inflation) as it is under current law. McCain would also make permanent the current deduction for estate taxes paid to states rather than revert to a credit. We assume no change in the gift tax.

Corporate income tax reductions. Corporations currently pay tax at rates of 15, 25, 34, and 35 percent and are also subject to 3 and 5 percent surtaxes in certain income ranges. Senator McCain proposes to cut the maximum corporate income tax rate from 35 to 25 percent. McCain's plan would eliminate the 35 percent bracket immediately and phase down the 34 percent rate to 30 percent in 2010, 28 percent in 2012, 26 percent in 2014, and 25 percent thereafter. The surtaxes would also be eliminated immediately.

Under current law, businesses must depreciate equipment over time, deducting part of its value each year. Equipment is classified by the time period over which its cost must be depreciated (e.g., 3 years, 5 years, 7 years, 10 years, and so forth). Senator McCain proposes to allow businesses to immediately deduct (expense) the full cost of three- and five-year business equipment purchased between 2009 and 2013. After 2013, businesses would again have to depreciate equipment over time. To prevent tax sheltering, the proposal would disallow the interest deduction for expensed equipment. However, it is not clear how such a policy would be implemented in practice as there often is no direct linkage between equity, debt, or cash-flow financing and equipment purchases.

Repeal of domestic production activities deduction. Under current law, U.S. companies may reduce taxable income attributable to qualifying domestic production activities. The deduction amount is increasing gradually to 9 percent of income in 2010. This effectively reduces the maximum tax rate on such income from 35 to 32 percent. Senator McCain would repeal the domestic production activities deduction.

Permanent extension and modification of the R&E credit. Under current law, companies may claim a tax credit of 20 percent for certain research and experimentation expenditures above a base amount. The effective rate of subsidy on all expenditures has been estimated at between 3 and 5 percent. Senator McCain has proposed making the research credit permanent and changing the formula for computing its value to be 10 percent of all wages spent on research and development.

Elimination of preferential treatment of oil companies. Under McCain's plan, several provisions benefitting oil companies would be repealed, including expensing of exploration and development costs, the 15 percent tax credit for enhanced oil recovery costs for tertiary wells, the exception to uniform capitalization rules for intangible drilling costs, and the special depreciable lifetimes for select oil company assets.

Corporate base broadening. Senator McCain has proposed broadening the corporate income tax base. In combination with the provisions targeting oil companies, the campaign claims these provisions would raise \$30 billion per year. Specific proposals to achieve this objective have not

been specified and thus the revenue figure cannot be verified. Our analysis assumes their first-year revenue gains and projects them to grow at the same rate as GDP throughout the 10-year budget window.

Gas tax holiday. Senator McCain has called for a federal gas tax holiday in summer 2008. Even if enacted, the holiday would occur before the presidential election, so we exclude it from our analysis.²

Tax subsidies for health insurance. Senator McCain has proposed replacing the current exclusion from income tax for health insurance provided by an employer with a refundable tax credit of \$2,500 for singles and \$5,000 for family coverage. Unlike the current exclusion, the credit would be available for privately purchased insurance as well as insurance provided by an employer. We assume that the credit amounts would be indexed for inflation after 2009 using the CPI-U, the usual price index used to index parameters of the tax code. (Alternative policy proposals have suggested indexing new health insurance credits and deductions to an index of medical prices, rather than overall prices as measured by the CPI-U).

² See "Quick Facts on the Gas Tax Holiday," http://www.taxpolicycenter.org/taxtopics/quick_gastax.cfm, for additional discussion of the economics of a gas tax holiday.

Box 1. Optional alternative maximum tax

Senator McCain has proposed to allow taxpayers to figure their taxes under an optional alternative tax system, but the only details released are that it would have two rates, a large standard deduction, and an increased personal exemption. A McCain economic advisor wrote in a post to *TaxVox* (the Tax Policy Center's blog) that he expects the proposal to be revenue-neutral, neither increasing nor decreasing federal tax revenues (Holtz-Eakin 2008).

The plan lacks sufficient details to model, but we also judge the notion of a revenue-neutral and optional alternative tax system as implausible. Taxpayers would tend to choose the alternative system only if they expected it to reduce their tax liability or reduce their compliance burdens enough to make additional taxes palatable. Although there is no hard evidence on how much people are willing to pay for simplicity, it is likely not a large amount. Indeed, if taxpayers were willing to pay higher taxes to simplify their return, they could do so under the current system simply by skipping all deductions, exemptions, and credits. Few, if any, taxpayers make this election. Furthermore, if the new alternative tax system does not offer significant tax cuts, the additional complexity of figuring taxes under two systems and estimating which one would be better would be a source of *additional* complexity, not less. An offsetting factor, however, would be a requirement that people electing the alternative tax would have to use that alternative for a number of subsequent years before they could return to using the regular tax. Some taxpayers might make a costly choice to save taxes now but end up paying more tax in future years.

It should be noted that both the Republican Study Committee and the presidential campaign of Senator Fred Thompson have proposed optional alternative taxes. We estimated that those plans would result in dramatically reduced revenues—by as much as \$6–7 trillion over the next decade compared with current law (Burman, Leiserson, and Rohaly 2008). Those proposals would have disproportionately benefited those with very high incomes, making the tax system less progressive.

A simpler, fairer, and more pro-growth tax system would be a huge improvement over the current system, but it should replace the current system rather than further complicate an already complex income tax.

B. Senator Obama's Plan

Partial extension of the 2001 and 2003 tax cuts. Senator Obama has called for extending the tax cuts affecting the middle class while eliminating those benefitting the wealthiest Americans. According to the campaign, this means that Obama would extend the child credit expansions; the changes to marriage bonuses and penalties; and the 10, 15, 25, and 28 percent income tax rates, as well as the lower tax rates on capital gains and qualified dividends for taxpayers in those four tax brackets. He would restore the 36 and 39.6 percent rates and increase the rate on capital gains and dividends for taxpayers in those brackets. In order to match the campaign's stated revenue

targets, we assumed a rate of 25 percent for capital gains and qualified dividends. Obama would also restore the phaseouts of personal exemptions and itemized deductions, but set the income threshold at \$250,000 for married couples filing jointly. As under current law, the thresholds for the phaseout of personal exemptions would be lower for singles and heads of households, but those for the phaseout of itemized deductions would not vary with filing status. The thresholds would be indexed for inflation as they are under current law. Senator Obama would also extend several smaller expiring tax cuts, including the adoption credit and the simplifications to the earned income tax credit. Certain other provisions would be modified, as described below.

Extension and indexation of the 2007 AMT patch. Senator Obama supports “fiscally responsible” AMT reform. Without further guidance as to what this means, we assume his plan would simply extend the policy in recent years, indexing AMT exemption amounts for inflation from 2007 levels and permanently allowing individuals to claim personal tax credits against the AMT.

Freeze 2009 estate tax law. Senator Obama’s plan would permanently fix the estate tax law in its 2009 form: an exemption of \$3.5 million and a top rate of 45 percent. We assume the exemption would remain fixed in nominal terms as it is under current law and that the state death tax credit would not be restored.

Making Work Pay credit. Senator Obama has proposed a new refundable tax credit for wage earners and the self-employed. His Making Work Pay credit would equal 6.2 percent of up to \$8,100 of earnings (yielding a maximum credit of approximately \$500). Spouses filing a joint return would each be eligible for the credit.³ In order to match the campaign’s stated revenue targets, we assume the credit phases out based on adjusted gross income at a 5 percent rate beginning at \$75,000 (\$150,000 for couples). All thresholds would be indexed for inflation after 2009.

Universal Mortgage credit. Under current law, taxpayers who itemize their deductions may deduct mortgage interest. Senator Obama has proposed a refundable credit equal to 10 percent of mortgage interest for non-itemizers, up to a maximum credit of \$800 (indexed after 2009).

New incentives for savings. Senator Obama has proposed a set of programs that would change the structure of and incentives to contribute to tax-favored retirement accounts. He would mandate automatic 401(k) plans for employers offering retirement plans. Automatic 401(k)s require individuals to opt out of their employer’s retirement plan rather than to opt in, but do not change the individual’s set of available options. Senator Obama would require employers who do not sponsor other retirement plans to offer access to automatic IRAs. Automatic IRAs allow individuals without employer retirement plans to contribute to tax-favored IRA accounts via payroll deduction. If an employee does not either opt out or specify her own IRA account, the employer would automatically contribute a share of earnings to a designated employee account set up on the employee’s behalf by a financial institution. Finally, Obama would also modify the current nonrefundable saver’s tax credit. The new saver’s credit would be fully refundable and would equal 50 percent of qualified retirement savings contributions up to \$500 for an individual

³ For example, a couple in which each individual earns \$8,100 would qualify for \$1,000 in tax credits, while a couple with one spouse earning \$16,200 would receive only the \$500 individual credit.

and \$1,000 for a couple (for a maximum credit of \$250 and \$500, respectively). The credit would begin to phase out at a 5 percent rate at AGI of \$32,500 for individuals and \$65,000 for couples. The credit thresholds would be indexed for inflation after 2009.

American Opportunity Tax Credit. The current Hope credit is a nonrefundable credit of 100 percent of the first \$1,200 of qualified higher educational expenses and 50 percent of the next \$1,200 up to a maximum of \$1,800 per student (in 2008). Qualifying expenses generally include tuition and fees for the first two years of a qualifying postsecondary education institution. Senator Obama has proposed making it a fully refundable, 100-percent tax credit for the first \$4,000 of qualifying higher education expenses and renaming it the American Opportunity Tax Credit. The credit would be computed using prior-year tax data and delivered upon enrollment directly to the higher education institution. Students receiving the American Opportunity credit would have to perform 100 hours of community service upon completing their education. We assume this credit would retain all other features of the current Hope credit, including the phase-out thresholds and indexation of the maximum qualifying expenses. We further assume no changes in the lifetime learning credit. The tuition and fees deduction is assumed to expire as scheduled under current law.

Expansion of the earned income tax credit. Senator Obama has proposed several expansions to the earned income tax credit. He would increase the maximum amount of earned income on which the credit for childless workers is calculated from a projected \$5,910 in 2009 to \$6,300, \$6,800 in 2010, \$7,100 in 2011, and \$7,250 in 2012. The threshold at which the phaseout begins would be increased from \$7,390 in 2009 to \$9,825, \$10,875 in 2010, \$12,325 in 2011, and \$14,500 in 2012. The amounts would be indexed for inflation after 2012.⁴ He would double the phase-in and phase-out rates for childless workers who pay child support from 7.65 to 15.3 percent.⁵ Thus, their maximum tax credit would double from \$555 to \$1,110 in 2012. Obama would also increase the credit rate from 40 to 45 percent for taxpayers with three or more children. The phaseout rate would remain at 21.06 percent. Finally, the phase-out threshold for joint filers would be \$5,000 higher than for heads of household, up from \$3,100 under current law, and that amount would be indexed for inflation after 2009.

Expansion of the child and dependent care credit. The child and dependent care credit is a nonrefundable tax credit available to individuals paying for child care needed so they can either work or look for work. Senator Obama's tax plan would make the credit refundable and increase the maximum rate from 35 to 50 percent. It would also increase the threshold at which the credit rate begins to phase down from \$15,000 to \$30,000 and reduce the rate by 2 percentage points, rather than the current 1, for each \$2,000 or fraction thereof in excess of that level. The current minimum credit rate of 20 percent would remain and would apply to taxpayers with income of \$60,000 or more.

⁴ Under current law, the EITC thresholds are rounded to the nearest multiple of \$10 in each year. For modeling convenience, we retain this practice during the years 2009 through 2012, even when it conflicts with the stated thresholds. The impact on the simulation results is negligible.

⁵ We do not model the doubled EITC for childless workers who are noncustodial parents paying child support due to data limitations that limit the quality of the estimate. The cost of the provision is small relative to the others.

Exempting seniors earning less than \$50,000 from income taxation. Senator Obama would exempt seniors earning less than \$50,000 from income taxation. A tax unit would pay no income tax if the primary taxpayer (and the spouse for married couples) is age 65 or older and the tax unit's adjusted gross income, untaxed Social Security benefits, and tax-exempt interest totals less than \$50,000. Tax units entitled to a net refund from the government would remain entitled to that refund. The threshold would be the same for both single and married households and would not be indexed for inflation (meaning that its value would erode over time). The eligibility threshold for seniors is a strict threshold—there is no phaseout.

Permanent extension of the R&D credit and renewable energy production credit. Senator Obama has proposed making permanent both the research credit and the renewable energy production credit.

Miscellaneous revenue-raisers (first set). Senator Obama has proposed (1) taxing carried interest as ordinary income, (2) eliminating all oil and gas loopholes, (3) codifying the economic substance doctrine (requiring transactions to have economic justification absent tax benefits to be eligible for tax benefits), (4) requiring publicly traded financial partnerships to pay the corporate income tax, and (5) creating an international tax haven watch list of countries that do not share information returns with the United States (and potentially enacting sanctions against those countries). Combined with other as-yet-unidentified provisions, the campaign expects these provisions to raise an additional \$41 billion in revenue each year. Because not all provisions are identified, we cannot verify that revenue estimate but use it for 2009. We assume that the amount would grow at the same rate as GDP throughout the 10-year budget window.

Miscellaneous revenue-raisers (second set). Senator Obama has also proposed (1) imposing a windfall profits tax on oil and gas companies, (2) requiring information reporting of basis for capital gains, reallocating multinational tax deductions, and (3) closing loopholes in the corporate tax deductibility of CEO pay. Combined with other as-yet-unidentified provisions, the campaign expects these provisions to raise an additional \$35 billion in revenue each year. Again, because we lack necessary details, we cannot verify the revenue figure but use it for 2009. We assume that the revenue raised would grow at the same rate as GDP throughout the 10-year budget window.

Excluded policies. We do not model the following policies for which Senator Obama has stated support because of data limitations and/or insufficient details about the policies that would be enacted: (1) permanent extension of the adoption credit; (2) creation of new incentives for first-time farmers; (3) elimination of capital gains taxes affecting start-up businesses, venture capitalists, and entrepreneurs; (4) creation of new incentives for small business investment; and (5) creation of an automated filing system for most taxpayers. The revenue and distributional consequences (by income) of these policies are small in relation to the other policies discussed.

Box 2. Earnings subject to Social Security payroll tax

In 2008, the first \$102,000 of earnings is subject to Social Security payroll taxes at rates of 6.2 percent on both employees and employers. The amount is indexed to inflation. (All earnings are also subject to Medicare payroll taxes at rates of 1.45 percent on employees and employers.) Senator Obama has spoken at times about subjecting the earnings of high earners to the Social Security tax, possibly with an exemption for earnings above the current cap but below a new threshold of \$200,000 or \$250,000, as a way to reduce long-term imbalances in the Social Security system. In combination with a top federal income tax rate of 39.6 percent (about 41 percent including the effect of the itemized deduction phaseout), the proposal could raise effective tax rates on labor income for high earners above 55 percent (and over 60 percent for residents of states with income taxes).

However, in response to questions from the Tax Policy Center, the Obama campaign has insisted that there is no specific policy to raise Social Security taxes on anyone. Thus, we have not included this aspect of the Senator's plan in our analysis. We may revisit this decision, especially if more specifics become available.

III. Economic Analysis

There is some common ground between the two plans. Both candidates agree that the elements of the 2001 and 2003 tax cuts primarily affecting those with incomes below \$250,000 should be extended, that the estate tax should be substantially reduced but not repealed, and that the research credit should be made permanent (though Senator McCain would change the formula by which it is calculated). Both candidates would continue to limit the number of taxpayers affected by the AMT but would not repeal it.

However, the differences between the candidates' plans are large. For one thing, they both have a back-to-the-future look to them—McCain continues major themes of the Bush administration (lower marginal tax rates, low taxes on capital) while Obama follows the Clinton administration approach of expanding targeted tax breaks for social policy objectives and introducing new tax breaks. Senator McCain's plan cuts taxes relatively more for high-income taxpayers, while Senator Obama's plan cuts them relatively more for lower-income taxpayers.

This section considers the effects of the candidates' proposals on efficiency and simplicity, with some discussion of the effects of the specific provisions on progressivity. Section IV examines the effects on the distribution of tax burdens.

A. Senator McCain's Plan

Senator McCain has proposed substantial tax cuts, offset only very partially by proposals to broaden the tax base. Some of these tax cuts would have positive economic benefits, but adverse

effects of the resulting increased deficits may make the net effect of the plan economically harmful.

1. Individual Income Taxes

The most striking feature of Senator McCain's plan is the substantially decreased top marginal income tax rates relative to current law. Under current law, the maximum statutory individual income tax rate after 2010 would be 39.6 percent and the maximum statutory corporate income tax rate would be 35 percent. Enactment of McCain's proposed policies would drop the top individual and corporate rates to 35 and 25 percent, respectively. Cutting the maximum tax rates reduces the economic distortions taxes create and thus enhances economic efficiency. With lower individual and corporate rates, taxpayers have less incentive to engage in tax-preferred behavior (such as borrowing to buy bigger homes or taking compensation in tax-free fringe benefits instead of wages for individuals, or investing in tax-favored activities for companies). Taxpayers may also increase hours of work and saving, although these effects are likely to be small. At the same time, reductions in the top marginal tax rates make the tax system less progressive.

The reduction in the top marginal rate on individual incomes comes as part of Senator McCain's proposal to permanently extend the 2001 and 2003 tax cuts. The full cost of this proposal is approximately \$1.7 trillion over ten years (table R1). These tax cuts encompass an array of provisions, including reduced marginal rates, reduced rates on capital gains and qualified dividends, expansions in the child tax credit, and reduced taxation of married couples compared with singles. Lower marginal rates would improve economic efficiency and lead to higher incomes in the long run, but expansion in the child credit does not improve economic incentives. Lower capital gains rates reduce lock-in to existing investments, but also encourage increased tax sheltering by conversion of ordinary income to capital gains. Lower dividend tax rates partially offset the adverse effects of taxing corporations more heavily than other businesses, but also provide large windfalls to investments in corporations that currently pay very low effective tax rates. Both capital gains and dividends are highly concentrated among upper income taxpayers.

Senator McCain would also permanently extend the AMT patch. This provision would substantially reduce the number of taxpayers affected by the AMT compared with current law, simplifying their tax calculations and frequently lowering the marginal tax rates they face. But the provision is quite expensive: federal tax revenues would fall by about \$1.1 trillion over 10 years. Furthermore, reductions in AMT liability also predominantly benefit higher-income taxpayers (See Burman, 2007).

Senator McCain proposes a two-thirds increase in the dependent exemption. This would reduce taxes for many taxpayers supporting dependents, but would provide no benefit for the many low-income filers who have no taxable income or for high-income filers subject to the AMT. Indeed, the proposal would subject more families to the AMT even with the proposed increase in the exemption because personal exemptions reduce regular tax liability but do not affect liability under the AMT. Assuming the proposed phase-in schedule, the proposal would cost approximately \$185 billion over the next 10 years, but would lose much more revenue if it were fully phased in: about \$265 billion over the 10-year period.

Table R1
Senator John McCain's Tax Proposals
Impact on Tax Revenue, 2009-18

| | 2009-13 | 2009-18 |
|--|-----------------|-----------------|
| (1) Make permanent all provisions of the 2001 and 2003 tax cuts other than estate tax repeal, including the reduced marginal tax rates, the marriage penalty relief, and the expanded child credit. | -516.3 | -1,663.7 |
| (2) Index AMT exemption for inflation permanently, increase by inflation plus 5% annually beginning in 2014 until the joint exemption surpasses \$143,000, and allow personal nonrefundable credits against the AMT. | -337.6 | -1,109.5 |
| (3) Increase estate tax exemption to \$5 million (unindexed), cut rate to 15%. | -85.2 | -338.7 |
| (4) Increase dependent exemption by \$500 annually between 2010 and 2016 and index for inflation thereafter. Accelerate increase for joint tax units. | -43.7 | -185.0 |
| (5) Reduce corporate income tax rate to 30% in 2010-11, 28% in 2012-13, 26% in 2014, and 25% thereafter. | -231.0 | -734.7 |
| (6) Repeal domestic production activities deduction. | 43.8 | 97.6 |
| (7) Allow expensing of all 3-year and 5-year business equipment. Deny interest deductions for expensed equipment. Sunset after 2013. | -92.5 | -18.0 |
| (8) Permanently extend and modify the R&D credit. | -51.5 | -133.1 |
| (9) Eliminate corporate welfare. Unverifiable campaign-provided revenue estimate | 157.8 | 364.8 |
| Total of all provisions | -1,156.3 | -3,720.5 |
| Addenda: | | |
| Total of all provisions fully phased in | -1,413.9 | -4,095.3 |
| Net revenue impact against tax cuts extended, AMT-patched baseline | -6.7 | -253.3 |
| Net revenue impact against tax cuts extended, AMT-patched baseline fully phased in | -264.4 | -628.2 |
| Federal tax revenue as a share of GDP | 18.0 | 17.8 |
| Federal tax revenue as a share of GDP fully phased in | 17.7 | 17.6 |

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0308-5).

2. Corporate Taxes

Senator McCain would reduce corporate tax rates, temporarily allow expensing for some investments, and make the research and experiment credit permanent. He would partially offset the revenue loss of these proposals by reducing business tax preferences.

The reduction in statutory tax rates for the corporate income tax rate would cost approximately \$700 billion over ten years if phased in as the McCain campaign has suggested; the cost would rise to \$1 trillion if it were enacted immediately. The top U.S. corporate income tax rate (including the effect of state corporate income taxes) is higher than the tax rates in most of our major trading partners, but other countries include a larger share of corporate economic income in the tax base, so their effective rates are not that different. As a share of GDP, the United States collects less revenue from corporate income tax than most of our trading partners. In recent years, other countries have been lowering their corporate tax rate and broadening the base and similar changes in the United States could be beneficial. A lower corporate tax rate would encourage multinational corporations to invest more in the United States and, for a given amount of investment, to report a larger share of their worldwide taxable income to the United States instead of foreign treasuries.

In addition to corporate rate cuts, Senator McCain has proposed expensing for all three- and five-year business equipment, while denying interest deductions on that equipment.⁶ If made permanent and extended to include all business investment, this would represent a radical change in tax policy, converting the base of the corporate tax from income to consumption by exempting the normal return to investment. Under Senator McCain's proposal, the expensing would sunset after five years. We estimate the proposal will cost only about \$20 billion over the next ten years, as the large up-front costs are partially offset by revenue gains from lower depreciation deductions after the provision expires. If the sunset is deemed to be credible, the revenue loss could be larger as investors accelerate capital purchase to take advantage of expensing. If the provision does not sunset, the 10-year cost rises to over \$100 billion.

Senator McCain would partially offset the revenue loss from the lower corporate tax rate, expensing, and increasing and permanently extending the research and experimentation credit with other proposals that would broaden the corporate tax base. He has proposed repeal of the domestic production activities deduction, which would remove a major economic distortion in the corporate tax. (Clausing 2004) The domestic production activities deduction provides a lower effective tax rate for selected activities (defined as domestic manufacturing) at the expense of other income-producing businesses (services). There is no economic justification for favoring some business activities at the expense of others, so eliminating this provision would increase economic efficiency. Repeal of the domestic production activities deduction would raise approximately \$100 billion over the next ten years. Senator McCain also proposes to eliminate a

⁶ It is not clear how the interest deduction limitation would be implemented. If the limit only applies to interest on loans that can be directly traced to three- and five-year equipment investment, as is done to enforce the limits on consumer interest deductions, then businesses will be able to skirt the limits by carefully attaching borrowing to depreciable investment, such as longer-lived equipment and real estate, and financing short-lived assets out of retained earnings in the same way that homeowners finance car purchases with deductible home equity loans. For a limit to be effective, explicit rules would have to reduce interest deductions based on the share of assets that a company expenses.

number of tax preferences for domestic oil and gas production and to eliminate other, unspecified, corporate loopholes.

3. The Estate Tax

Senator McCain's proposal to reduce the estate tax rate to 15 percent and increase the exemption to \$5 million would reduce estate tax revenue by approximately \$340 billion over 10 years, more than 90 percent of the revenue that the tax would raise under current law. It would also reduce the extent to which the estate tax serves as a backstop to the income tax (that is, taxing assets that might have escaped income tax as they accumulated because of careful tax planning or loopholes, including the exemption of capital gains on assets transferred at death).

The estate tax has ambiguous effects on working and saving. The tax may discourage some wealthy people who care about their heirs from saving or working by reducing the size of after-tax bequests. Others, however, may have a target amount of wealth they want to transfer, in which case they would need to save more to offset the expected tax liability. Further, the tax may encourage some potential heirs to work and save more because they are less able to live well off the proceeds of inherited wealth (for discussion, see Burman, Gale, and Rohaly 2005). On balance, the proposal is likely to have very small effects on work effort, saving, or overall economic performance. It would, however, reduce the progressivity of the tax system because only the richest estates now pay estate tax. Compared with leaving the 2009 rates and exemptions in place, near repeal of the tax as Senator McCain has proposed would disproportionately benefit a very small group of extremely wealthy individuals.

4. Efficiency Consequences

The consequences of all these proposals for economic efficiency and the distribution of economic burdens depend critically on how they are financed. To the extent that individual and corporate marginal tax rate reductions are deficit-financed (that is, the government simply borrows more to pay for its spending programs), the positive effects of lower tax rates will be offset by the costs of increased government debt. More government debt eventually translates into higher interest rates, which discourage business investment and consumers' demand for homes and durable goods such as automobiles, or, alternatively, into increased debt owed to foreigners, which mortgages our long-term economic future. And if swelling deficits are closed by future tax increases rather than spending cuts, we impose much greater economic costs of taxation on our children and grandchildren than they would face if we do not enact tax cuts today.

If growing deficits eventually require draconian spending cuts—a stated goal of those who adhere to the “starve the beast” theory of government—then vulnerable populations may lack essential services, critical infrastructure investments for roads, bridges, and dams may be deferred, and the national defense may suffer.

B. Senator Obama's Plan

Senator Obama has also proposed substantial tax cuts and would similarly reduce federal tax revenues. The cuts are primarily aimed at reducing burdens on low- and middle-income taxpayers. By many measures, the distribution of income has become much less equal over the

past 20 years and the recent tax cuts have exacerbated that trend. The distribution of after-tax income has become even more unequal than the distribution of before-tax income. The Obama proposal is aimed at bucking that trend by making the tax system much more progressive (as detailed in the next section)

However, it does so at the cost of higher tax rates and additional complexity. There are substantial new tax subsidies for education, child care, work, homeownership, and saving, and most senior citizens would be exempt from the income tax. The estate tax would be restored with a \$3.5 million exemption and a top rate of 45 percent, a substantial cut from current law, but less generous than Senator McCain's proposal. Tax credits for research and renewable energy would be made permanent.

High-income taxpayers would face higher marginal tax rates on both ordinary income and capital gains and dividends than under current law starting in 2009. From 2011 on, the proposal primarily undoes the Bush tax cuts for high-income taxpayers. Capital gains would be taxed at higher rates than under current law while dividends would be taxed at lower rates. The loophole closers would also primarily affect high-income taxpayers.

Senator Obama does not rely on phase-ins and sunsets to limit the revenue cost of his proposals as Senator McCain would do, but he is counting on a very large amount of revenue from a long list of revenue offsets—about \$78 billion per year (table R2). (Senator McCain probably also overstates the revenue potentially gained from eliminating corporate welfare, but his target is more modest at \$30 billion.)

Senator Obama's plan would substantially increase the deficit compared with current law and would add nearly \$4 trillion to the national debt over ten years. Top marginal income tax rates would increase to their pre-2001 levels, but top capital gains tax rates would be higher and dividend tax rates lower. The effect of the higher capital gains tax is a mixed bag, however. (See Burman, 1999, for a discussion.) Higher tax rates on capital gains encourage investors to hold assets longer than they would otherwise, may deter risk-taking, and contribute to the double-taxation of corporate equity. But reducing the difference between the tax rates on capital gains and other income reduces the incentive to try to convert ordinary income into capital gains via economically inefficient tax shelter arrangements. The lower tax rate on dividends compared with current law in 2011 reduces double taxation of corporate equity and reduces the artificial incentive for companies to retain earnings instead of paying dividends. On balance, the capital gains and dividends provisions probably have little or no effect on economic performance.

The proposals to tax carried interest as ordinary income, limit international corporate tax shelters, improve information reporting, apply the "economic substance doctrine," and reduce the tax gap may improve economic efficiency by reducing the incentive to engage in purely tax-motivated transactions. High-income individuals and corporations would be motivated to select investments and methods of arranging compensation to maximize productivity instead of to reduce tax liability at the expense of the most economically efficient arrangements. But some of the proposals may generate much less revenue than the Obama campaign is claiming, as the sophisticated tax avoidance techniques they are trying to reduce are difficult to control.

