# The President's Budget: An Unhappy Valentine's Day card for high income taxpayers

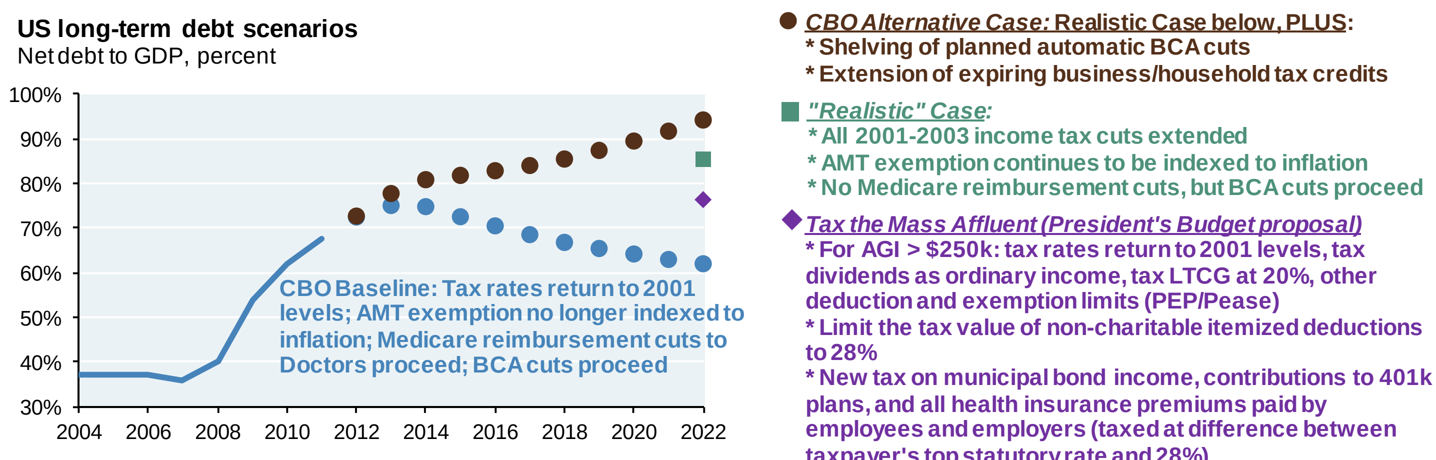
## Summary

The President's budget was released yesterday. Due to the political impasse between the parties, it seems unlikely to result in tax legislation this year. But as a reflection of the priorities of the Administration, and as a reflection of its stance in any future budget negotiations, it is an interesting document. The proposal aims to raise revenue from upper income taxpayers by any means necessary. [*Note: upper income begins at around $200k in adjusted gross income*]. The proposal would, according to Administration projections, stabilize the Federal debt close to today's elevated levels. Revenue increases play a large role, specifically the following three proposals. The second one surprised us the most.

- reset tax rates on ordinary income, dividends and capital gains for upper income taxpayers back to 2001 levels
- for upper income taxpayers, include a portion of municipal bond income, pre-tax employee contributions to defined contributed plans, and pre-tax employee *and* employer health insurance payments as **taxable income**
- limit non-charitable itemized deductions such as state/local taxes and mortgage interest for upper income taxpayers

## Background

The following chart outlines some basic budget scenarios. The CBO baseline assumes that 3 tough decisions are taken: Bush tax cuts all sunset back to 2001 levels, the AMT is no longer indexed to inflation, and Medicare reimbursements to doctors are cut. The CBO also provided an Alternative Case, assuming no action is taken at all to reduce deficits. Our Realistic case is an estimate of what would happen if Congress sticks to what it agreed in the Budget Control Act and nothing more. Lastly, the purple diamond is the President's proposal, as estimated by the Office of Management and Budget.




Source: CBO, OMB, IRS, J.P. Morgan Private Bank. AGI is adjusted gross income.

The President's budget proposal would get around halfway to closing the yawning gap between CBO Alternative Case and the CBO Baseline. There are elements of the Buffett rule here, but the budget does not contain a minimum tax rate on adjusted gross income on those with AGI over $1 million. Instead, many of the clauses apply specifically to those with AGI over $250k (the numbers shown in parentheses are OMB estimates of revenue raised over ten years).

- Ordinary income rates back to 2001 levels ($442 bn)
- Dividends taxed at ordinary income rates ($206 bn)
- Long term capital gains taxed at 20% ($36 bn)
- Restoration of limits on itemized deductions and exemptions ($165 bn)

In addition, the proposal raises another $584 bn by, among other things, limiting the tax value of itemized deductions (such as state and local income taxes and mortgage interest) to 28%. While this in theory applies to all taxpayers, in practice it will only affect taxpayers with statutory tax rates above 28%, which means people with AGI over $217k.

**The most controversial part of the proposal (at least in our view) was buried on page 73 of the Green Book, which is the Treasury's "*General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals*".** We were wondering why the Administration estimated the benefit of the above proposal at $584 bn, when the CBO estimated it at $293 bn just last year. The answer: **this proposal includes a new category of taxable income,** which would include your municipal bond income, your contributions to 401k plans and other similar vehicles, and your entire health insurance premium (regardless of who pays it). The approach appears to apply a tax rate to these items equal to the difference between your top statutory tax rate and 28%. For example, a taxpayer subject to a top statutory rate of 35% would pay a 7% tax on this income.

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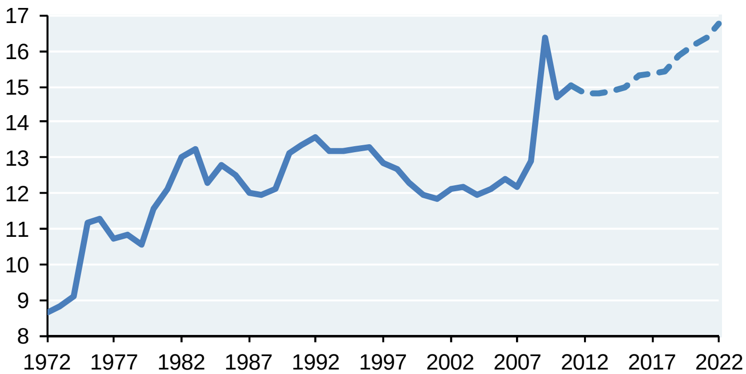
**The battles of the future, after the discretionary spending well is empty**

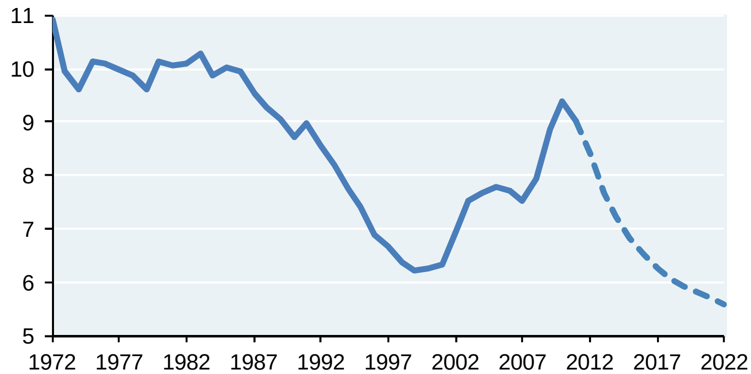
The Administration projects that tax revenues will rise from their current 15% of GDP to 20% by 2022, and that spending will decline from 24% of GDP to 23%. **Both numbers need to be dissected in order to make sense of them**. The projected revenue increase is as much from an assumed cyclical recovery as it is a product of tax legislation. Secondly, the modest decline in spending as a % of GDP obscures cuts in some categories and increases in others: the Budget Control Acts cut discretionary spending to a 50-year low close to 5% of GDP, but is offset by continually rising entitlement and interest costs (mandatory items). Budget negotiations of the future are likely to revolve around the tradeoffs between tax revenue increases and entitlement reform. The discretionary spending well is empty.

**Mandatory spending and interest costs**
Percent of GDP



Source: Congressional Budget Office. Forecasts assume Baseline Case.

**Discretionary spending**
Percent of GDP

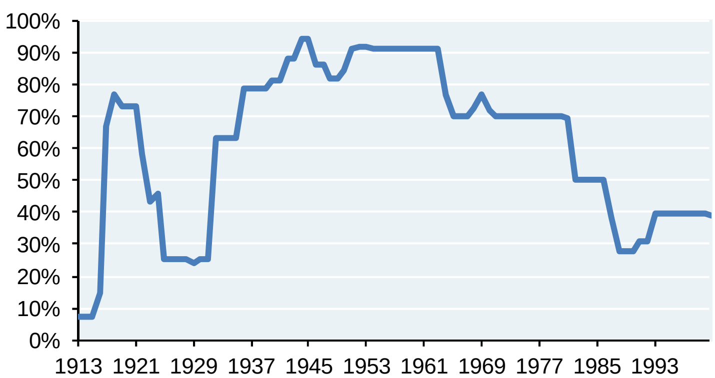


Source: Congressional Budget Office. Forecasts assume Baseline Case.

**Welcome to the club**

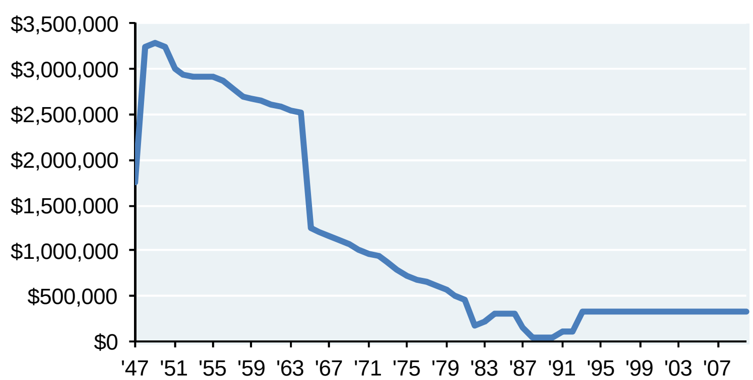
The top statutory tax rate used to be much higher than 35%. But what most press articles neglect to mention is that the top statutory rate used to apply to a narrower class of the ultra-rich. Today's revised definition of rich (for tax purposes) is more inclusive. The second chart below shows the inflation-adjusted income level at which the top bracket kicks in, since 1947. While the top bracket kicks in at around $380,000 today, during the War years, the top bracket threshold was almost 10 times higher. During the 1950's and 1960's, top marginal rates were still reserved for a very small subset of the rich. It is not until the late 1960's and the need to finance the Great Society and the Vietnam War that the top marginal rate was applied to a much broader group of affluent individuals. The President's budget follows a similar approach, in that a lot more revenues are raised by tinkering with deductions and creating new forms of new taxable income than by increasing statutory rates.

**Top statutory individual income tax rate**
Percent



Source: Congressional Budget Office.

**Bracket threshold for top statutory tax rate**
Real 2005 USD



Source: IRS, BLS.

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