Proposal 7: Limiting Individual Income Tax Expenditures

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Deficit Reduction (10-year): $1 trillion

Broader Benefits: Raises revenue more efficiently by reducing tax expenditures; limits potential negative impacts on subsidized sectors by preserving certain tax incentives; equalizes implicit subsidies across middle- and higher-income taxpayers.

Introduction

It is often said that base-broadening tax reform—that is, expanding the definition of taxable income—should be an important part of solutions to address the fiscal trilemma of reducing the deficit, promoting fairness, and encouraging economic growth. Such reform would be expected to garner bipartisan support, but getting policymakers to move from that vague sound bite to specific policy proposals, without the usual ideological bickering, is another story. In this paper I argue why an across-the-board reduction in broad classes of individual income tax preferences, rather than targeting certain tax expenditures within a comprehensive overhaul of the tax system, could be an easy step to ensure we achieve our nation's fiscal and economic goals, despite our seemingly dysfunctional political system. Indeed, if implemented correctly, base-broadening reform could raise tax revenues by more than $1 trillion over the next decade.

The Challenge

REDUCING DEFICIT SPENDING, PROGRESSIVELY

It is difficult to reduce the deficit in a way that burdens the rich relatively more than others (in a progressive manner) without going to the tax side of the federal budget ledger, because the benefits of most government spending—whether they come from income transfer programs such as Medicare or Social Security, or from public goods and services—are broadly enjoyed by the entire population. Raising revenue to reduce the deficit allows the burden to be steered more toward higher-income households, at the same time providing an opportunity to reduce rather than increase the size and scope of government if the revenue is raised by broadening the tax base (reducing so-called individual tax expenditures) rather than by raising marginal tax rates.

There are several reasons why reducing individual income tax expenditures is a sensible, progressive approach to deficit reduction. Because the income tax system is progressive, many holes (exemptions, deductions, and credits) and dips (the parts of the base subject to lower rates) in the income tax base tend to benefit higher-income households the most. Therefore, unlike most direct spending, many subsidies embedded in tax expenditures disproportionately benefit the rich, since the highest-income households in the highest marginal tax rate brackets receive the largest subsidy rates. For example, a high-income household whose taxable income reaches the 35 percent tax rate bracket would receive a 35 percent discount per dollar of mortgage interest paid, so that for every $1,000 in mortgage interest, that household's tax liability (and true cost of holding a mortgage and owning a home) is reduced by $350. A lower-income household in the 15 percent tax bracket, by contrast, would receive only a 15 percent subsidy (or $150

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for every $1,000 paid in mortgage interest), even if its total mortgage interest paid were just as much as that paid by the high-income household.

We can make an especially progressive approach to deficit reduction by mostly or entirely reducing these tax expenditures, which disproportionately benefit higher-income households. One way to accomplish this progressive deficit reduction is by capping the total dollar value of tax expenditures or by restricting them to certain marginal tax rates, decreasing the effective subsidy rate for higher-bracket households. Another method is through means testing, or, in other words, by gradually phasing down or out tax expenditures over higher income levels.

REDUCING THESE TAX EXPENDITURES TO ADDRESS OUR MACROECONOMIC CONCERNS

Our economy currently faces the dual challenges of persistent demand-side weakness in the short term, and inadequate public and private saving to grow the supply side of the economy over the longer term. Reducing the deficit by raising revenues through base-broadening strategies would be an effective fiscal policy plan to respond to both conditions.

If we can raise revenue by broadening and leveling the tax base without having to raise marginal rates, there unambiguously would be a net positive effect on supply-side economic growth, from increased public saving (due to lower deficits), an improved allocation of resources (due to a more neutral tax treatment across sectors of the economy), and maintenance of incentives for private saving and labor supply (due to lower or constant marginal tax rates).

By raising revenue primarily from higher-income households, there would be less potential damage to the near-term, demand-constrained economy, since high-income households are not as cash-constrained to begin with and hence are less likely to reduce consumption when their incomes fall. In fact, anticipation of near-term reductions in tax expenditures could stimulate those presently subsidized activities, because taxpayers would be encouraged to engage in those activities before effective tax rates on them are scheduled to rise.

Reducing these individual tax expenditures primarily at the top also would help reverse the decades-long trend of rising income inequality and the more recent trend (since 2001) of tax policy exacerbating that inequality.

By reducing overall tax expenditures, policymakers can minimize the extent to which they would have to increase marginal income tax rates to achieve a given level of deficit reduction. But if a base-broadening effort alone fails to raise adequate revenues to meet these fiscal targets, marginal tax rate increases may be necessary to make up the difference, and are justified provided that the economic benefits of the additional deficit reduction outweigh the economic costs resulting from the increased distortions on private incentives. Experience and research, in fact, suggests that the effects of marginal tax rates on private saving are small relative to the effects of aggregate revenue-level changes on public and national saving (Greenstone, Looney, and Samuels 2012, fact 9).

A POLICY APPROACH THAT IS POLITICALLY FEASIBLE, ADMINISTRATIVELY EASY, AND DESIGN FLEXIBLE

There may be economic arguments for reducing or eliminating some income tax expenditures more than others, but across-the-board approaches are probably more feasible than reducing particular tax expenditures, because lobbying pressures may be less prevalent when no one particular interest or industry is being singled out. On the other hand, across-the-board approaches certainly will not be easy unless there is significant public support for “mutual sacrifice” solutions.

Many across-the-board approaches to trimming tax expenditures are easy to specify and implement and can be calibrated to different revenue goals and marginal tax rate specifications. Rate-increasing and base-broadening approaches can be viewed as both policy substitutes and complements in order to scale and fine-tune the combined tax policy changes to their various economic purposes and fiscal goals.

The Proposal

There are several different ways to reduce income tax expenditures across the board, which can be sorted into two categories: those that reduce the tax subsidies by affecting the size of the subsidies at the margin (a price-incentive effect), and those that reduce the subsidies primarily by capping or limiting the total value of the subsidies (an income effect).

The following are three policy options that reduce the price-subsidy effects of tax expenditures, thereby affecting the price-incentive effects:

1. Limit marginal-tax-rate-dependent tax preferences to one of the lower-bracket rates. President Obama has proposed a limit of itemized deductions to the 28 percent rate in each of his past budgets; in 2012 he expanded the proposal to include some other tax expenditures such as the exclusion of employer-provided health benefits and the preferential tax rate on dividends. The Congressional Budget Office (CBO) estimated that this expanded version would raise $523 billion over ten years (CBO 2012). (The prior versions of the 28-percent limitation, which were limited to itemized

deductions, were estimated to raise almost $300 billion over ten years.) The CBO has also described a proposal to further limit the rate on itemized deductions (but not other tax preferences) to 15 percent. The CBO estimates this proposal would raise $1.2 trillion over ten years (see CBO 2011, revenue option 7, pp. 151–152).[1]

2. Convert marginal-tax-rate-dependent tax preferences to nonrefundable tax credits. This is similar to option 1 except it would benefit non-itemizers as well, and everyone would receive the same subsidy rate regardless of one's marginal tax rate bracket. The Tax Policy Center (TPC) has estimated the effects of a 15 percent credit to replace not just itemized deductions, but also the exclusion of employer-provided health insurance and the preferential tax rate on capital gains and dividends. The TPC estimates the option would raise more than $2.7 trillion over ten years (Baneman et al. 2012).[2]

3. Reduce a broad variety of tax expenditures by the same percentage. This is sometimes called a "haircut" approach. For example, the TPC estimated that a 39 percent cut in a broad class of tax expenditures (including the employer-provided health insurance exclusion, itemized deductions, and the preference given to capital gains and dividends) would raise almost as much revenue as the 15 percent credit option (around $2.4 trillion over ten years).

The following are three policy options that reduce the dollar value of tax expenditures (the income effect) without affecting the prices of tax-expenditure-subsidized activities at the margin (below or above any phaseout/phase-down range):

4. Cap the total dollar value of itemized deductions without regard to income level. This is a popular option that was discussed in negotiations about the fiscal cliff in December. The TPC has estimated the effects of $17,000, $25,000, and $50,000 caps (which would raise $1.6 trillion, $1.2 trillion, and $727 billion, respectively) over ten years relative to the (old) current-law baseline (with all of the 2001–2003 tax cuts expired).

5. Limit the total value of a combination of tax expenditures to a certain percentage of income. The TPC estimates that a cap of selected tax expenditures at 3.9 percent of adjusted gross income would raise approximately the same amount of revenue as the 15 percent credit and the 39 percent haircut.

6. Phase-down (or phaseout) of tax expenditures at higher incomes. The dollar cap (option 4) is like a variant of the percent of income limit (option 5). A phasing down (or even out) of overall tax expenditures at higher incomes can be considered a more progressive version of either. We actually had such a policy prior to the 2001 tax cuts (and extensions); this is just the old Pease provision—that is, a limitation on itemized deductions. The maximum reduction under Pease was 80 percent of itemized deductions; the phaseout rate was 3 percent of adjusted gross income in excess of the threshold (high) income level. This is yet another reason why the pre-2001 version of tax law, including its version of Pease or an even larger phasedown, might be a good fallback option if other ways of raising revenue by way of reducing tax expenditures cannot be agreed on. In the fiscal cliff deal, the Pease provisions were reinstated but only for households with gross incomes above $250,000 (or $300,000 joint).

Policymakers have considered several of these options in their debates over how to achieve base-broadening tax reform; they have tended to focus on trying to agree on one option as the best. But combinations of these price and income approaches are certainly possible policies. For example, we could limit both itemized deductions and other tax expenditures to the 28 percent marginal rate and cap the total dollar value. We also could means-test a cap in deductions or exemptions so that the policy affects only households over a certain income threshold.

Other variants on these approaches may be warranted in order to fine-tune the incentive effects of the policies. For example, some have suggested that the itemized deduction for charitable contributions is both desirable and effective, so policymakers could exempt the charitable-contributions preference from any limits or reductions to itemized deductions.

Another approach to trim the overall cost of tax expenditures is to cut them from the first dollars rather than from the last by putting a floor on qualifying activities, such as the current treatment of deductible medical expenses, which has a floor of 7.5 percent of adjusted gross income. While limiting last-dollar benefits is more likely to cut the tax benefits more progressively than reducing first-dollar benefits, it also reduces the marginal incentive of the tax subsidy for people over the ceiling. Some experts therefore argue for putting floors on activities that policymakers want to continue subsidizing (e.g., charitable contributions) and for putting ceilings on the tax subsidies that are judged to have fewer social benefits (e.g., mortgage interest).

These base-broadening policies to reduce overall tax expenditures also can be combined with and substituted for marginal tax rate increases, to achieve revenue goals and fine-tune progressivity goals.

Besides the rate structure applied to labor income, another important part of the progressivity calculus is what to do with the current preferential tax rates on capital gains and dividends. Reducing that preference could be far more progressive than limiting itemized deductions, for example.[3] There are many other ways in which the tax system taxes various forms of capital income at lower rates as well, so any base-broadening efforts that have increased progressivity as a top goal should look at filling in the dips in the tax base (the parts of the base subject to lower rates) and not just the holes. (See Op-Ed by Lawrence Summers in the *Washington Post*, "A Tax Reform to Cut Complexity, Increase Fairness," December 16, 2012.)

As is evident, there are many ways by which policymakers could pare back individual income tax expenditures. Each method has its advantages and disadvantages—and, indeed, any of the methods discussed here could be appropriate—but there are three approaches that I find the most compelling. First, policymakers should limit itemized deductions to 15 percent (without converting fully to refundable credits) in order to raise more revenue than the limit to 28 percent. Second, if keeping the current level of tax incentives for charitable giving is a concern, policymakers can allow charitable contributions above a certain dollar amount or percentage of adjusted gross income to remain deductible at the taxpayer's marginal tax rate. This would allow policymakers to keep these higher subsidies for higher-income households who make the largest charitable donations. Third, if base-broadening changes cannot meet policymakers' deficit-reduction target, the remainder of the revenue should be raised through marginal tax rate increases. This should be achieved using a combination of bringing tax rates on capital gains and dividends at least closer to ordinary income tax rates, and applying across-the-board percentage increases in marginal tax rates, increasing each rate by the same percentage.

In other words, this is an incremental, rather than fundamental, tax-reform strategy. Rather than going for a wholesale replacement of the federal income tax system, policymakers should start with the tax structure in place, first trying to achieve as much progressive base-broadening as they can, then increasing marginal tax rates to raise the requisite amount of revenue. Raising about $1 trillion in tax revenues over ten years from this combination of proposals should be fairly doable, even given the political constraints. Whether marginal tax rates will have to increase, and by how much, depends on how comprehensive the limit on itemized deductions is. Because this approach to limiting itemized deductions does not eliminate any taxpayer's current tax subsidy, but merely reduces the subsidy so that high-income households receive no higher subsidy rate than other households, the effect on the subsidized sectors of the economy should be small. However, it is possible that some of the policy options discussed in this paper could be phased in—for example, gradually reducing the top subsidy rate down to 15 percent over a few years, instead of immediately—to make the proposal more politically palatable.

Conclusion

Limiting deductions and exemptions will raise a significant amount of revenue over the next decade and will help the United States achieve many of its other economic and fiscal goals. The policy has bipartisan appeal and would be quick to implement; furthermore, its announcement could actually be stimulative in the short term. By moderating marginal tax rate increases on taxable income, it would not harm supply-side growth in the long term. The approach also would work towards eliminating the rather perverse ("upside-down") nature of the distribution of tax breaks, which currently provides larger percentage subsidies to higher-income individuals; as such, the proposal would improve progressivity and reduce income inequality. Thus, an across-the-board policy approach to reducing federal income tax expenditures seems ideal to reduce government spending and deficits in a progressive, economically efficient way. Considering the accompanying $1 trillion in savings over the next ten years, it is hard to think of a legitimate excuse for continuing to avoid these policy changes.

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Diane Lim (formerly Rogers) has recently joined The Pew Charitable Trusts as their Chief Economist. She had been Chief Economist at the Concord Coalition from April 2008 to December 2012, when she completed this paper. Over the same period she was the author of the “Economist Mom” blog. She was previously Chief Economist for the House Budget Committee Democrats; Chief Economist for the House Ways and Means Committee Democrats; Principal Economist for the Joint Economic Committee Democrats, and Senior Economist on the staff of the Council of Economic Advisers during the last year of the Clinton Administration and first hundred days of the Bush Administration. Lim has worked at the Brookings Institution, the Urban Institute, and the Congressional Budget Office, and was Assistant Professor of Economics at Penn State University. She teaches tax policy as an Adjunct Professor for the School of Public Policy and Public Administration at The George Washington University. She currently serves as President of the National Tax Association. Lim received her B.A. in Economics from the University of Michigan, her MA from Brown University, and her Ph.D. from the University of Virginia. She is the proud mother of four, ages fourteen to twenty-one.

Endnotes

1. Note that the baseline used for this revenue estimate assumed the expiration of the 2001–2003 tax cuts; with the fiscal cliff deal extending most of the rate cuts permanently, the revenue gains would now (relative to the new, post-deal, current-law baseline) be lower.
2. The revenue estimate is also relative to a (then-) current-law baseline that assumed the expiration of all of the Bush-era tax cuts at the end of 2012.
3. Compare distributional tables 4 and 7 in Baneman and colleagues (2012, 23, 27).

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