RAISING REVENUE BY LIMITING TAX EXPENDITURES

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ABSTRACT

Limiting tax expenditures can raise revenue without increasing marginal tax rates. Such a policy is equivalent to reducing government spending now done as subsidies through the tax code for a wide range of household spending and income. This paper explores one way of limiting tax expenditures: a cap on the total reduction in tax liabilities that each individual can achieve by the use of deductions and exclusions. The analysis describes the revenue effects and the distributional consequences of such a cap, and examines the sensitivity of these results to various design features.

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The national debt of the United States is now 74 percent of GDP, double what

it was a decade ago. The current annual deficit of about three percent means that

the debt will grow at about the same pace as nominal GDP, keeping the ratio of

debt to GDP unchanged. Although that is likely to continue for the next several

years, the Congressional Budget Office has recently warned us that the debt ratio

will start rising again and will grow to very high levels during the CBO's

long-term forecast period.[2]

More specifically, under the "extended baseline," the CBO projects that the debt

to GDP ratio will rise during the next two decades to more than 100 percent of GDP.

And when the CBO drops some of the unrealistic assumptions that are required to

be used in its "baseline" analysis, the forecasts in its "alternative fiscal scenario"

show the debt rising to as much as 183 percent of GDP in 2039. The rising debt

levels reflect the greater interest payments on the national debt and the

increased cost of the middle class health and retirement transfer programs.

Limiting and reversing the rise in the national debt requires only relatively small decreases in annual deficit ratios. If real GDP grows at 2.5 percent and inflation is 2 percent, an annual deficit of 4.5 percent of GDP will cause the national debt to rise to 100 percent of GDP. But lowering the deficit to two percent of GDP will reverse the direction of the debt, causing it to decline to less than 50 percent of GDP.

There is little scope for reducing the deficit by cutting spending on the annually appropriated "discretionary" programs. While there is no doubt substantial waste in many programs, total outlays for nondefense discretionary programs is now just 3.4 percent of GDP and is projected to decline to 2.5 percent of GDP in 2024. Similarly, the defense programs are projected to decline to just 2.7 percent of GDP in 2024. Reducing the annual deficit therefore requires some combination of slower growth of the retiree and health programs and increases in tax revenue.

Tax rates have continued to rise in the years since the Tax Reform Act of 1986. That legislation reduced the top marginal tax rate to 28 percent. Since then the top personal income tax rate has increased to 40 percent. An additional tax increase on investment income was part of the Affordable Care Act. And the overall payroll tax on wage and salary income was increased when the old ceiling on income subject to the 2.9 percent Medicare tax was completely abolished

It is a central tenet of public economics that raising marginal tax rates increases the distorting effects of the tax system and thus the deadweight loss to the

economy.

Fortunately, it is possible to increase revenue without raising marginal tax rates. The key is to limit the reductions in tax revenue that result from the use of tax rules that substitute for direct government spending.

Some examples will illustrate the nature of these "tax expenditures." If I buy a hybrid car or a solar panel for my house, the government rewards me with a subsidy payment. The subsidy does not take the form of a check from the government but of a reduction in my tax liability. If I pay more in mortgage interest or in local property taxes, the government subsidizes my spending by allowing those expenses to be deducted in calculating my taxable income and therefore my tax liability.

According to the Joint Committee on Taxation, the tax expenditure subsidies in the personal income tax code reduces revenue this year by approximately $1.6 trillion.[3] Those tax rules (especially the exclusion of employer payments for health insurance) also reduce the income that is subject to the payroll tax, leading to an additional loss of government revenue.

Eliminating any of the tax expenditures or limiting their use would shrink the

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[3] Joint Committee on Taxation, Estimates of Federal Tax Expenditures for the Fiscal Years 2014-2018. JCX-97-14 Dated August 5, 2014, page 35.

size of the annual deficits. Although the effect would show up on the revenue side of the government budget, that is just an accounting convention. In terms of real economic impact, limiting tax expenditures should be viewed as a reduction in government spending.

The ability to frame tax expenditures as either revenue increases or spending decreases should make limiting tax expenditures appeal to those Republicans who want to reduce government spending as well as to those Democrats who want to use additional revenue to help shrink fiscal deficits. Some of the revenue produced by limiting tax expenditures could also be used to reduce marginal tax rates.

Any attempt to limit a particular tax expenditure will be resisted by those who now benefit from it. That suggests that a comprehensive approach may be more politically feasible because no group of taxpayers will feel that they have been unfairly singled out. It also suggests that it would be politically difficult to eliminate completely any of the major tax expenditures. Instead the analysis in this paper focuses on a method of limiting the extent to which each individual can benefit by using the full set of current tax expenditures.

The first section describes a potential basic cap on the benefit that individuals can receive from an extensive set of tax expenditures. Section two discusses several features of using such an overall cap. The third section examines several variations

of the basic cap. Section 4 considers two alternatives to the cap stated as a percentage of GDP: limiting the overall dollar amount of deductions; and limiting the benefit of deductions and exclusions to the 28 marginal tax rate. There is a brief concluding section.

1. <u>A Basic Two Percent Cap on Tax Expenditures</u>

The Tax Expenditure Cap that I have been studying would limit each individual's ability to reduce his tax liabilities by the use of deductions and exclusions to a fixed percentage of that individual's adjusted gross income. Note that the cap is on the reduction of tax liabilities and not on the amount of the deductions and exclusions.

For example, a tax expenditure cap of two percent of AGI implies that someone with a marginal tax rate of 25 percent can have deductions and exclusions totaling 8 percent of his AGI, whereas someone with a marginal rate of 40 percent would be limited to 5 percent of AGI.

To implement this cap, the taxpayer would calculate his taxable income in the usual way and find the corresponding marginal tax rate. He would then multiply his total deductions and other tax expenditures by this marginal tax rate. If the resulting amount is less than two percent of his AGI, there is nothing more to do. If the resulting amount exceeds two percent of his AGI, the excess amount is added to his tax obligation.

The basic cap that I have analyzed would apply to all itemized deductions except charitable gifts. Although it could also be applied to charitable gifts, there are both economic and political reasons that policymakers may wish to maintain the current treatment of charitable gifts, a point to which I will return below.

The cap also applies to the exclusion of interest on state and local bonds and the exclusion of employer payments for health insurance in excess of $8,000 per taxpayer.

The cap that I study in this paper would not apply to tax-filers with AGI less than $25,000.

If that two percent cap had been in place in 2013 it would have increased personal tax revenue by $141 billion, about one percent of that year's GDP. The 2 percent cap would have been binding on about 22 million taxpayers or about 15 percent of the total number of tax returns.

As a rule of thumb, the annual revenue gain can be converted to a revenue gain for the next decade that is 13 times as large. The ten-year revenue gain would therefore be $1.8 trillion. The national debt would be reduced by more than this amount because of the interest saving each year on the reduced national debt.

A major advantage of the tax expenditure cap is that it would greatly simplify tax

preparation for millions of taxpayers who would shift from itemizing their deductions to using the standard deduction. The two percent cap would reduce the number of itemizers from the current 46 million to just 15 million, or 10 percent of the 146 million annual returns. After one or two years experimenting with itemization, the 30 million who shift to the standard deduction would no longer bother to calculate their deductions.

These calculations assume that the Alternative Minimum Tax (AMT) remains in place as under current law. The cap achieves much of the effect of the effect of the AMT. More specifically, if the AMT were eliminated, the 2 percent cap would recover two thirds of the revenue lost by eliminating the AMT.

The two percent cap would also raise the progressivity of the individual income tax. The following figures show the increase in tax revenue as a percentage of the current net-of-tax AGI in each AGI group:

Progressivity: Increased revenue as percent of current net-of-tax AGI

AGI	25k-	30k-	50k-	75k-	100k-	200k+
	0.66	0.81	1.33	1.55	2.28	2.98

Of the $141 billion, $41 billion would come from individuals with AGIs below $100,000. Of the remaining $100 billion, $63 billion would come from individuals with AGI above $200,000.

The two percent cap would also lower the marginal tax rate of all the affected

taxpayers. For anyone subject to the cap, a one hundred dollar increase in income would reduce the allowable amount of tax expenditures by enough to reduce taxable income by two dollars. As a result, the extra $100 of income would raise taxable income by only $98, implying that the marginal tax on the extra $100 would be reduced by two percent, e.g., someone in the 30 percent marginal tax rate bracket would face an effective marginal tax rate of 29.4 percent.

2. The Political Economy of an Overall Cap on Tax Expenditure Benefits

The example of the basic two percent cap on tax expenditure benefits illustrates why this approach to limiting tax expenditures as a way of raising revenue may make this approach politically feasible.

It avoids focusing on any particular tax expenditure and therefore appears more equitable because it treats all major tax expenditures equally.

It encourages large numbers of individuals to shift to the standard deduction, simplifying tax compliance and reducing the distorting incentives associated with features like the mortgage interest deduction and the deduction for local property taxes. For those who continue to itemize deductions, a binding cap removes the distorting incentives that depend on marginal itemization.

Revenue is raised in a way that is progressive in the sense that it reduces after tax

income proportionately more for high income taxpayers. The degree of progressivity can be modified by using different caps for lower and higher income taxpayers.

The limit on tax expenditures can begin with a higher cap and gradually reduced (tightened) over time to avoid hurting a weak economy.

3. <u>Variations on the Basic Two Percent Cap</u>

3.1 *The Low Cost of Preserving the Charitable Deduction*

The charitable deduction, unlike other deductions and exclusions, does not benefit the taxpayer directly but is important for maintaining private support for universities, hospitals and cultural institutions. That is why I preserve the charitable deduction in the basic plan and most other plans.

Extending the cap to include charitable contributions would increase revenue by only a relatively small amount (by $24 billion to $165 billion). It would also increase progressivity at the top of the income distribution because charitable gifts are relatively more significant than other deductions for high income individuals.

With a binding cap on all tax expenditures, the cost to the taxpayer of additional charitable gifts rises from 1-mtr (one minus the individuals marginal tax rate) to

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one. For a taxpayer with a 40 percent marginal tax rate, the increased cost of giving rises from 0.6 to 1.0, a 67 percent increase. Since a substantial body of research indicates that the elasticity of charitable giving with respect to the net cost to the donor is about one, that 67 percent increase in the net cost implies a two-third decline in giving by high income donors. That would be a substantial blow to a variety of cultural and educational institutions.

More specifically, taxpayers claimed charitable deductions of $160 billion on individual income tax returns in 2011 of which $73 billion were claimed by

individuals with adjusted gross incomes of more than $200,000. That group would have marginal tax rates of 40 percent, implying a reduction of their giving by some $49 billion. Additional reductions would occur from individuals with lower levels of adjusted gross income.

Progressivity if charitable contributions are included in the cap:

Increased revenue as percent of current net-of-tax AGI

AGI	25k-	30k-	50k-	75k-	100k-	200k+
	0.69	0.88	1.40	1.71	2.43	3.88

Comparing these increases to those for the overall previous distribution of revenue shows that the increase in revenue would be particularly high for those with AGI above $200,000.

3.2 Excluding the Deduction for State and Local Income Taxes

State income taxes are similar to charitable contributions and unlike most other deductions in not benefiting the taxpayer directly. In contrast, most <u>local</u> taxes represent a payment for services (schools, maintenance, trash collections, recreation facilities). Although the IRS data combine state and local income taxes, the local <u>income</u> taxes are only about 10 percent of the total tax revenue collected by local governments.

Excluding the deduction for State and Local Income Taxes from the cap would reduce the 2013 revenue from $141 billion to $102 billion but would still reduce the number of itemizers from 47 million to 24 million.

The distribution of increased tax liabilities would be substantially less progressive than it would be if these state and local income taxes are subject to the cap.

Progressivity: Increased revenue as percent of current net-of-tax AGI

AGI	25k-	30k-	50k-	75k-	100k-	200-500k	200k+
	0.63	0.72	1.17	1.29	1.83	2.36	1.70

This shows that the progressivity declines above $200,000 because of the impact on individuals with more than $500,000 of AGI.

3.3 Alternative Treatments of Employer Health Insurance Payments

The basic plan and all of the previous variations treated employer payments for health insurance in excess of $8000 as part of the tax expenditure subject to the cap. This section considers two alternative treatments: (i) subjecting all employer paid health insurance to the cap and (ii) subjecting none of it to the cap.

(i) Subjecting all employer-paid health insurance to the cap

Subjecting all employer-paid health insurance to the cap would raise the 2013 revenue increase from $141 billion to $196 billion. The $8000 exclusion thus reduces revenue by $55 billion.

The distribution of increased tax liabilities would still be progressive but substantially less progressive than it would be if the cap only applied to insurance in excess of $8000.

Progressivity: Increased revenue as percent of current net-of-tax AGI

AGI	25k-	30k-	50k-	75k-	100k-	200k+
	2.49	2.31	2.46	2.20	3.01	3.22

(ii) Excluding employer paid health insurance from the cap
Excluding all employer-paid health insurance from the cap would reduce

the 2013 revenue increase from $141 billion to $126 billion. Subjecting

employer paid health insurance to the cap but only to the extent that the

benefit exceeds $8000 (i.e., the basic case) increases revenue by $15

billion. The revenue effect of subjecting all benefits to the cap is $70

billion.

The distribution of increased tax liabilities would be more progressive

than it would be if the cap applied only to insurance premiums in excess of

$8000.

Progressivity: Increased revenue as percent of current net-of-tax AGI

AGI	25k-	30k-	50k-	75k-	100k-	200k+
	0.36	0.53	1.21	1.39	2.00	2.79

3.4 Excluding Municipal Bond Interest from the Cap

The basic option and all of the previous alternatives subject all municipal bond

interest to the 2 percent cap. Excluding municipal bond interest reduces the

revenue increase by $18 billion (from $141 billion to $123 billion). The tax

saving for taxpayers over $200,000 is $15 billion.

The distribution of increased tax liabilities would still be progressive but would

be less progressive than it would be if the cap applied to municipal bond interest.

Progressivity: Increased revenue as percent of current net-of-tax AGI

AGI	25k-	30k-	50k-	75k-	100k-	200k+
	0.66	0.80	1.33	1.53	2.05	2.27

3.5 Phasing in the Cap Over Time

The basic plan with a two percent cap would be a substantial fiscal shock in a weak economy. The cap could instead be phased in, starting with a 5 percent cap and gradually reducing it over several years. The near term effect would be less reduction in the number of itemizers, less revenue, and a smaller increase in progressivity. The phase in would reduce the extent that the cap lowers the value of owner occupied residences.

Replacing the two percent cap with an initial 5 percent cap would reduce the revenue gain from $141 billion to $53 billion in 2013. The number of itemizers would decline from 46 million to just 39 million.

With a five percent cap, the progressivity schedule would look like this:

Progressivity: Increased revenue as percent of current net-of-tax AGI

AGI	25k-	30k-	50k-	75k-	100k-	200k+
	0.12	0.18	0.48	0.48	0.76	1.18

3.6 Increasing Progressivity by Varying the Cap with Income

The progressivity of the cap method could be increased by allowing a

higher cap on lower income taxpayers. Raising the cap from 2 percent to 5

percent on the first $75,000 of AGI would reduce revenue to $130 billion

and increase progressivity.

The number of itemizers would still decline from 46 million to 28 million

Progressivity: Increased revenue as percent of current net-of-tax AGI

AGI	25k-	30k-	50k-	75k-	100k-	200k+
	0.31	0.41	0.86	1.00	1.87	3.50

4. Alternative Methods of Limiting Deductions and Exclusions

The previous analysis focused on capping the tax reduction that the taxpayer gets

from deductions and exclusions. This section analyzes two alternatives: (i) a cap

on the dollar amount of total deductions or of deductions and exclusions. Four

alternatives are presented, each with a $25,000 total cap. (ii) limiting the

deduction and exclusion to the 28 percent bracket.

(i) *Capping the total dollar amount of all deductions*

A $25,000 cap on all deductions, including charitable contributions, would

increase revenue by $106 billion of which $76 billion would come from taxpayers

with AGI above $200,000. In contrast, the basic plan with the 2 percent cap would

raise $141 billion of which $63 billion would come from taxpayers with AGI above

$200,000.

A $25,000 cap on all deductions but preserving the deduction for charitable contributions would increase revenue by only $81 billion of which $55 billion from taxpayers with AGI above $200,000.

A $25,000 cap on all deductions plus the excluded municipal bond interest and employer paid health insurance in excess of $8000 would raise $175 billion of which $94 billion would come from taxpayers with AGI above $200,000. Note that this combination of deductions and exclusions is directly comparable to the 2 percent cap with the charitable deduction preserved that would raise $165 billion. Although this raises only an extra $10 billion of revenue, $12 billion comes from individuals with AGI above $200,000.

A $25,000 cap on all deductions (but preserving the deduction for charitable contributions) plus municipal bond interest and employer paid health insurance in excess of $8000 would raise additional revenue of $145 billion, almost exactly the same as the $141 billion of the basic two percent plan. The extra revenue from taxpayers with AGI over $200 billion would be $71 billion, or $8 billion more than basic two percent plan.

(ii) *Capping the Marginal Tax Rate for Deductions and Exclusions to 28%*

In this option, which was proposed at one point by the Obama administration, individuals with marginal tax rates above 28 percent are limited to the tax reduction that they would obtain with a 28 percent rate. This is achieved operationally by denying them the specified deductions and exclusions and then giving them a tax credit equal to 28 percent of the amount of those deductions and exclusions.

The 28 percent cap applied to the same tax expenditures as the basic 2 percent cap produces revenue of only $21 billion of which $20 billion comes from taxpayers with incomes above $200k.

5. Conclusion

The prospect of very large future deficits and a rapidly increasing national debt is an important fiscal challenge for the U.S. Limiting those deficits and therefore the growth of the national debt requires slowing the growth of the retirement and health programs. Additional tax revenue could contribute to that process. Limiting tax expenditures would raise revenue without increasing marginal tax rates. It would also be equivalent to reducing government spending now done as subsidies through the tax code for a wide range of household spending and income. An effective way of limiting tax expenditures would be a cap on the total tax reduction in tax liabilities that each individual can achieve by the use of

deductions and exclusions.

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