

Capping Individual Tax Expenditure Benefits

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The authors propose capping tax expenditures as a share of one's income in an effort to improve the tax code and generate revenues.

This article examines a new approach to limiting the budgetary impact of tax expenditures, those special tax rules that substitute for direct government spending as a way to subsidize health insurance, mortgage borrowing, and other things. In total, tax expenditures cost more than \$1 trillion per year in lost revenues. When we exclude preferences for saving and business investment, which would be considered a normal part of a consumption-based tax system, the major tax expenditures will raise the deficit in 2011 by more than \$350 billion and, therefore, more than half of the \$660 billion in non-defense discretionary spending.

In the past, there have been many recommendations to reduce or eliminate specific tax expenditures that are viewed to be inefficient, ineffective, outdated, or unfair. However, given the political resistance to those proposals, it is worth evaluating an alternative framework for tax expenditure reform.

The approach analyzed here is a cap on the total tax expenditure benefit that each taxpayer can receive. We focus on the effects of caps set at 2 percent of the individual's adjusted gross income. We also report results for caps at 3 and 5 percent of AGI as well as the effect of imposing an explicit dollar cap combined with a cap related to AGI.

For most individuals, the biggest tax expenditure benefits are the exclusion of employer-provided health insurance or the deductibility of mortgage interest payments. Other large personal tax ex-

penditures are the deductions for state and local taxes and for charitable gifts.

To simplify taxpayer compliance, the cap that we analyze would not apply to all tax expenditures but to total itemized deductions, the health insurance exclusion, and a small number of tax credits.¹ This article also shows the effect of removing individual items from our tax expenditure list.

A key point to stress is that for tax expenditures that reflect deductions and exclusions, the cap is based on the value of the tax expenditures (TE benefit), not on the total amount deducted or excluded. For example, for someone with a 30 percent marginal tax rate who pays annual mortgage interest of \$5,000, the related TE benefit would be \$1,500.

Recent discussion in Washington has proposed scaling back the deduction for home mortgage interest or for state income taxes. Taxpayers might complain that such a targeted approach is unfair in focusing on just one or two tax expenditures. President Obama's National Commission on Fiscal Responsibility and Reform proposed a broader approach of removing all tax expenditures in return for dramatically lower rates, followed by increasing rates commensurately for any tax breaks that were returned to the tax code. Our proposal relies on a similar broad-based approach. Because the TE benefit cap that we analyze would not single out any particular form of tax expenditure but would apply to the total of all deductions and the key tax exclusion, our approach would reduce the revenue cost of tax expenditures without unfairly burdening taxpayers who benefit from a particular deduction.

Our analysis uses the NBER TAXSIM model to calculate the effect of the cap on TE benefits. The calculations use a sample of nearly 150,000 anonymous individual tax returns for 2006 provided by the IRS. Those returns are adjusted to approximate the total taxes and tax expenditures projected by Treasury for 2011. Because the tax expenditures that result from the exclusion of employer payments for health insurance are not reported on the 2006 tax

¹For a list of all tax expenditures, see Office of Management and Budget, "Analytical Perspectives, Budget of the United States Government, Fiscal Year 2011," Table 17-3 (Feb. 14, 2011), *Doc 2011-3135, 2011 TNT 31-36*.

returns, we use an imputation method developed by Prof. Jon Gruber based on data collected in the Medical Expenditure Panel Study.²

Our analysis recognizes that some individuals will respond to the cap on tax expenditure benefits by shifting from itemizing their deductions to using the standard deduction whenever doing so reduces their total tax liability. That shift to the standard deduction is an important source of simplification for taxpayers. While an estimated 33 percent of taxpayers will itemize deductions in 2011 under current law, the introduction of the 2 percent TE benefit cap would reduce the number of itemizers to just 9 percent of all tax returns. That represents a reduction of more than 35 million itemizers from a projected 48 million itemizers under existing law to less than 13 million with the 2 percent cap.

Our analysis implies that a 2 percent of AGI cap on TE benefits would reduce the fiscal 2011 deficit by \$278 billion dollars, or about 1.8 percent of projected GDP. The annual deficit reduction caused by a 2 percent TE benefit cap would grow over time. Because the fiscal deficit is now projected to be about 5 percent of GDP when the economy reaches full employment (that is, an unemployment rate of 5 percent), a 2 percent TE benefit cap that reduces the deficit by 1.8 percent of GDP would eliminate more than one-third of the annual full-employment deficit.

Basic Results for the 2 Percent Cap

The NBER TAXSIM calculations imply that there will be 146 million personal income tax returns for 2011, with total AGI of \$8.6 trillion and tax liabilities of \$1.1 trillion. The tax expenditures described above reduce personal income tax revenue by \$360 billion, almost exactly one-third of those tax liabilities. The exclusion of health insurance benefits paid by employers also reduces payroll tax revenue by about \$110 billion in 2011; we do not take that into account in our analysis. Other deductions and tax credits do not affect the payroll tax.

If each taxpayer's ability to reduce its tax liabilities by using those tax expenditures is limited to 2 percent of that taxpayer's AGI, the additional tax

revenue would be \$278 billion, or a 26 percent increase in revenue from the individual income tax.

Table 1 provides a detailed analysis by AGI group. The first column shows the number of returns (in millions) and columns 2 and 3 show total AGI and total tax expenditures in each AGI group in billions of dollars.

Column 4 shows the proportion of returns in each AGI group that is affected by the 2 percent cap. That rises from 75 percent among taxpayers with AGIs less than \$25,000 (where the health insurance exclusion generates large tax expenditure benefits even among those who do not itemize) to 98 percent among taxpayers with incomes between \$50,000 and \$75,000, and remains at 77 percent in the group with AGIs exceeding \$500,000.

The cap has two important effects in addition to raising substantial revenue. First, it causes a major simplification by inducing a large fraction of taxpayers to shift from itemizing their returns to using the standard deduction, because the tax benefit of using the standard deduction is not officially considered a tax expenditure (as well as for our cap). Second, it reduces the dead-weight loss (that is, the inefficiency) caused by the distortions of taxpayer behavior that result from the deductions, exclusions, and tax credits that correspond to tax expenditure rules. We return to both those effects in the next section.

Column 5 shows the increase in tax liability in billions of dollars that would result from limiting each taxpayer's tax expenditure benefit to no more than 2 percent of that taxpayer's AGI.

The increased tax revenue per return (shown in column 6) rises continually, from \$370 for returns with AGIs less than \$25,000 to \$2,114 per return for those with AGIs between \$50,000 and \$75,000 and then to \$43,337 for returns with AGIs more than \$500,000. Each figure in column 7 is the ratio of the total increased tax liability in the corresponding AGI group to the total AGI in that group. The ratio of incremental revenue to AGI (shown in column 7) varies between 2.7 and 3.6 percent, averaging 3.2 percent.

The relatively small increase in revenue per dollar of AGI in the highest income group (those with AGIs exceeding \$500,000) can be raised to a level that is more typical of the other income groups by limiting tax expenditure benefits to the smaller of \$10,000 or 2 percent of AGI. That only affects the top AGI group because in all other groups, 2 percent of AGI is less than \$10,000. That extra limit on the tax benefit raises the additional revenue as a percentage of AGI in the top income group from 2.7 percent of AGI (an average of \$43,337) to 3.7 percent of AGI (an average of \$60,310). That additional cap increases total revenue by \$17.5 billion.

²Gruber divided the Current Population Survey into cells by income, marital status, and whether the household had children. Using the Medical Expenditure Panel Study data, he calculated for each household the probability that that household had employer-based insurance and, conditional on having that insurance, the average expenditure for that insurance by employers and by the individuals themselves. Those data include, where applicable, the separate insurance of husbands and wives. A portion of employee expenditures for health insurance was treated as made through tax-favored "flexible fringe" accounts.

AGI Group (000)	Returns (1)	AGI (2)	Tax Expenditure Benefits (3)	Percentage With Limits (4)	Increased Revenue (5)	Increased Revenue per Return (6)	Increased Revenue as Percentage of AGI (7)	Increased Revenue as Percentage of Tax Expenditure Benefit (8)
0-25	61	620	33	73	22	370	3.6	68
25-50	35	1,268	52	92	37	1,049	2.9	70
50-75	20	1,250	51	98	43	2,114	3.4	84
75-100	12	1,057	45	96	36	2,899	3.4	79
100-200	13	1,762	64	95	61	4,590	3.4	95
200-300	2	547	24	92	20	8,683	3.6	82
300-500	1	444	23	82	15	12,758	3.4	65
500 and more	1	1,680	68	77	45	43,337	2.7	66
All	146	8,627	360	86	278	1,901	3.2	77

Notes:
Column 1 in millions.
Columns 2, 3, and 5 in billions of dollars.
Column 6 in dollars.
Columns 4, 7, and 8 in percentages.
Estimates refer to 2011.

The 2 percent limit reduces the tax expenditure benefits by 68 percent for those with incomes below \$25,000, rising to 95 percent for those with incomes between \$100,000 and \$200,000. The reduction of tax expenditure benefits then declines to 66 percent in the highest income group. This is shown in column 8. With the additional \$10,000 limit, the tax expenditure benefits of the top AGI group are reduced by 98 percent, the largest reduction of any AGI group.

Simplification, Reduction in Dead-Weight Loss

The 2 percent cap would have the major advantage of simplifying taxpayers' filing by inducing nearly 75 percent of itemizers to use the standard deduction, which would reduce the number of itemizers by more than 35 million taxpayers.

Table 2 shows the number of taxpayers in each AGI group that would be expected to itemize in 2011 under current law (column 1) and with a 2 percent cap (column 2). The percentage reduction in the number of itemizers, shown in column 3, indicates that about 74 percent of all itemizers would shift to the standard deduction while almost no itemizers with incomes exceeding \$300,000 would shift.

The cap and the induced shift to using the standard deduction has an important effect on the incentive to increase the scale of various deductions, exclusions, and activities that lead to tax credits. For example, for someone who is not subject to the 2 percent cap, an extra \$1 of mortgage interest reduces tax liability by the marginal tax rate; for someone in the 30 percent bracket, the net cost of an

AGI Group (000)	Current Law (millions) (1)	With 2 Percent Cap (millions) (2)	Percentage Reduction (3)
0-25	2.83	0.86	70
25-50	10.09	1.38	86
50-75	10.89	0.95	91
75-100	8.45	2.09	75
100-200	11.23	3.68	67
200-300	2.17	1.51	30
300-500	1.12	1.06	5
500 and more	0.97	0.95	2
All	47.75	12.48	74

extra \$1 of mortgage deduction is only 70 cents. A substantial volume of research confirms that the reduced cost of mortgage interest causes an increased consumption of housing services and an increased use of mortgage debt leverage, both of which create dead weight efficiency losses. In contrast, for someone whose total tax expenditure benefits exceed 2 percent of GDP, the net cost of the extra \$1 of mortgage interest would be \$1 because there would be no further tax reduction.

The 2 percent cap reduces dead-weight losses in two ways. For any taxpayer whose tax expenditure benefits are limited by the 2 percent cap (that is, those who would otherwise have tax expenditure benefits of more than 2 percent of AGI), the cap reduces the volume of wasteful "tax spending" and

AGI Group (000)	Charitable Giving	Property Tax	State and Local Income Tax	Mortgage Interest	Health Insurance Exclusion	Child Credit
0-25	-0.03	-0.02	-0.01	-0.31	-20.71	-0.88
25-50	-0.22	-0.15	-0.12	-3.12	-25.56	-9.15
50-75	-0.62	-0.25	-0.24	-5.31	-25.32	-10.84
75-100	-0.7	-0.22	-0.29	-4.85	-21.3	-7.67
100-200	-1.95	-0.72	-1.56	-12.4	-31.31	-4.63
200-300	-1.36	-0.58	-2.32	-5.31	-7.89	0
300-500	-1.76	-0.75	-3.92	-4.92	-4.6	0
500 and more	-15.42	-2.25	-20.29	-10.09	-3.62	0
All	-22.07	-4.94	-28.76	-46.31	-140.32	-33.16

the associated dead-weight loss. Also, even for those taxpayers for whom the cap is not binding but who are induced by the cap to shift from itemizing to the standard deduction, the dead-weight loss associated with deductible expenditures is completely eliminated.

Revenue Effects of Different Tax Combinations

The list of tax expenditures that we have examined includes all the itemized deduction plus credits and exclusions that are not related to saving and investment incentives. The list could be reduced or increased, of course.

Table 3 shows the effect on aggregate revenue of dropping specific tax expenditures from the cap while retaining the 2 percent cap on all others. The final row of the table shows the overall total while the previous rows show the aggregate revenue loss in the eight broad AGI groups.

For example, removing the charitable deduction from the list subject to the 2 percent cap reduces revenue by \$22 billion, approximately 8 percent of the \$278 billion that would be raised by applying the cap to all the items on the list. Nearly all that revenue comes from taxpayers with AGIs exceeding \$100,000 and three-quarters from those with incomes more than \$500,000.

Subjecting the deduction for property taxes to the 2 percent cap adds \$22 billion to total revenue. About half of that comes from individuals with AGIs more than \$300,000.

The largest revenue effect among the deductions is for mortgage interest, totaling \$46 billion. An even larger tax expenditure is the exclusion of employer payments for health insurance, with a revenue effect of \$140 billion.

Raising the Cap From 2 Percent to 3 or 5 Percent

Raising the cap from 2 percent of AGI to 3 or 5 percent would have a substantial effect on revenue and on the tax simplification of using the standard deduction.

While the 2 percent cap would limit the total deduction for 126 million taxpayers, raising the cap to 3 percent would affect only 101 million taxpayers, while a 5 percent cap would affect only 66 million taxpayers.

In contrast to the \$278 billion of revenue that would result from the 2 percent cap, raising the cap to 3 percent would reduce the revenue gain to \$208 billion and to just \$110 billion with a 5 percent cap.

The number of individuals who shift from itemizer to standard deduction would decrease from 35 million (74 percent) with the 2 percent cap to 17 million (37 percent) with a 3 percent cap and to just 8 million (17 percent) with a 5 percent cap.

Alternative Minimum Tax

The 2 percent cap reduces the number of taxpayers who would pay the alternative minimum tax in 2011 by 58 percent. The revenue effect is very small, however — just \$2.2 billion. All the simulations reported in this article reflect the resulting AMT offset.

Conclusion

Special features of the individual income tax subsidize personal spending on a wide range of goods and services, including housing, health insurance, and local government services. Because those tax benefits substitute for direct government outlays, they are known as tax expenditures. Eliminating or reducing tax expenditures would raise substantial revenue that could be used to lower tax rates and reduce the budget deficit.

Singling out one or a small number of tax expenditures to eliminate strikes many taxpayers as unfair. This article considers a way to reduce the major individual tax expenditures by capping the total amount that tax expenditures as a whole can reduce an individual's tax burden. More specifically, we examine the effect of limiting the total value of the tax reduction resulting from tax expenditures to 2 percent of the individual's AGI. Each

individual can benefit from the full range of tax expenditures but can receive tax reduction only up to 2 percent of his AGI.

Simulations using the NBER TAXSIM model for 2011 project that the 2 percent cap would be binding for 86 percent of taxpayers and would raise \$278 billion of the \$360 billion of tax expenditures benefits that would otherwise be used by taxpayers in 2011. The article analyzes the distribution of revenue increases by AGI class.

An important advantage of the 2 percent cap is that it causes a substantial simplification for more than 35 million taxpayers who are induced by the cap to shift from itemizing their deductions to using the standard deduction. Although some individuals might have to calculate their liabilities under both approaches for one or two years, they would eventually learn which option is best in their case.

A further advantage of the 2 percent cap is the increased economic efficiency that results from reducing the incentives for taxpayers to increase their outlays for the tax expenditure categories. For any taxpayer for whom the 2 percent cap is binding, the cap reduces the volume of wasteful spending and the associated dead-weight loss. In addition, even for those taxpayers for whom the cap is not binding but who are induced by the cap to shift from itemizing to the standard deduction, the dead-weight loss associated with deductible expenditures is completely eliminated.

Finally, our approach to raising revenues is far more efficient than raising marginal tax rates. Given the need to consider revenues as part of closing the fiscal gap, this approach would be one of the most efficient means of increasing revenues while simultaneously improving the tax code.

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