

Capping Individual Tax Expenditure Benefits

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This paper examines a new approach to limiting the budget impact of tax expenditures, those special tax rules that substitute for direct government spending as a way to subsidize health insurance, mortgage borrowing and many other things. In total, these tax expenditures cost over \$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 budget deficit in 2011 by more than \$350 billion and therefore more than half of the \$660 billion of all 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many recommendations to reduce or eliminate specific tax expenditures that are viewed to be inefficient, ineffective, outdated or unfair.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 such proposals, it is worth evaluating an alternative framework for tax expenditure reform.

The approach that we analyze here is a cap on the total tax expenditure benefit that each taxpayer can receive. We focus on the effects of caps set at two percent of the individual's adjusted gross income (AGI). We also report results for caps at three percent and five 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. Some of the other large personal tax expenditures are the deductions for state and local taxes and for charitable gifts.

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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. (See the Budget of the United States, Analytic Perspectives, Table 17-3 for a list of all tax expenditures.) This paper 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.

Some 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. The recent White House Fiscal Commission proposed a broader approach to reform of removing all tax expenditures in return for dramatically lower rates, and then 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, this 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. These calculations use the sample of nearly 150,000 anonymous individual tax returns for 2006 provided by the Internal Revenue Service. These tax returns are adjusted to approximate the total taxes and tax expenditures projected by the Treasury Department for 2011. Because the tax expenditures that result from the exclusion of employer payments for health insurance are not reported on the 2006 tax returns, we use an imputation method developed by Jon Gruber based on data collected in the Medical Expenditure Panel Study.²

² Professor Gruber divided the Current Population Survey into cells by income, marital status and whether or not 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 such insurance the average expenditure for that insurance by employers and by the individuals

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 two percent TE benefit cap would reduce the number of itemizers to just nine percent of all tax returns. This 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 two percent of AGI cap on tax expenditure benefits would reduce the 2011 fiscal deficit by \$278 billion dollars or about 1.8 percent of the projected GDP. The annual deficit reduction caused by a 2 percent TE benefit cap would grow over time. Since the fiscal deficit is now projected to be about 5 percent of GDP when the economy reaches “full employment” (i.e., at an unemployment rate of five 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 Two Percent Cap

The 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 group of tax expenditures described above reduces 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 his tax liabilities by using these tax expenditures is limited to two 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.

themselves. These 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.

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. This rises from 75 percent among taxpayers with AGI below \$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 AGI's over \$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 since 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 deadweight loss (i.e., 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 of these 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 two percent of that taxpayer's AGI.

The increased tax revenue per return (shown in column 6) rises continually from \$370 for returns with AGI under \$25,000 to \$2,114 per return for those with AGI between \$50,000 and \$75,000 and then to \$43,337 for returns with AGI over \$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 percent 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 AGI over \$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 and 2 percent of AGI. This only affects the top AGI group since in all other groups 2 percent of AGI is less than \$10,000. This 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

Table 1
Effects of Two Percent of AGI Cap on Tax Expenditure Benefits

AGI Group	Returns	AGI	Tax Exp. Benefits	Percentage With Limits	Increased Revenue	Increased Revenue per Return	Increased Revenue as % of AGI	Increased Revenue as % of Tax Expenditure Benefit
(000)	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
0-25	61	620	33	73	22	370	3.6	68
25-50	35	1268	52	92	37	1049	2.9	70
50-75	20	1250	51	98	43	2114	3.4	84
75-100	12	1057	45	96	36	2899	3.4	79
100-200	13	1762	64	95	61	4590	3.4	95
200-300	2	547	24	92	20	8683	3.6	82
300-500	1	444	23	82	15	12758	3.4	65
500 plus	1	1680	68	77	45	43337	2.7	66
ALL	146	8627	360	86	278	1901	3.2	77

Column 1 in millions

Columns 2,3 and 5 in billions

Column 6 in dollars

Columns 4,7 and 8 in percentages

Estimates refer to 2011

average of \$43,337) to 3.7 percent of AGI (an average of \$60,310). This additional cap increases total revenue by \$17.5 billion.

The two 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 is reduced by 98 percent, the largest reduction of any AGI group.

Effect of the Cap on the Use of the Standard Deduction and on Deadweight Efficiency Losses

The two percent cap would have the major advantage of simplifying taxpayers' filing by inducing nearly 75 percent of all current itemizers to use the standard deduction. This 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 two 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 over \$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 two percent cap, an extra dollar of mortgage interest reduces tax liability by the marginal tax rate, e.g., for someone in the 30 percent bracket, the net cost of an extra dollar 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 deadweight efficiency losses. In contrast, for someone whose total tax expenditure benefits exceed two percent of GDP, the net cost of the extra dollar of mortgage interest would be a dollar because there would be no further tax reduction.

Table 2
Effects of Two Percent Cap on Number of Itemizers
Thousands of Taxpayers

AGI Group (000)	Current Law (1) (million)	With Two Percent Cap (2) (million)	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 +	0.97	0.95	2
ALL	47.75	12.48	74

The two percent cap reduces deadweight losses in two ways. For any taxpayer whose tax expenditure benefits are limited by the two percent cap (i.e. who would otherwise have tax expenditure benefits of more than two percent of AGI), the cap reduces the volume of wasteful “tax spending” and the associated deadweight 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 deadweight loss associated with deductible expenditures is completely eliminated.

Marginal Revenue Effects of Individual Tax Expenditures

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 of course be reduced or increased.

Table 3 shows the effect on aggregate revenue of dropping specific tax expenditures from the cap while retaining the two percent cap on all of the 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 two percent cap reduces revenue by \$22 billion, approximately 6 percent of the \$360 billion that would be raised by applying the cap to all of the items on the list. Nearly all of this revenue comes from taxpayers with AGI above \$100,000 and three quarters from those with incomes over \$500,000.

Subjecting the deduction for property taxes to the two percent cap adds \$22 billion to total revenue. About half of this comes from individuals with AGI over \$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 Two Percent to Three Percent or Five Percent

Raising the cap from two percent of AGI to three percent or five percent would have a substantial effect on revenue and on the tax simplification of using the standard deduction.

Table 3
Effect of Excluding Specific Tax Expenditures from 2 Percent Cap
(Billions of Dollars)

AGI Group (000)	Charitable Giving	Property Tax	State & 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	-0.70	-0.22	-0.29	-4.85	-21.30	-7.67
100-200	-1.95	-0.72	-1.56	-12.40	-31.31	-4.63
200-300	-1.36	-0.58	-2.32	-5.31	-7.89	0.0
300-500	-1.76	-0.75	-3.92	-4.92	-4.60	0.0
500 +	-15.42	-2.25	-20.29	-10.09	-3.62	0.0
ALL	-22.07	-4.94	-28.76	-46.31	-140.32	-33.16

While the two percent cap would limit the total deduction for 126 million taxpayers, raising the cap to three percent would affect only 101 million taxpayers while a five percent would affect only 66 million taxpayers.

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

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

Alternative Minimum Tax

The two percent cap reduces the number of taxpayers who would pay the alternative minimum tax in 2011 by 58 percent. The revenue effect is however very small, just \$2.2 billion. All of the simulations reported in this paper 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 these tax benefits substitute for direct government outlays they are known as “tax expenditures.” Eliminating or reducing these 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 paper considers a way of reducing the major individual tax expenditures by capping the total amount that the tax expenditures as a whole can reduce the individual’s tax burden. More specifically, we examine the effect of limiting the total value of the tax reduction resulting from tax expenditures to two percent of the individual’s adjusted gross income. 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 paper analyzes the distribution of revenue increases by AGI class.

An important advantage of the two 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 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 two percent cap is binding, the cap reduces the volume of wasteful spending and the associated deadweight 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 deadweight loss associated with deductible expenditures is completely eliminated.

Finally, this 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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