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Raise Taxes, but Not Tax Rates

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REDUCING the budget deficit and stopping the explosion of our national debt will require more tax revenue as well as reduced government spending. But the need for more revenue needn't mean higher tax rates.

As the bipartisan fiscal commission appointed by President Obama stressed last year, tax revenues can be increased substantially by limiting the deductions, credits and exclusions that are essentially government spending by another name.

Tax credits for buying solar panels or hybrid cars are just like government spending to subsidize those purchases. Similarly, the exclusion from employees' taxable incomes of employer payments for health insurance is no different from subsidizing the purchase of those insurance policies. The deduction for interest on residential mortgages, probably the best-known tax expenditure, amounts to a giant subsidy for homeownership.

At their worst, such tax expenditures create incentives for wasteful borrowing and spending; they have been factors in the mortgage crisis and the rising cost of health care.

Tax expenditures collectively increase the budget deficit by more than all other nondefense spending combined, other than Social Security and Medicare. And unlike those direct outlays, these tax expenditures are not subject to annual review as part of the appropriations process. Once they are part of the law, they automatically continue and become more costly with time.

Despite the strong case for limiting tax expenditures, it is politically difficult to do so because no one wants to give up benefits.

So here is a way to curb this loss of revenue without eliminating any individual deduction: limit the total tax saving for any individual to a maximum percentage of his total income. Daniel Feenberg of the National Bureau of Economic Research, Maya MacGuineas of the New America Foundation and I have been studying a reform that would cap the tax reduction that each taxpayer could get from tax expenditures to 2 percent of his adjusted gross income.

What's the result? Taxpayers with incomes of $25,000 to $50,000 would pay about $1,000 more in taxes; those with incomes of more than $500,000 might pay $40,000 more.

The cap would affect more than 80 percent of taxpayers. Although they would continue to benefit from the mortgage deduction, the health insurance exclusion and other tax expenditures, their tax savings would not increase if they took out a larger mortgage or a more expensive insurance policy. Similarly, they would not be penalized and get a lesser tax benefit if they scaled back their mortgage or their health insurance premium by moderate amounts.

A key point to stress about this proposal is that the 2 percent cap refers to the reduction in an individual's taxes, not to the size of the tax deduction or exclusion.

> To reduce the deficit, cap deductions for items like mortgages.

Consider a taxpayer with an adjusted gross income of $150,000 who faces a 25 percent marginal tax rate and has total deductions (for mortgage interest, state taxes and other items) of $30,000 and a $10,000 health insurance premium provided by his employer.

The deductions and exclusion together reduce taxable income by $40,000 and the tax liability by 25 percent of that, or $10,000 — well above the 2 percent cap of $3,000. This calculation (which would appear on a modified version of the current tax form, reflecting insurance premiums reported by employers) would seem to imply a tax increase of $7,000.

But if he switched to the standard deduction, the only tax expenditure benefit he would get would be from the health insurance exclusion. That $10,000 premium implies a tax expenditure of $2,500, which is less than the 2 percent cap. The result is an increase in taxable income by $18,400 (the difference between the $30,000 in itemized deductions and the $11,600 standard deduction) and a tax increase of $4,600.

With the 2 percent cap, individuals would continue to benefit from all of their current deductions, exclusions and credits. It is the total tax benefit and not any particular tax reduction that is limited.

To estimate the macroeconomic effects of this proposal we used the tax simulation model of the National Bureau of Economic Research, as well as a sample of nearly 150,000 anonymous tax returns for 2006 provided by the Internal Revenue Service, adjusted to approximate the total taxes and tax expenditures for 2011.

We found that a 2 percent cap on tax expenditures in 2011 would raise tax revenue by $278 billion — nearly 30 percent of total projected income tax revenue for this year. The extra revenue would increase over time, reaching nearly half of the projected future fiscal deficits.

The tax expenditures that we cap in our analysis include all itemized deductions, the health insurance exclusion and the child tax credit. We do not limit the tax expenditures associated with saving and investment like the individual retirement account deduction, the interest accumulating in I.R.A. accounts, and the reduced rate on capital gains.

The 2 percent cap would also simplify tax payments by inducing some 35 million taxpayers who itemize their deductions to shift to the standard deduction method. That is about three out of four of those who now itemize their deductions.

It would be possible, of course, to start with a higher ceiling on the tax expenditure benefit and gradually reduce the cap to 2 percent. A 3 percent cap would raise $208 billion, while a 5 percent cap would raise only $110 billion. Our list of tax expenditures could also be modified — to exempt charitable contributions from the cap, for example.

Federal revenue must be raised to deal with our very serious fiscal problems. But it would be far better to do so by capping tax expenditures than by raising marginal tax rates. □

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