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Reforming Individual Income Tax Expenditures

Congress Should End the Most Regressive Ones, Maintain the Progressive Ones, and Reform the Rest to Be More Progressive and Better Achieve Policy Goals

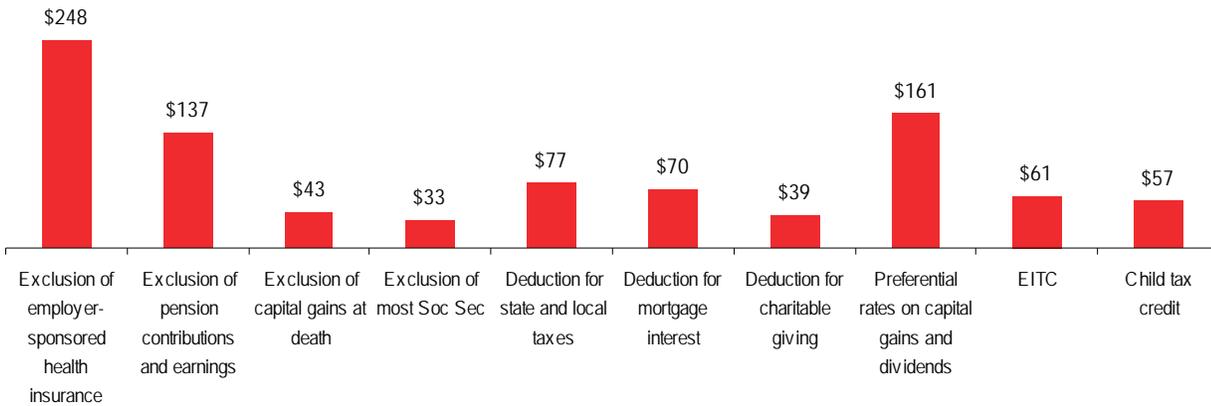
I. Introduction

To restore funding for public investments, Congress should enact a tax reform that reduces tax expenditures (subsidies provided through the tax code) to raise revenue. Some lawmakers have debated whether or not revenue saved from reducing tax expenditures should be used to reduce tax rates rather than finance needed public investments, an issue that has been addressed in previous CTJ reports.¹ Less attention has been given to how Congress should prioritize which tax expenditures should be limited or reformed. This is particularly true of tax expenditures for individuals. (A future CTJ report will address tax expenditures for businesses.)²

Tax expenditures can be evaluated based on three criteria: cost, progressivity and effectiveness in achieving non-tax policy goals. This report takes cost into account by focusing on the ten most costly tax expenditures for individuals, illustrated in the bar graph on the following page. This report evaluates these tax expenditures based on progressivity and effectiveness in achieving non-tax policy goals — which include subsidizing home ownership and encouraging charitable giving, increasing investment, encouraging work, and many other stated goals. Based on data from Congressional Budget Office (CBO) and from the Institute on Taxation and Economic Policy (ITEP), this report concludes:

1. Tax expenditures that take the form of breaks for investment income (capital gains and stock dividends) are the most regressive and least effective in achieving their stated policy goals, and therefore should be repealed.
2. Tax expenditures that take the form of refundable credits based on earnings, like the Earned Income Tax Credit (EITC) and the Child Tax Credit, are progressive and achieve their other main policy goal (encouraging work) and therefore should be preserved.
3. Tax expenditures that take the form of itemized deductions are regressive and have mixed results in achieving their policy goals, and therefore should be reformed.
4. Tax expenditures that take the form of exclusions for some forms of compensation from taxable income (like the exclusion of employer-provided health insurance and pension contributions) are not particularly regressive and have some success in achieving their policy goals, and therefore should be generally preserved.

Billions of Dollars Spent on Personal Income Tax Expenditures in 2013



Source: Congressional Budget Office, "The Distribution of Major Tax Expenditures in the Individual Income Tax System," May 2013.

This report draws partly on recent data from the Congressional Budget Office on the ten largest tax expenditures affecting individuals, which CBO concludes will cost more than \$900 billion in 2013 and make up two-thirds of the cost of all federal tax expenditures.³ The graph above illustrates the revenue foregone in 2013 for each of the top ten tax expenditures for individuals in 2013.

These revenue amounts do not necessarily indicate how much would be raised by repealing one or more of these tax expenditures. (This is because people may respond to the repeal of one tax break by utilizing another more heavily or changing their behavior in other ways.) Nonetheless, these figures are useful for comparing the relative importance of tax expenditures.

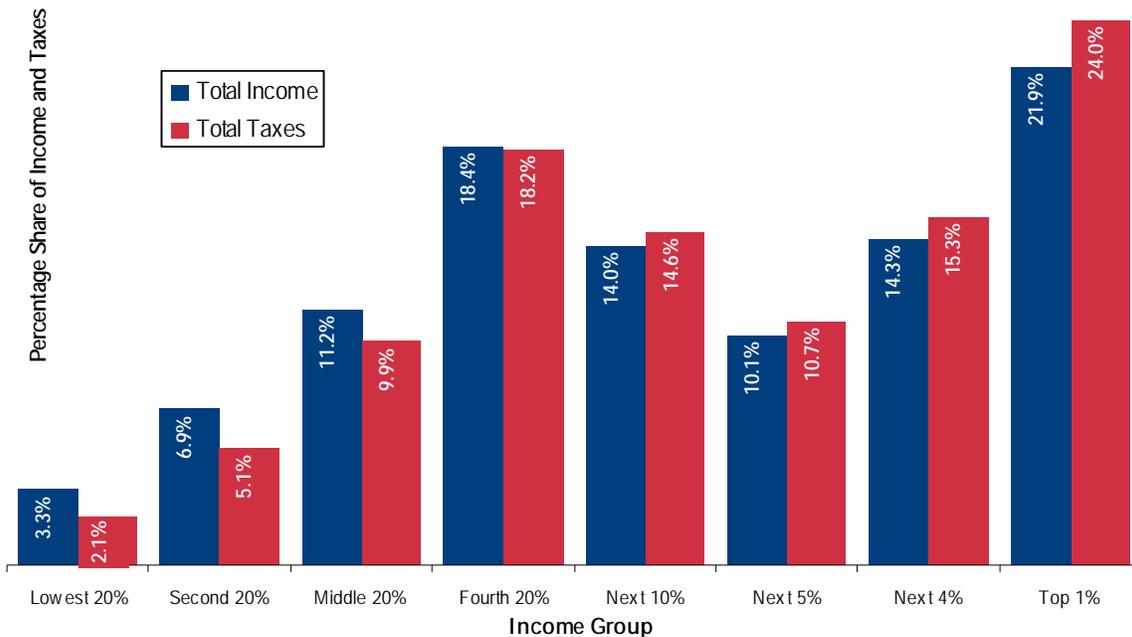
A. Progressivity

Lawmakers have paid insufficient attention to the need for progressivity in the tax system. For example, lawmakers of both parties now discuss limiting tax expenditures that take the form of deductions and exclusions but very few propose to scale back the tax expenditure most targeted to the richest one percent, the preferential income tax rates for capital gains and stock dividends.⁴ Others claim that tax expenditures for the poor like the Earned Income Tax Credit are problematic because they result in people paying no income taxes, ignoring all the regressive taxes that lower-income Americans do pay and that make our overall tax system nearly "flat."

Part of the confusion comes from the fact that some policymakers erroneously believe that our current tax system is overly progressive. But data from the Institute on Taxation and Economic Policy (ITEP) show that America's system overall is just barely progressive.

A recent Citizens for Tax Justice report using ITEP data (illustrated in the bar graph below) shows that the share of total taxes (including all federal, state and local taxes) paid by each income group is roughly equivalent to the share of total income received by that income group. For example, the poorest fifth of taxpayers will pay only 2.1 percent of total taxes this year, which is not so surprising given that this group will receive only 3.3 percent of total income this year. Meanwhile, the richest one percent of Americans will pay 24 percent of total taxes and receive 21.9 percent of total income in 2013.⁵

Shares of Total Taxes Paid by Each Income Group Will Be Similar to their Shares of Income in 2013



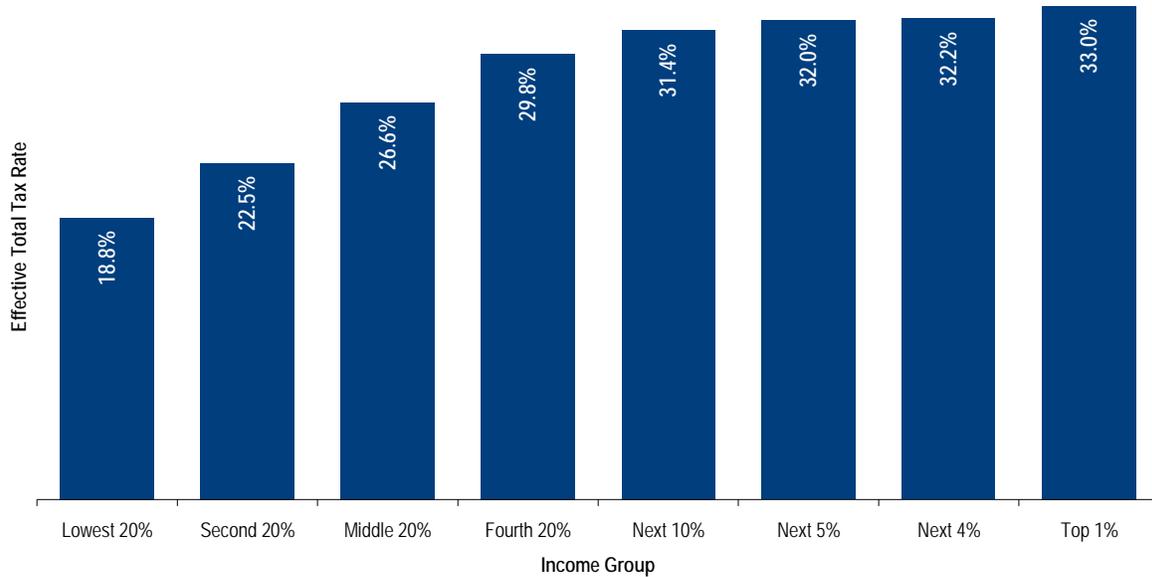
Source: Institute on Taxation and Economic Policy (ITEP) Tax Model, April 2013
 Citizens for Tax Justice, April 2013.

Looked at another way, the percentage of income paid in all types of taxes (the total effective tax rate, as illustrated on the following page) does not vary as much across income groups.

In other words, America’s tax code is progressive, but just barely so. Concerns that it is too progressive (either because there are too many tax breaks like the EITC for the poor or because tax rates are too high on the rich) are unfounded. Tax reform should make our tax system more progressive, not less.

Given that America’s tax system is not particularly progressive, it makes sense to target for repeal or reform those tax expenditures that are most concentrated on the best-off Americans, while preserving those tax expenditures that are targeted to low-income Americans.

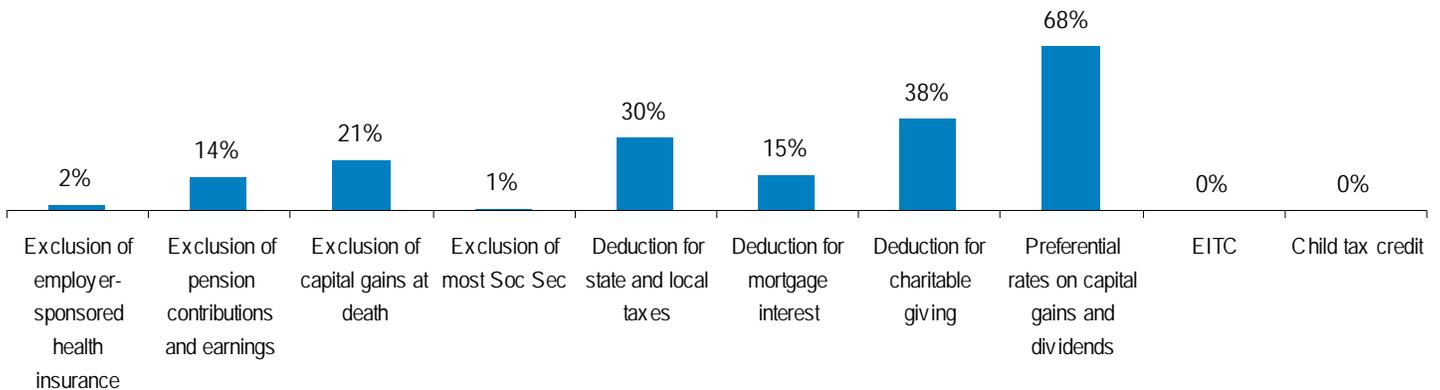
Total Effective Tax Rates Will Not Be Dramatically Higher for Richest Taxpayers than for Middle Class in 2013



Source: Institute on Taxation and Economic Policy (ITEP) Tax Model, April 2013
 Citizens for Tax Justice, April 2013.

This way of prioritizing which tax expenditures to repeal, preserve or reform logically leads to conclusions that are very different from those that have largely dominated the debate over tax reform. The following bar graph illustrates the fraction of each of the largest ten tax expenditures that will go to the richest *one* percent of Americans in 2013.

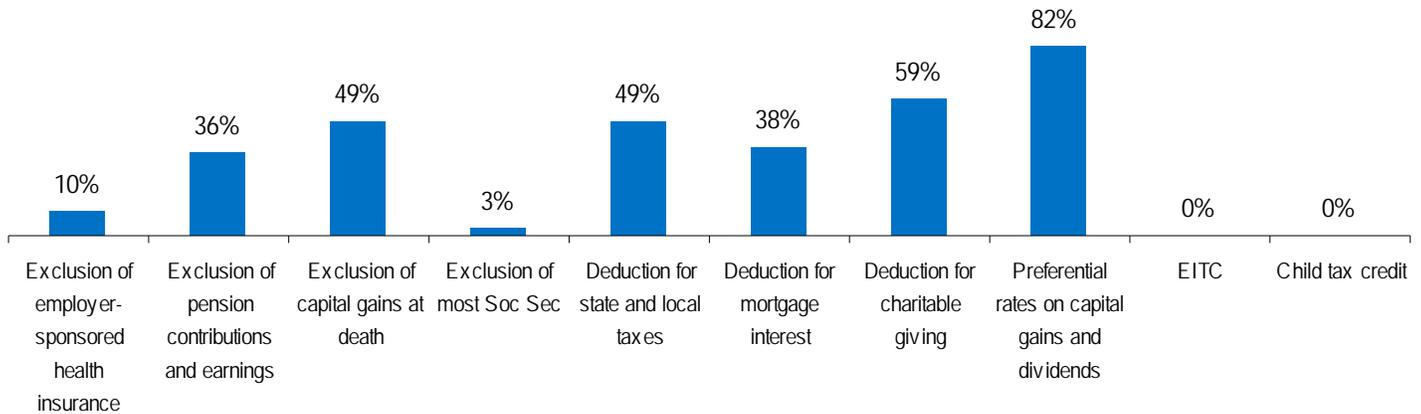
Share of Personal Income Tax Expenditures Going to Richest One Percent in 2013



Source: Congressional Budget Office, "The Distribution of Major Tax Expenditures in the Individual Income Tax System," May 2013.

The following bar graph illustrates the fraction of each of the largest ten tax expenditures that will go to the richest *five* percent of Americans in 2013.

Share of Personal Income Tax Expenditures Going to Richest Five Percent in 2013



Source: Congressional Budget Office, "The Distribution of Major Tax Expenditures in the Individual Income Tax System," May 2013.

The table of figures below illustrates CBO's estimates for the share of each tax expenditure that will go to Americans in each income group in 2013. While the tax expenditures vary in the extent to which they benefit the wealthy, none but the Earned Income Tax Credit and Child Credit are targeted to the poorest two fifths of Americans.

Share of Largest Ten Individual Tax Expenditures Going to Income Groups, and Total Cost in Billions, in 2013

	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 10%	Next 5%	Next 4%	Top 1%	ALL	Cost
Exclusion of employer-sponsored health insurance	8%	14%	19%	26%	16%	9%	8%	2%	100%	\$ 248
Exclusion of pension contributions and earnings	2%	5%	9%	18%	17%	13%	22%	14%	100%	\$ 137
Exclusion of capital gains at death	0%	3%	15%	17%	10%	6%	28%	21%	100%	\$ 43
Exclusion of most Soc Sec	3%	15%	36%	33%	8%	3%	2%	1%	100%	\$ 33
Deduction for state and local taxes	0%	1%	4%	14%	17%	15%	19%	30%	100%	\$ 77
Deduction for mortgage interest	0%	2%	6%	18%	19%	16%	23%	15%	100%	\$ 70
Deduction for charitable giving	0%	1%	4%	11%	13%	12%	21%	38%	100%	\$ 39
Preferential rates on capital gains and dividends	0%	0%	2%	5%	5%	5%	14%	68%	100%	\$ 161
EITC	51%	29%	12%	6%	2%	0%	0%	0%	100%	\$ 61
Child tax credit	22%	29%	26%	18%	3%	1%	0%	0%	100%	\$ 57

Source: Congressional Budget Office, "The Distribution of Major Tax Expenditures in the Individual Income Tax System," May 2013.

B. Effectiveness in Achieving Non-Tax Policy Goals

The goal that is most easily achieved through the tax code is the most obvious — raising revenue to fund public services and public investments, and doing so in the fairest manner possible. It would be relatively easy to design a tax system that did nothing but this.

But given that lawmakers seem determined to use tax expenditures to achieve various non-tax policy goals — which include subsidizing home ownership and charitable giving, increasing investment, encouraging work, subsidizing health care and many other goals — it therefore seems reasonable to ask which tax expenditures efficiently accomplish their apparent objectives.

An evaluation of the largest ten tax expenditures for individuals based on effectiveness in achieving these policy goals leads to conclusions that are generally similar to the evaluation based on progressivity or regressivity. The preferential rates for capital gains and stock dividends fail to accomplish the purported policy goal of encouraging investment and should therefore be repealed, while the refundable tax credits (the EITC and the CTC) succeed in achieving the non-tax policy goal of encouraging work, and should therefore be preserved.

Between these two extremes are several expenditures with a mixed or questionable record in achieving policy goals. The following discussion of individual tax expenditures includes possible reforms for these that would address these concerns.

II. Assessments of the Fairness and Effectiveness of Individual Tax Expenditures

A. Tax Expenditures for Investment Income (preferential rates for capital gains and dividends, exclusion of capital gains at death)

If one recognizes that our tax system is not particularly progressive, then it seems fair for policymakers to repeal tax expenditures that mainly benefit the richest one percent of Americans. That would lead policymakers to repeal the preferential income tax rates for capital gains (the profits made from selling assets for more than they cost to purchase) and corporate stock dividends. (The preferential rate in the top income tax bracket is about half the rate for “ordinary” income, 20 percent vs. 39.6 percent).

CBO estimates that these preferential rates will cost \$161 billion in 2013 (as illustrated in the graph on page two), making it the second most costly individual tax expenditure. The bar graph at the bottom of page four illustrates CBO’s estimate that 68 percent of the benefits of this tax expenditure will go to the richest one percent of Americans in 2013. The graph on page five illustrates that 82 percent of the benefits will go to the richest five percent of Americans in 2013.

A previous report from Citizens for Tax Justice explains that the preferential rates for capital gains and dividends primarily benefit the richest Americans for two reasons. First, the richest Americans receive most of the capital gains and stock dividends. Second, the difference between the regular tax rate and the tax rate on capital gains and dividends is larger for people at the top of the income scale.⁶

In addition to repealing the preferential rate for capital gains and stock dividends, lawmakers should also repeal a related tax expenditure, the exclusion of capital gains at death. This tax expenditure is the rule that allows an asset held by a person at the time of death to be passed on to heirs with no income tax applying to the appreciation (increase in the value) that occurred while the decedent owned the asset. CBO estimates that this break will cost \$43 billion in 2013 (as illustrated in the graph on page two) and 49 percent of the benefits will go to the richest five percent of Americans (as illustrated in the graph on page five).

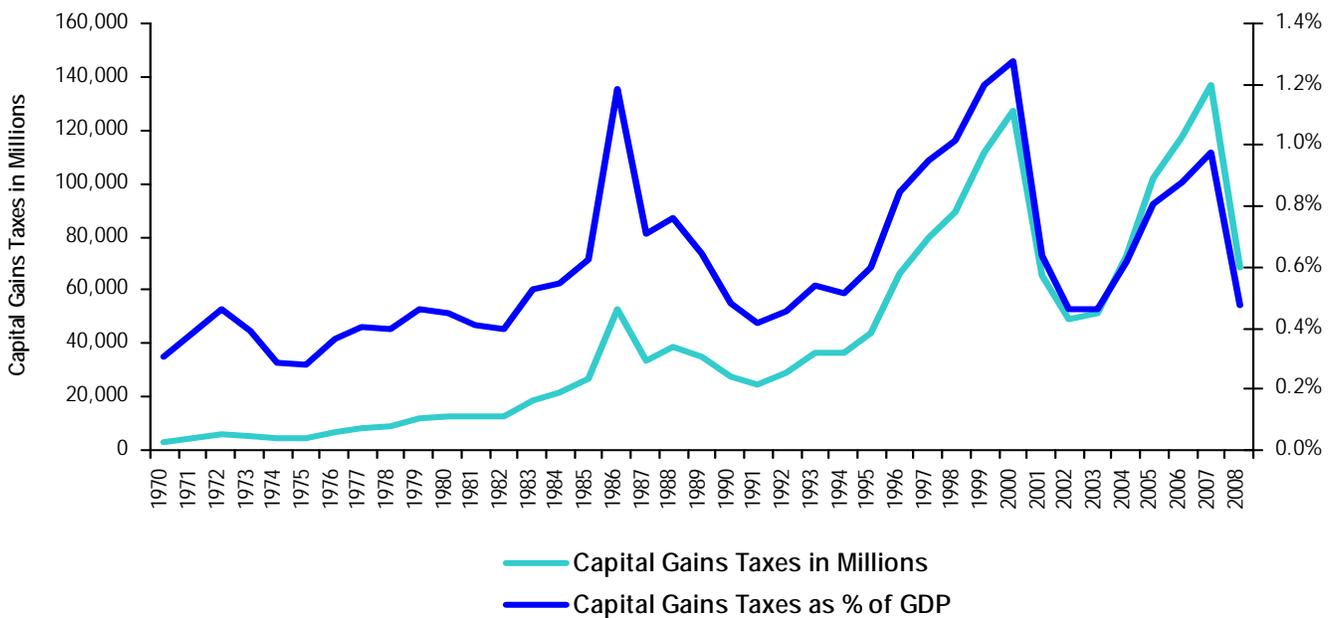
If Congress repealed the preferential rate for capital gains and dividends but left in place the exclusion for capital gains at death, wealthy individuals might respond by holding onto more appreciated assets until death to avoid the tax increase, consequently reducing the amount of revenue raised and reducing the progressivity of the reform. (There is currently some debate over

the extent to which the wealthy would use this and other techniques to avoid any tax increase on capital gains.)⁷ The straightforward solution is to repeal both the preferential rate and also repeal the exclusion of capital gains at death to block the main route to avoiding the resulting higher tax rate on capital gains.

Some observers (such as the editorial board of the *Wall Street Journal*) argue that lowering tax rates on capital gains results in a huge increase in both investment and (somewhat contradictorily) in sales of capital assets. The combined impact is so great, it is argued, that the amount of taxes paid on capital gains actually increases as a result of the tax preference.⁸

This argument (which is a key tenet of “supply-side economics”) is not supported by the evidence. The rise and fall of taxes collected on capital gains is not correlated with tax rates but rather with the rise and fall of the stock market and the economy generally.

Capital Gains Taxes in Millions and as a Share of GDP 1970-2008

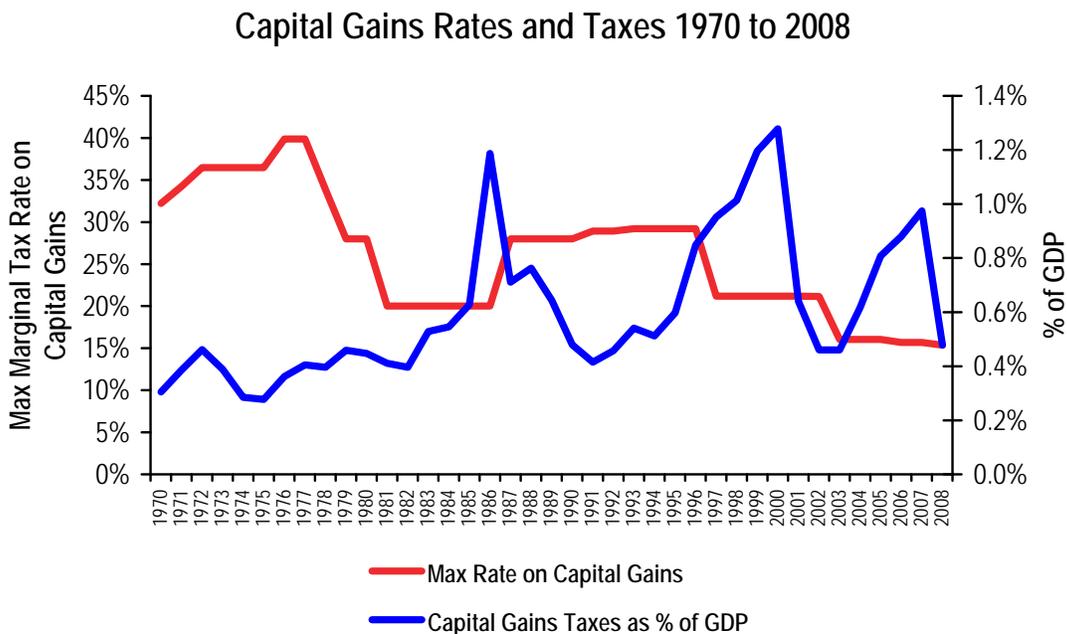


Source: U.S. Department of Treasury, “Capital Gains and Taxes Paid on Capital Gains for Returns with Positive Net Capital Gains, 1954-2008,” December 30, 2010.

Proponents of supply-side economics cannot demonstrate that the three spikes in capital gains taxes collected over the last four decades (shown in the graph above) were caused by reductions in the tax rate for capital gains. The first spike, in the 1980s, actually occurred because the income tax rate for capital gains was *raised* under the Tax Reform Act of 1986, which was signed into law by President Reagan and which resulted in a tax system that applied the same rates to all types of income. People rushed to cash in their assets before the higher rate went into effect, and once it did, asset sales logically fell from the artificial high point they had reached. The other two spikes are correlated with the tech bubble that burst in 2000 and the housing and financial bubble that burst in 2008.

Supply-siders essentially argue that the revenue collected from capital gains taxes is inversely correlated with the tax rates on capital gains. No such correlation is readily apparent in the graph below, which compares the top marginal tax rates on capital gains (the rate that applies to most capital gains income because most of it goes to the rich) to capital gains tax revenue as a percentage of GDP.

For example, the graph shows that after the Bush tax cut for capital gains was enacted in 2003, capital gains tax revenue failed to reach the heights seen during the Clinton years, when the top rate was higher, and this revenue plummeted sharply in 2008 even though there was no change in the rate that year.



Source: U.S. Department of Treasury, "Capital Gains and Taxes Paid on Capital Gains for Returns with Positive Net Capital Gains, 1954-2008," December 30, 2010.

B. Refundable Tax Credits for Earnings (the Earned Income Tax Credit and Child Tax Credit)

Of the ten costliest tax expenditures for individuals, only the Earned Income Tax Credit (EITC) and Child Tax Credit (CTC) are targeted to the poorest two-fifths of Americans (as illustrated in the table on page five).

These are refundable income tax credits, meaning they can benefit taxpayers who are too poor to have any federal income tax liability. A tax credit that is not refundable cannot lower one's income tax liability to any less than zero, but a refundable tax credit can result in negative income tax liability, meaning the taxpayer receives a check from the IRS.

The EITC is completely refundable while the CTC is partially refundable. The EITC is a credit equal to a certain percentage of earnings (40 percent of earnings for a family with two children) up to a maximum amount (a maximum credit of \$5,372 for a family with two children in 2013, for

example). It is phased out at higher income levels. The CTC is a credit equal to a maximum of \$1,000 per child. The refundable part of the CTC is equal to 15 percent of earnings (above a minimal threshold) up to the maximum of \$1,000 per child.

The EITC was first enacted in 1975 and expanded several times since then. President Ronald Reagan praised the part of the Tax Reform Act of 1986 that expanded the EITC, calling it “the best antipoverty, the best pro-family, the best job creation measure to come out of Congress.”

Several empirical studies have found that the EITC increases hours worked by the poor. These studies have also found that the EITC has had a particularly strong effect in increasing the hours worked by low-income single parents, and there is evidence that it had a larger impact on hours worked than did the work requirements and benefit limits enacted as part of welfare reform.⁹

The refundable part of the CTC is likely to have similar impacts. The EITC and the refundable part of the CTC are credits equal to a certain percentage of *earnings*, meaning these refundable tax credits are only available to those who work.

Criticisms of the EITC have taken two forms. One is a more general criticism of tax breaks directed at low- and middle-income people that relieve them from paying federal personal income taxes.¹⁰ These criticisms ignore the other types of taxes (including federal and state and local taxes) that Americans at all income levels pay. As already explained, the combination of all these different taxes results in a tax system that is just barely progressive overall. Without the EITC and the refundable part of the CTC, the tax system would lose a significant portion of what little progressivity it has.

A second type of criticism of the EITC is the claim that it actually discourages work. Some analysts have speculated that the EITC may provide a work disincentive for some people because the credit is phased down for households with income above a certain level, which is determined by number of children and marital status. For example, in 2013 a married couple with two children will see their EITC reduced from the maximum amount of \$5,372 by about 21 cents for each dollar of income exceeding \$22,870. That means this family of four will not be eligible for any EITC in 2013 if their income exceeds \$48,378. (In other words, this family would see their EITC phased down to zero once their income exceeds \$48,378.) This has led to the criticism that the EITC may provide a work disincentive for working people whose income is in the “phase-out range” (between \$22,870 and \$48,378 in the example of the family of four).

But empirical research has found that the EITC’s phase-out has either no impact on work incentives or a very small impact that is limited to married couples. (It seems that this merely means one parent of a married couple is somewhat more likely to spend more time caring for children rather than working, and it’s not obvious that this is a negative result.)¹¹

This fits a common sense view of how people think about taxes. Many low-income people may be aware that the EITC exists and that it will increase the amount of income they can obtain by working. But once a person is employed, it seems highly unlikely that he or she will use formulas and calculations to figure out how much benefit there is to increasing or decreasing the number

of hours worked, and few people have the ability to control the number of hours they work so precisely.

Instead of scaling back the EITC and CTC, tax reform should include provisions to make permanent those expansions of the credits that were first enacted as part of the economic recovery act in 2009. The recent “fiscal cliff” legislation extended these expansions only through 2017.¹²

C. Itemized Deductions (for state and local taxes, mortgage interest, and charitable giving)

Three of the ten largest tax expenditures for individuals are itemized deductions. In some cases, itemized deductions can be seen as ways for Congress to subsidize certain activities (like paying state and local taxes, borrowing to purchase a home, or donating to charity) through the tax code.

When filing their personal income taxes, Americans are allowed to either “itemize” their deductions or take the “standard” deduction for their filing status in computing their taxable income. For most low- and middle-income people it is more beneficial to take the standard deduction because it is greater than the sum of all the itemized deductions they could claim. This is one reason why itemized deductions favor higher-income people.

Another reason why itemized deductions are disproportionately targeted to the rich is the fact that their benefits are worth more for each dollar deducted for people in higher income tax brackets. This means that high-income people are subsidized at higher rates than lower-income people.

For example, a very high-income family might be in the 39.6 percent income tax bracket, meaning a portion of their income is taxed at a rate of 39.6 percent. Such a family is likely to save almost 40 cents in taxes for every dollar deducted. This family could, for example, make a donation of \$1,000, claim the itemized deduction for charitable giving for that amount, and enjoy a \$396 reduction in their income tax bill.

On the other hand, a middle-income family might be in the 15 percent income tax bracket and thus save just 15 cents for each dollar of deductions. Such a family could make a \$1,000 donation and claim the itemized deduction for charitable giving for that amount, but this would lower their income tax bill by just \$150.

If lawmakers proposed to provide a subsidy through direct spending for charitable giving or for borrowing to purchase a home, and proposed to subsidize wealthy families at higher rates than lower-income families, the public would naturally be outraged. But this type of regressive subsidization does take place through the tax code, where it receives little attention.

As a result, the three itemized deductions that rank among the largest ten tax expenditures for individuals are disproportionately targeted to the rich (although much less so than the preferential rates for capital gains and stock dividends).

As illustrated in the bar graph on page four, in 2013 the richest one percent of Americans will receive 30 percent of the tax savings from the deduction for state and local taxes, 15 percent of the tax savings from the deduction for home mortgage interest, and 38 percent of the tax savings from the deduction for charitable giving.

If lawmakers are mainly concerned with the lack of progressivity of these itemized deductions, one possible way to address that is President Obama's "28 percent rule," which would place the same limit on these and other tax expenditures for high-income households, and which is discussed in the final section of this report. (This proposal would limit the tax savings of each dollar of certain deductions and exclusions to 28 cents.)

However, if lawmakers are mainly concerned about the effectiveness of these itemized deductions in achieving non-tax policy goals, then other reforms may be appropriate. Because each of these three itemized deductions has a different policy goal and varying levels of success in achieving its goal, the effectiveness of each is discussed separately.

Itemized Deduction for State and Local Taxes

The itemized deduction for state and local taxes is in many ways the most justified of all the itemized deductions, which is a strong argument for leaving it unchanged. The deduction is sometimes seen as a subsidy for state and local governments because it effectively transfers the cost of some state and local taxes away from the residents who directly pay them and onto the federal government. For example, if a state imposes a higher income tax rate on residents who are in the 39.6 percent federal income tax bracket, that means that each dollar of additional state income taxes could reduce federal income taxes on these high-income residents by almost 40 cents. The state government may thus be more willing to enact the tax increase because its high-income residents will really only pay 60 percent of the tax increase, while the federal government will effectively pay the remaining 39.6 percent.

But viewed a different way, the deduction for state and local taxes is not a tax expenditure at all, but instead is a way to define the amount of income a taxpayer has available to pay federal income taxes. State and local taxes are an expense that reduces one's ability to pay federal income taxes in a way that is generally out of the control of the taxpayer. A taxpayer in a high-tax state has less income to pay federal income taxes than a taxpayer who has the same pre-tax income but resides in a low-tax state.

If one takes the first view (that the deduction is a federal subsidy for state and local government) one justification for such a subsidy is that the public investments funded by state and local taxes produce benefits for the entire nation. The deduction for state and local taxes paid encourages state and local governments to raise the tax revenue to fund these public investments that the jurisdictions might otherwise not make.

For example, state and local governments provide roads that, in addition to serving local residents, facilitate interstate commerce. State and local governments also provide education to those who may leave the jurisdiction and boost the skill level of the nation as a whole, boosting the productivity of the national economy. State and local governments may have an incentive to provide less of these public investments than is optimal for the nation because the benefits partly

go to those outside the jurisdiction. The deduction for state and local taxes may counter this inclination of state and local governments to under-invest in these areas.

Itemized Deduction for Home Mortgage Interest

When first enacted, the federal income tax allowed deductions for all kinds of interest. The 1986 Tax Reform Act eliminated the deductibility of consumer interest (interest paid on loans financing anything that does not generate income) but left in place the deduction for interest on home mortgages, presumably because it was felt that this tax benefit had become an important policy to make home ownership possible for many Americans. The Omnibus Budget Reconciliation Act of 1987 limited mortgage interest to no more than two homes and to total mortgage debt of a million dollars.

Reasonable people can differ on whether or not the federal government should encourage home ownership. But if lawmakers are determined that it should, then they must acknowledge that the home mortgage interest deduction is failing to achieve this policy goal.

As a percentage of interest paid, the mortgage interest deduction subsidy follows an odd pattern. For low- and moderate-income homeowners, the subsidy is little or nothing. Most of these taxpayers do not itemize deductions and even if they do, the amount that their deductions exceed the standard deduction is very small, and their marginal tax rate is low. In the middle- and upper-middle income ranges, the interaction with the standard deduction still matters, but the subsidy rate is higher, in the range of about 20 percent of mortgage interest payments. At the very top of the income scale, homeowners with mortgages are generally in the top income tax bracket of 39.6 percent. But the mortgage interest deduction is limited to interest on a million dollars of mortgage, so most of the very richest people's mortgage interest is likely to be non-deductible. As a result, the subsidy rate falls at the highest income levels. A rich person with a \$4 million mortgage, for example, might pay about \$200,000 in annual interest, but only a quarter of that (i.e., \$50,000) would be deductible. So the subsidy rate would be only about 10 percent.

In any event, most of the benefits of the mortgage interest deduction go to those who are relatively well-off and therefore more likely to own a home even without a tax subsidy for doing so. Less well-off people whose decision to buy a home or rent might be influenced by the availability of a tax subsidy are less likely to receive any benefit from the mortgage interest deduction.

President Obama's 28 percent rule would limit the benefits of the deduction for mortgage interest for high-income people without affecting low- or middle-income people (the households most likely to respond to a tax incentive to buy a home). While low- and middle-income people would see no change in their taxes, the proposal would nevertheless increase the percentage of the total tax subsidy going towards these households, which would increase the "bang for the buck" (would increase the incentive to purchase a home created with each dollar of tax subsidy).

Other reform proposals have been discussed that would alter the tax expenditure for mortgage interest in specific ways. Some relatively minor reforms to the mortgage interest deduction might further restrict the amount of the tax subsidy going to well-off households whose home purchasing decisions are probably not affected by it very much. For example, some have

proposed lowering the maximum mortgage for which interest can be deducted from \$1 million to \$500,000. It should be noted, however, that the million-dollar cap, which took effect in 1988, was intentionally not indexed for inflation. As a result, the inflation-adjusted cap has already been cut in half since 1988, and will continue to slowly decline in the future.

Another proposal along these lines is to make the deduction available for a mortgage on only one home, not two as is currently allowed. There is no obvious justification for a tax subsidy for vacation homes.

More dramatic reforms to the mortgage interest deduction would shift more of the tax subsidy towards lower-income people whose decisions to purchase a home are more likely to be affected by a tax break, but who currently receive no benefit or very little benefit from the deduction. For example, the Center on Budget and Policy Priorities suggests converting the mortgage interest deduction into a non-refundable tax credit equal to 15 percent of mortgage interest. This would reduce the cost of the tax subsidy by \$17 billion in 2015 but also allow it to reach more moderate-income families.¹³ At the same time, the tax break available for high-income people would be reduced. But the overall improvement in fairness and effectiveness would be rather modest.

To truly make the mortgage interest deduction more progressive and more effective in helping those who need help the most, the subsidy rate should be highest at the bottom of the income scale and least at the top. For example, a *refundable* tax credit could replace the current deduction, with subsidy rates just the opposite of the current approach based on tax brackets. The revised subsidy rates could start at 40 percent for the lowest-income homeowners and be phased down to 10 percent at the highest income levels. Such a plan could be designed to cost the same as the current deduction (or to raise or lose revenues).

Whatever significant changes, if any, are made to the mortgage interest deduction should be phased in gradually, to avoid unfairness to those who currently rely upon it.

Itemized Deduction for Charitable Giving

The deduction for charitable donations is usually defended as a tax subsidy to encourage people to make donations to charities that serve the public good. An additional defense, on tax policy grounds, is that money that is given away should not be taxed because it is neither saved nor spent on personal consumption by the taxpayers who make those donations. Since in the classical definition, “income” equals consumption plus savings, money given away (with no resulting benefit to the taxpayer) should not be treated as “income,” according to this argument.

Both arguments can be challenged on the grounds that the donations may indeed provide benefits to the donors, whether those benefits are psychic (the “warm glow” that comes from giving) or more concrete (for example, when a group of wealthy individuals donate to fund an opera that they attend regularly).

■ *Incentives for Charitable Giving and How They Can Be Made More Effective*

While the motivations for charitable giving are not well understood, it is clear that a large part (if not all) of these motivations are unrelated to tax incentives. This graph, from a 2011 report from the Congressional Budget Office (CBO), shows that increases in charitable donations over the years do not seem correlated in any significant way with changes in tax subsidies for charitable giving.¹⁴ The increases in donations seem more correlated with upswings in the economy generally. (The two significant drops in donations coincide with falls in the stock market and the broader economy.)

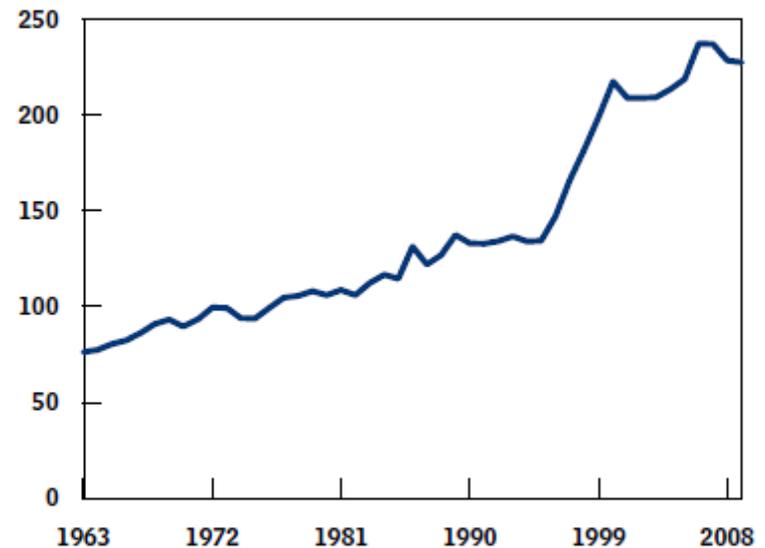
While the deduction for charitable giving was available for all the years covered in this graph, the tax incentive changed (in theory, at least) because marginal tax rates changed. For example, the top personal income tax rate was lowered from 77 percent to 50 percent in 1970, and then lowered from 50 percent to 28 percent in 1988 (by which time the Tax Reform Act of 1986 was phased in).¹⁵ This meant that a very high-income person saved 77 cents for each dollar of charitable donations made in 1969, 50 cents for each dollar of donations made during the 1970s and most of the 1980s, and 28 cents during the period when the top income tax rate was 28 percent. As the CBO report explains, any changes in charitable giving that resulted from changes in the tax incentive seem to be small and short-lived. For example, it seems some people may have increased donations in 1986, knowing that income tax rates would be lower the following year when rates fell under the tax reform law, and then donations fell a bit from that artificial high point. But the overall trend of increased donations seems unaffected by changes in the tax incentives provided.

Given this evidence, it seems unlikely that a reform that limits the tax savings of each dollar of deductions to 28 cents (as President Obama proposes) would have much of an impact on charitable giving, since it would essentially limit the tax incentive for charitable giving to what it was when the top income tax rate had been lowered to 28 percent in the late 1980s.

The CBO report on the charitable deduction explains that studies have come to various conclusions about the extent to which people actually respond to the tax incentive to donate to charity. The bulk of the CBO report adopts the assumption that a one percent increase in the price of donating would lead to a half percentage point decrease in donations. In other words,

Total Charitable Contributions by Individual Donors, 1963 to 2009

(Billions of 2009 dollars)



Source: Congressional Budget Office based on data from the Center on Philanthropy at Indiana University, *Giving USA 2010: The Annual Report on Philanthropy for Year 2009* (Chicago: Giving USA Foundation, 2010).

the cost of donating (which is affected by tax breaks for donating) determines part of the motivation for donating, while the rest comes from the other motivations discussed above (whether psychic benefits or more concrete ones).

Based on this assumption, CBO models the impacts of several options to change the charitable deduction and finds that there are some that would reduce the revenue cost and at the same time actually increase charitable contributions. If CBO's modeling really does reflect the way people would react to changes in tax policy, this would mean that the tax expenditure could be altered to have more "bang for the buck," meaning more incentive to donate created with each dollar of tax subsidy.

For example, one of the many options CBO examined would convert the deduction for charitable giving into a credit equal to 25 percent of charitable giving in excess of \$500 for singles and in excess of \$1,000 for married couples. This option would make the tax subsidy available to more people (because it would be available to people who do not itemize deductions) even as it would decrease the tax savings enjoyed by wealthy people. (For example, a very high-income person would only save 25 cents for each dollar of charitable contributions even though their marginal tax rate would be higher than 25 percent). The \$500/\$1,000 floor would remove the tax subsidy for small donations that (the thinking goes) people will make regardless of whether or not there is a tax incentive. CBO concluded, based on the assumptions it used in modeling taxpayers' responses, that if this change had been in effect in 2006 it would have increased total contributions by \$1.5 billion but would have reduced the revenue loss from the tax subsidy by \$2.4 billion.

■ *Loopholes Allowing the Charitable Deduction to Be Used as a Tax Shelter Rather than an Incentive for Charitable Giving, and How to Close Them*

While reasonable people can disagree over the extent to which the charitable deduction provides an effective tax incentive for charitable giving, there are particular uses of the deduction that are indefensible on policy grounds. For example, the charitable deduction is often claimed on donations of appreciated property (such as stocks or artwork that has gone up in value). Current law allows what amounts to a *double* deduction for such donations. The appreciation of the property (the amount by which its value increases during the time the donor owns it) is never taxed, and yet the donor is allowed to claim the itemized deduction for charitable giving for that amount.

Normally, when you make a donation, you receive a deduction for an amount on which you have already paid taxes. For example, if you make a cash donation of \$100 to a charity, you claim a deduction for \$100, but that \$100 was income on which you already paid income taxes.

But now imagine that you purchase a painting for \$5,000. Ten years later, you still own that painting, and you have it appraised at \$20,000. You donate this painting to a museum and claim the charitable deduction for the full \$20,000. The appreciation of the property, the \$15,000 increase in the value of the painting, is income that was never taxed, but you nonetheless enjoyed a deduction for that amount.

In addition to allowing a double-deduction for the appreciation on the donated property, this also seems to provide an enormous incentive to inflate the value of donated property (although it might be impossible to know how common such abuse is).

The 1986 Tax Reform Act eliminated the double deduction for appreciated property donations by disallowing it under the Alternative Minimum Tax. But pressure from elite universities and museums led to repeal of that reform in the early 1990s.

From a tax policy point of view, at the very least, Congress should limit the deduction to whatever the property cost the donor to purchase.

D. Exclusions of Earned Compensation or Benefits from Taxable Income (employer-provided health care, pension contributions and earnings, Social Security benefits)

Among the ten most costly tax expenditures for individuals, there are three “exclusions” from taxable income of compensation for work or benefits tied to earnings. These are not targeted to the richest Americans to the same degree as many other tax expenditures. There is therefore little reason on grounds of progressivity/regressivity for Congress to alter these three tax expenditures.

Exclusion for Employer-Provided Health Care

One of these tax expenditures is the exclusion of employer-provided health care from taxable income. This is the rule that allows an employer to provide part of what it pays its workers in the form of contributions towards the costs of health care (like premiums for health insurance) without those contributions counting as taxable income to the employees the way that most other types of compensation normally do.

As illustrated in the graph at the bottom of page four, only two percent of the benefits from the exclusion for employer-paid health insurance go to the richest one percent of Americans, compared to 68 percent of the benefits of the preferential income tax rates for capital gains and dividends. In other words, lawmakers have no reason to prioritize the exclusion of employer-provided health care for repeal or reform based on progressivity/regressivity.

There are at least two reasons why the exclusion for employer-provided health care is not as regressive as most other tax expenditures. First, the typical amount of employer-provided health benefits received by high-income families is not that much greater than the typical amount received by middle-income families. This is quite different from the vast discrepancy between the amount of capital gains and dividends going to high-income families versus middle-income families.

Second, unlike most other tax expenditures, the exclusion for employer-provided health care reduces payroll taxes as well as income taxes. This makes the exclusion much less regressive than, for example, the itemized deductions discussed above.

The example above describes how for each dollar of charitable donations or mortgage interest, itemized deductions would reduce income taxes by 15 cents for a middle-income person in the

15 percent income tax bracket and 39.6 cents (nearly 40 cents) for a high-income person in the 39.6 percent income tax bracket.

In contrast, for each dollar of employer-provided health care, the middle-income person in the 15 percent income tax bracket would save 15 cents in income taxes *and* about 15 cents in payroll taxes. The person in the 39.6 percent bracket would save nearly 40 cents in income taxes but would save just 3.8 cents in payroll taxes. (Most of the payroll tax is the Social Security tax, which does not apply to earnings in excess of \$113,700. The 3.8 percent Medicare tax on high-earners is the only part of the payroll tax that would apply to a very high-income person's earnings.)¹⁶

In other words, the exclusion for employer-provided health care does subsidize high-income families at somewhat higher rates than middle-income families, but the difference is not nearly as great as in the case of certain other tax expenditures.

In many ways the exclusion for employer-provided health care is an accident of history. It began as employers sought ways to provide compensation in forms other than wages in order to circumvent wage and price controls during World War II.

In more recent years the exclusion has often been justified as a way to make health insurance more affordable and comprehensive than it might otherwise be. For example, the exclusion encourages employees to have health insurance and it encourages employers to pool health risks among their employees and thus bargain for lower health insurance premiums than the employees could obtain on their own.

The exclusion has achieved these goals for many employed people. Health insurance obtained through an employer is more affordable (with lower premiums and lower out of pocket expenses) and more comprehensive than insurance obtained in the "individual market" for health insurance.¹⁷ (The health care reform legislation enacted in 2010 has several provisions designed to make health insurance obtained in the individual market more affordable and comprehensive.)

Many health analysts have worried that the exclusion, which is a very large government subsidy for health insurance, causes people to use more health care than they otherwise would, thus helping to drive up the cost of health care. But there is little evidence that the amount of government subsidies going towards health care (whether through the tax code or through direct government spending) is the primary factor driving up health care costs, which seem to be more connected to the inefficiencies in the way health care services are actually provided. A 2009 study from the Economic Policy Institute concluded that employer-provided health insurance costs are not associated with the level of health services provided as much they are associated with the size of the company and the average age of its workforce.¹⁸

Despite this, Congress included a provision to limit the exclusion for employer-provided health care in the health care reform law enacted in 2010. Under the new law, starting in 2018, health insurance companies will pay an excise tax of 40 percent on health insurance premiums to the extent that they exceed \$10,200 for single people and \$27,500 for families. This is thought to be the equivalent of imposing this tax directly on the workers because the health insurance providers will raise their premiums, and employers will respond to choosing more modest health

insurance plans. Unlike health benefits or wages, the excise tax would not be deductible by employers in computing their federal and state taxable income. So for most employers, the real excise tax rate would exceed 60 percent.

It is estimated that about 25 percent of employer-provided health insurance plans will have premiums exceeding \$10,200 for single people and \$27,500 for families in 2018, but only 16 percent of plans will be affected by the excise tax because the law provides higher thresholds for companies with workforces likely to face higher premiums because they are older, more heavily female or engaged in riskier types of work.

The thresholds would be adjusted each year for overall inflation, which is expected to be much lower than health care inflation. As a result, it is estimated that 75 percent of plans will be affected by the excise tax within a decade after it takes effect.¹⁹

Given that there is little reason to assume that the tax subsidy for employer-provided health care is what is driving up the costs of health care, as well as the fact that Congress has just acted to limit any such effect, there seems to be little if any policy rationale to further restrict this tax expenditure.

Exclusion for Pension Earnings and Contributions

Another tax expenditure is the exclusion for pension contributions and earnings. This is the rule that exempts from taxable income the employer-contributions and most employee-contributions to an employee's retirement savings, as well as the earnings on those contributions, until the employee's retirement. These are advantageous tax breaks because most compensation paid to employees is taxable in the year it is earned and earnings on an ordinary savings account are taxed each year. If retirement savings were taxed this way, they would accumulate much more slowly, leaving less to live on during retirement.

Most people probably don't realize that the result is the equivalent of a zero tax rate or more often a *negative* tax rate, on the earnings from retirement savings. That's because many people move into a lower income tax bracket when they retire, meaning this income is taxed at lower rates than would be the case if it was taxed when it was earned.

This tax expenditure is less regressive than the preferential rates for capital gains and dividends and the itemized deductions for state and local taxes, home mortgage interest, and charitable giving. However, it nonetheless is targeted towards the wealthy. As the table on page five illustrates, two-thirds of the benefits of this tax expenditure go towards the richest fifth of Americans.

Exclusion for Most Social Security Benefits

Another tax expenditure in this category is the rule allowing most Social Security benefits to be excluded from income for the purpose of calculating income taxes. The rules generally require individuals with "combined income" (meaning half of Social Security benefits plus other income) between \$25,000 and \$34,000 (between \$32,000 and \$44,000 for married couples) to include half of their Social Security benefits in their taxable income. Those with "combined income"

exceeding those amounts may be required to include as much as 85 percent of their Social Security benefits in their taxable income.

Prior to 1984, Social Security benefits were completely tax-free. A portion of benefits became taxable in 1984 as a back-door way of reducing Social Security benefits for better-off retirees. The maximum percentage potentially taxable started at 50 percent and was increased to 85 percent during the Clinton administration. Most of the revenue generated by taxing benefits goes to the Social Security Trust Fund, while a fraction of the revenue goes towards the Medicare Trust Fund.

The table of figures on page five illustrates that the tax savings from *not* taxing *all* Social Security benefits are concentrated on middle-income people.

III. Proposals to Place a Limit on Most Tax Expenditures

The lack of progressivity in our tax system points to fairly straightforward ways to address the most regressive and most progressive tax expenditures. The most regressive tax expenditure, the one most concentrated on the richest one percent of Americans, should simply be repealed. This means Congress should repeal the preferential rates for capital gains and dividends, and should also repeal the exclusion of capital gains at death (which would otherwise increasingly serve as a tax shelter to avoid income taxes on capital gains). The most progressive tax expenditures, the Earned Income Tax Credit and the Child Tax Credit, should be preserved and the recent expansions of these credits should be made permanent.

For the majority of tax expenditures that fall somewhere in between these two extremes, the analysis is more complicated. There are several that are somewhat regressive, but for policy reasons already discussed, lawmakers may not want to repeal them entirely. Some of the potential reforms discussed already would make these tax expenditures more progressive as well as more effective in achieving their policy goals.

Other proposals would not target specific tax expenditures for reform but would apply a limit to a large group of tax expenditures.

Mitt Romney, during his presidential campaign, offered a proposal to limit itemized deductions to \$25,000 per return. Overall, his plan would have *reduced* progressivity because all the revenue savings would be used to pay for reductions in income tax rates.²⁰ Romney's plan would have cut income tax rates on "ordinary income" (income that is not capital gains or stock dividends) so much that very high-income people would have received a net tax cut no matter how the rest of the details of the plan were filled in.²¹

President Obama has proposed a very different type of limit on tax expenditures, one that would raise revenue and make the tax code more progressive, even if it fails to address all the problems with tax expenditures. The President's proposal, often called the "28 percent rule," would limit the tax savings from each dollar of certain deductions and exclusions to 28 cents. Currently, the richest Americans can save almost 40 cents for each dollar of deductions and exclusions.

Five of the ten largest individual tax expenditures (along with several other tax expenditures that are less significant) would be subject to the President’s 28 percent rule. These include the exclusion for employer-provided health insurance, the exclusion of employee (but not employer) contributions to retirement savings plans, and the itemized deductions for state and local taxes, mortgage interest, and charitable giving. While some of these tax expenditures are regressive to various degrees, none are as regressive as the tax expenditure for capital gains and dividends, which would not be addressed at all by the 28 percent rule.

To understand how the 28 percent rule would work, recall that a family in the highest income tax bracket, the 39.6 percent bracket, can save almost 40 cents for each dollar of home mortgage interest they pay (to take an example). A middle-income person might only be in the 15 percent bracket and would therefore save just 15 cents for each dollar of home mortgage interest.

President Obama’s proposal to limit the tax savings for each dollar of certain deductions and exclusions to 28 cents would make the tax code more progressive because it would limit (although not eliminate) this unfairness.

Under current law, there are three income tax brackets with rates higher than 28 percent (the 33, 35, and 39.6 percent brackets). People in these tax brackets (and people who would be in these tax brackets if not for their deductions and exclusions) could therefore lose some tax breaks under the proposal. They would save 28 cents for each dollar of specified deductions or exclusions — meaning they still benefit more than families in the tax brackets that are below the 28 percent bracket, but the difference would be reduced.

Impact of President's Proposal to Limit Tax Expenditures for the Wealthy, in 2014

Percentage of Taxpayers Affected by Proposal	Average Tax Increase in Dollars (for those w/increase)	Average Tax Increase as % of Income (for those w/increase)
3.6%	\$ 5,950	0.9%

Source: Institute on Taxation & Economic Policy (ITEP) microsimulation tax model, April, 2013.

Composition of Tax Breaks Limited by President Obama's Proposal to Cap Savings at 28 Cents Per Dollar of Deductions/Exclusions, in 2014

tax break	composition of tax breaks
state and local taxes deduction	36%
charitable deduction	15%
mortgage interest deduction	15%
employer-provided health exclusion	12%
bond interest exemption	10%
retirement breaks	3%
self-employed health deduction	2%
itemized deductions (excluding those above)	8%

Source: Institute on Taxation & Economic Policy (ITEP) microsimulation tax model, April, 2013.

The President’s 28 percent rule is projected to raise around half a trillion dollars over a decade. A recent CTJ report finds that it would affect only 3.6 percent of Americans. (State-by-state figures are also provided in the report.) The report also finds that limiting the tax benefits from the deduction for state and local taxes would make up over a third of the revenues raised by the proposal.²² In combination, the deduction for state and local taxes and the deduction for charitable giving would account for just over half of the revenues raised.

While the 28 percent rule would make all the deductions and exclusions it applies to more progressive (and would raise revenue), Congress may still want to make specific changes to individual deductions and exclusions, either to eliminate them or to make them better suited for achieving their intended goals, as already discussed.

¹ For example, see Citizens for Tax Justice, “The U.S. Continues to Be One of the Least Taxed of the Developed Countries,” April 8, 2013. http://ctj.org/ctjreports/2013/04/the_us_continues_to_be_one_of_the_least_taxed_of_the_developed_countries.php

² For information about problems with the corporate income tax and how it can be reformed, see the reports on corporate taxes from Citizens for Tax Justice at www.ctj.org.

³ Congressional Budget Office, “The Distribution of Major Tax Expenditures in the Individual Income Tax System,” May 29, 2013. <http://cbo.gov/publication/43768>

⁴ The only proposal in this direction is included in the fiscal year 2013 budget plan proposed by the Congressional Progressive Caucus, which would tax capital gains and dividends at the same rates as other types of income. <http://cpc.grijalva.house.gov/back-to-work-budget/>

⁵ For more see Citizens for Tax Justice, “Who Pays Taxes in America in 2013?” April 1, 2013. http://ctj.org/ctjreports/2013/04/who_pays_taxes_in_america_in_2013.php; Citizens for Tax Justice, “New Tax Laws in Effect in 2013 Have Modest Progressive Impact,” April 1, 2013. http://ctj.org/ctjreports/2013/04/new_tax_laws_in_effect_in_2013_have_modest_progressive_impact.php

⁶ Citizens for Tax Justice, “Ending the Capital Gains Tax Preference would Improve Fairness, Raise Revenue and Simplify the Tax Code,” September 20, 2012. http://ctj.org/ctjreports/2012/09/ending_the_capital_gains_tax_preference_would_improve_fairness_raise_revenue_and_simplify_the_tax_co.php

⁷ There is currently a debate between the Congressional Research Service and the Congressional Joint Committee on Taxation over how much revenue can be raised by repealing or reducing the preferential tax rates for capital gains, because of disagreement over how such behavioral responses by taxpayers will limit the amount of revenue raised. For more information, see the appendix to Citizens for Tax Justice, “Policy Options to Raise Revenue,” March 8, 2012. http://ctj.org/ctjreports/2012/03/policy_options_to_raise_revenue.php In any event, it is clear that the behavioral response most likely to limit revenue raised would be taxpayers holding more of their appreciated assets until death. By eliminating the rule that forgives income taxes on capital gains at death while at the same time eliminating preferential rates for capital gains, Congress can raise significant revenue.

⁸ The Wall Street Journal has made this argument frequently in editorials, including “Dynamic Scoring,” January 29, 2008; “Washington’s Tax Oracles,” July 21, 2010; “Obama’s Revenue Soup: A History Lesson on Capital Gains Taxes,” April 9, 2012.

⁹ Chuck Marr, Jimmy Charite, and Chye-Ching Huang, “Earned Income Tax Credit Promotes Work, Encourages Children’s Success at School, Research Finds,” Center on Budget and Policy Priorities, revised April 9, 2013, <http://www.cbpp.org/cms/index.cfm?fa=view&id=3793>.

¹⁰ For example, in 2011 and 2012, several of the Republican presidential candidates complained that too many Americans are not paying federal personal income taxes. In addition, Senators Orrin Hatch and Dan Coats argued that all Americans need to have positive personal income tax liability in order to have “skin in the game,” and House Majority Leader Eric Cantor questioned whether it was “fair” that such people did not pay federal income taxes. See Nancy Cook, “The 51 Percent,” *National Journal*, updated May 29, 2013. <http://www.nationaljournal.com/magazine/the-51-percent-20120209>; Bill Straub, “Coats: Change Tax Code to Get More People Paying into System,” *Evansville Courier & Press*, July 23, 2011. http://www.courierpress.com/news/2011/jul/23/no-headline---ev_taxes/; Citizens for Tax Justice, “House GOP Leader Calls for Tax Increases on Lower-Income Americans,” April 20, 2012. http://www.ctj.org/taxjusticedigest/archive/2012/04/house_gop_leader_calls_for_tax.php

¹¹ Chuck Marr, Jimmy Charite, and Chye-Ching Huang, “Earned Income Tax Credit Promotes Work, Encourages Children’s Success at School, Research Finds,” Center on Budget and Policy Priorities, revised April 9, 2013, <http://www.cbpp.org/cms/index.cfm?fa=view&id=3793>.

¹² A report from CTJ estimated how many children and families in each state benefited from the extension of the expanded rules into 2013. See Citizens for Tax Justice, “The Debate over Tax Cuts: It’s Not Just About the Rich,” July 19, 2012. http://ctj.org/ctjreports/2012/07/the_debate_over_tax_cuts_its_not_just_about_the_rich.php

¹³ Will Fischer and Chye-Ching Huang, “Mortgage Interest Deduction Is Ripe for Reform: Conversion to Tax Credit Could Raise Revenue and Make Subsidy More Effective and Fairer,” Center on Budget and Policy Priorities, April 4, 2013. <http://www.cbpp.org/cms/index.cfm?fa=view&id=3948>

¹⁴ Congressional Budget Office, “Options for Changing the Tax Treatment of Charitable Giving,” May 24, 2011. <http://www.cbo.gov/publication/41452>

¹⁵ Citizens for Tax Justice, “Top Federal Income Tax Rates Since 1913,” November 2011. <http://www.ctj.org/pdf/regcg.pdf>

¹⁶ For most people, the Medicare tax is a 2.9 percent tax on earnings. However, under a provision enacted as part of health care reform in 2010, high-income people pay the Medicare tax at a marginal rate of 3.8 percent on earnings and pay a related tax at a rate of 3.8 percent on investment income.

¹⁷ H. Whitmore, J. R. Gabel, J. Pickreign et al., “The Individual Insurance Market Before Reform: Low Premiums and Low Benefits,” *Medical Care Research and Review*, published online March 21, 2011.

¹⁸ Josh Bivens and Elise Gould, “The House Health Care Bill Is Right on the Money: Taxing High Incomes Is Better than Taxing High Premiums,” Economic Policy Institute, December 11, 2009. <http://www.epi.org/publication/ib267/>

¹⁹ Bradley Herring and Lisa Korin Lentz, “What Can We Expect From the ‘Cadillac Tax’ in 2018 and Beyond?” *Inquiry*, Winter 2011.

²⁰ Citizens for Tax Justice, “Romney’s Latest Proposal to Pay for His Tax Cuts Would Offset Only a Fraction of Their Costs,” October 24, 2012. http://ctj.org/ctjreports/2012/10/romneys_latest_proposal_to_pay_for_his_tax_cuts_would_offset_only_a_fraction_of_their_costs_national.php

²¹ Citizens for Tax Justice, “How Big Is the Romney-Ryan Tax Cut for Millionaires?” August 29, 2012. http://ctj.org/ctjreports/2012/08/how_big_is_the_romney-ryan_tax_cut_for_millionaires.php

²² Citizens for Tax Justice, “State-by-State Figures on Obama’s Proposal to Limit Tax Expenditures,” April 30, 2013. http://ctj.org/ctjreports/2013/04/state-by-state_figures_on_obamas_proposal_to_limit_tax_expenditures.php