Congressional Research Service

MEMORANDUM October 5, 2012

To: Senator Bernard Sanders
Attention: Warren Gunnells

From: Jane G. Gravelle, Senior Specialist in Economic Policy, 7-7829

Subject: **Discussion of Tax Reform That Cuts the Top Income Tax Rate to 28%**

This memorandum responds to your request for a discussion of the effect of tax expenditure offsets in lowering the top income tax rate to 28% with special reference to the proposals of The National Commission on Fiscal Responsibility and Reform (the Fiscal Commission) on the top 1% of taxpayers (with respect to income).[1]

The Fiscal Commission plan, as is the case of a number of other proposals, makes a few specific proposals and generally refers to eliminating most tax expenditures.[2] The Fiscal Commission proposal sets forth a plan that allows rates to be cut roughly by 20%, compared to a baseline that assumes the 2001 and 2003 tax cuts are extended. Thus, the top rate would be 28% (which would apply to the current 33% and 35% brackets). If some additional tax expenditures were to be preserved, the rates would need to rise, to maintain revenue levels.

This plan aims to offset the rate reductions and also raise revenue. The commission suggests that no rate be higher than 29%, so that taxes might have to rise more in the middle classes if it proves not to be feasible to eliminate some tax expenditures. Thus one question is whether tax expenditures are adequate to offset the rate cuts and, possibly to raise revenue.

A recent CRS report provides a specific review the major tax expenditures, and discusses some of the barriers to eliminating those tax expenditures. These issues include:

- Tax expenditures that reduce the tax rate on the return to saving account for 30% of all tax expenditures: Many proponents of lowering marginal tax rates also want lower tax rates (or at least not higher ones) on the return to savings and investment. Most of these provisions relate to retirement savings or rates on capital gains and dividends. The share would be 42% of all tax expenditures if preferences for owner-occupied housing were included and 44% if business preferences were included.

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[1] The National Commission on Fiscal Responsibility and Reform, *The Moment of Truth*. http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf.

[2] See CRS Report R41641, *Reducing the Budget Deficit: Tax Policy Options*, by Molly F. Sherlock and CRS Report R41970, *Addressing the Long-Run Budget Deficit: A Comparison of Approaches*, by Jane G. Gravelle for discussions of various proposals.

- A number of tax expenditures may serve desired public and social purposes such as the itemized deduction for charitable giving. Subsidies for employer health insurance have some merits as well, as they address some serious market failures in the health market (although this argument would be less compelling as the Patient Protection and Affordable Care Act (P.L. 111-148) goes into effect). There are also arguments for the benefits of home ownership, including homes as a way of creating retirement assets. The capital gains exclusion for owner-occupied housing removes a barrier to labor mobility.

- Eliminating many of the large tax expenditures would be extremely difficult from an administrative and technical standpoint, because the underlying information is either not known to the taxpayer or government. These include benefits received in kind (employer provided health care and defined benefit pension plans, exclusion of Medicare benefits, and numerous employer fringe benefits). Taxing capital gains at death is also difficult because basis is often hard to establish; even when a milder provision (carry-over basis)[3] was in place in 2010 it was accompanied with a large exemption so that it affected only extremely wealthy estates. Also taxing income that is not actually received, such as the inside buildup or capital gains at death, will confront taxpayers with a liability with no corresponding cash income.

- Behavioral responses can considerably reduce some tax expenditures which are generally calculated on a fully static basis, the most notable being preferential rates for capital gains where reductions in realizations can reduce revenue gain; current scoring methodology has a reduction of around 70%.

- Some tax expenditures are viewed by some as important for distributional reasons, because they might have a large impact on low income households. Examples are the earned income credit and exclusions of transfers from income. These issues are not generally a concern for high income taxpayers.

- Some tax expenditures are widely used and extremely popular, so that it is difficult to imagine eliminating them. One example of provisions that are technically easy to eliminate but may be popularly resisted are itemized deductions for mortgage interest and state and local taxes.

Overall, the report suggests, in light of these issues, that eliminating only 10% to 15% of tax expenditures, allowing around a one to two percentage point rate reduction, may be possible.

In order to address the use of tax expenditure reductions for higher income taxpayers, **Table 1** begins the analysis of the value of tax expenditures based on estimates from the Tax Policy Center, for the top 1% of taxpayers in 2011.[4] This group generally covers taxpayers in the top tax bracket and some in the second highest bracket. It also includes an estimate of the tax reduction from the rate cut, although it does not account for the repeal of the AMT. The tax collected under the current AMT is relatively small for this group, about $1,600 on average.[5]

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[3] With carryover basis, gain accrued during the decedent's lifetime would be taxed when heirs sell the assets. Removing the tax expenditure would impose a capital gains tax at the time of death.

[4] The Tax Policy Center's distributional tables on tax expenditures are at http://www.taxpolicycenter.org/numbers/listdocs.cfm?BrowseTPC=true.

[5] Tax Policy Center, share of income tax at http://taxpolicycenter.org/numbers/displayatab.cfm?DocID=2437&topic2ID=40&topic3ID=81&DocTypeID=2; data on AMT at http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=3023&topic2ID=60&topic3ID=61&DocTypeID=.

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Column 2 reports the effects of repealing most tax expenditures grouped into a series of categories. There is a significant residual that arises from the fact that when many exemptions and deductions are eliminated at the same time the revenue gain is greater than the sum of the individual parts, because the score associated with eliminating provisions differs depending on when in a series of provisions a specific proposal is "scored." (This effect occurs because base broadening leads to higher average marginal rates). For example, if the preferential rate on capital gains and dividends is the first tax expenditure to be eliminated it raises an average of $49,000 while if it is the last to be eliminated, it raises an average of $65,000. Most of the tax expenditures are calculated as if they were the first to be eliminated so all are understated, by an average of over 20%.

Table 1. Effects of 20% Rate Reduction and Tax Expenditures, Top 1% of Income Distribution, 2011

Item	Initial Effect ($billions)	Effect Adjusted for Tax Rate ($billions)	Average Benefit ($thousands)
Rate Reductions	63		54
Base Broadening	258	193	170
Preferential Rates, Capital Gains and Dividends	58	39	33
Capital Gains at Death	49	40	34
Itemized Deductions	39	31	27
Major Exclusions	35	28	24
Other Exclusions and Miscellaneous	21	17	15
Behavioral Response for Mortgage Interest	6	5	4
Credits and Some Above-the Line Deductions	1	1	1
Residual	52	45	39

Source: CRS calculations based on data from the Tax Policy Center, see text.

Note: Major exclusions includes the following items likely to be significant for high income taxpayers: imputed net rent, tax exempt bond interest, inside buildup on annuities and life insurance, foreign earned income exclusion, cafeteria plans, employer insurance and pensions and retirement plans. Other exclusions and miscellaneous includes the passive loss restriction deferral of sales on installment sales. The residual category is the difference between the total base broadening effect and the sum of the individual categories; it reflects an understatement of individual categories as discussed in the text.

Note also that there is an interaction term for mortgage interest, since the estimates assume that high income individuals if denied the mortgage interest deduction would pay off part of the mortgage from savings and continue to realize the benefit through the absence of earnings on equity. If denying the mortgage interest deduction were to be combined with taxing imputed rent,[6] this behavioral response

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[6] Imputed rents is the net benefit of living in a home, equivalent to the amount that would be paid to rent it net of the costs such as interest, property taxes, depreciation, and maintenance. It could also be thought of as the return to the equity investment in the (continued...)

would not occur because the savings that reduced the mortgage principal would result in an offsetting increase in imputed rent.

The third column adjusts the estimates for the lower tax rates due to the rate reductions. For deductions and exclusions, the amounts are, as expected, 80% of the original because tax rates are 80% as high. For preferential rates on capital gains and dividends, however, the benefit is the differential in rates and the revenue raised is about two thirds of the amount in the second column. For the top rate of 35% the value of the differential is 35% minus 15%, which is 20 percentage points; if the rate is reduced to 28%, the value is 28% minus 15%, for a differential of 13 percentage points, so the new benefit is 65% of the old one. (The actual calculation uses a rate of 34.6% to account for some small portion of income in the 33% bracket for this group).

The final column converts the tax expenditures into average dollars per taxpayer. Recall, however, that individual items are understated. For example, the average $33,000 benefit for preferential rates on capital gains and dividends would be almost $44,000 if the provision were repealed last.

Turning now to the distributional analysis in the Fiscal Commission report, they estimate taxes paid by the top 1% of taxpayers to increase by $112,000 in 2015 under their proposed reform (p. 32).[7] The distributional table in the Fiscal Commission report also shows their reform as a revenue raiser and a more progressive tax since after-tax income declined for all taxpayers by 2.6% but declined 7.8% for the top one percent. Deflating the $112,000 to 2011 nominal income leads to about $97,000. These numbers suggest that most tax expenditures were eliminated for this group, since the sum of $97,000 and $54,000 (from **Table 1**) is $151,000. Although there is some potential error in combining data sources, the results imply that about 90% of the tax expenditures were eliminated for the top 1%.

The approximately $20,000 of remaining tax expenditures, according to the description of the plan, come from two primary sources. About $4,000 is due to the benefits of a 12% credit for mortgage interest and charitable deductions that substitutes for the elimination of itemized deductions for mortgage interest, medical expenses, charitable deductions, and state and local taxes. The remainder is largely due to the retention of employer defined benefit pensions, the retention, although with ceilings, of retirement accounts such as 401(k)s, and employer health exclusions, all provisions contained in the category of major exclusions. In addition, only interest on newly issued tax exempt bonds would be included, also in that category.

Following the analysis in the CRS report, there would be significant barriers to eliminating most of the tax expenditures that make up the approximately $150,000 increase in taxes. Consider for example, the taxation of capital gains at death. This provision has not been considered in past legislation. At most carryover basis was adopted, which was subject to a very large exclusion and has since been eliminated. This provision would expose many estates to taxes at death, not just the very wealthy, and executors would probably have difficulty determining basis. It is a savings incentive and taxes on the savings may be unattractive to those who most strongly favor lowering marginal rates. On many fronts, it is a difficult provision to imagine enacting. Scaling the $34,000 benefit for this provision from **Table 1** up by 20-25% to account for interactions would lead to a figure in excess of $40,000, eliminating close to half of the $97,000 gain.

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[7] This figure would round up to $113,000 but also includes some additional gasoline taxes, so that $122,000 is used in the calculations..

If taxing capital gains at death is not enacted, the powerful behavioral responses in revenue scoring would come into play. (Taxing gains at death would eliminate much of the ability to avoid taxes by not realizing gain). Although there is some dispute about the size of these responses, they would eliminate around 70% of the gain. For the $33,000, scaled up by 30% to account for being close to last in revising, would lead to another $30,000 of increased tax would be eliminated, accounting for another 30% of the $97,000 net increase. Therefore, one single provision if not enacted would trigger effects that eliminated 70% of the total net increase.

There is reason to expect that capital gains preferential rates would not be a feasible tax expenditure to eliminate, since this provision is important to those who would otherwise support lowering marginal rates. If the entire provision were eliminated, the two capital gains provisions together would account for $85,000 or 88% of the total net gain.

Although it is straightforward to eliminate the major itemized deductions, there would likely be popular resistance to doing so. If all itemized deductions were eliminated, scaling up the amount and netting out the 12% credits, $25,000 of benefit would be eliminated, which accounts for 26% of the net gain. Adding this amount to the effects of capital gains would more than eliminate the additional taxes, lead to an additional loss of $14,000 and require a tax rate close to 30% to remain revenue neutral.

There are a number of other provisions that cannot be separately identified that also may be difficult to envision changing or that may, by their nature, not contribute much to maintaining a fixed tax burden. For example, consider the next largest category, major exclusions, which scaled up accounts for $30,000. The bulk of this category provision is tax exempt bonds. For example, tax exempt bonds have a value of about 50% of the value of preferential capital gains and dividends taxes and if they were concentrated to the same degree would account for $20,000.[8] A significant portion of this amount would, however, not be included in the short run and thus this category may account for some of the difference between total tax expenditures and expenditures raised. But some of it is contributing to increased taxes.

There are other provisions that are unlikely to be considered as well, where it is difficult to assess the effect. For example, the imputed rent on owner occupied housing, which is not considered a tax expenditure in the Joint Committee on Taxation's lists, is unlikely to be taxed for a variety of reasons. Similarly, taxing the inside build up on annuities and life insurance, which probably constitute most of the remainder of major exclusions. These provisions account for most of any remaining amounts in the major exclusions category, which is probably around $15,000 and would account for another two percentage points.

When these provisions are considered in the same framework as those in the CRS report, the conclusion in that report appears to apply roughly to this high income group as well: with revenue neutrality a reduction of around two percentage points might be all that can be achieved.

[8] See **Table 3** in CRS Report R42435, *The Challenge of Individual Income Tax Reform: An Economic Analysis of Tax Base Broadening*, by Jane G. Gravelle and Thomas L. Hungerford.