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Economic and Distributional Effects of Tax Expenditure Limits

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This draft: November 25, 2015

[*] Prepared for "The Economics of Tax Policy," Brookings Institution, December 3-4, 2015. Views expressed are those of the authors and should not be attributed to our funders or the institutions with which we are affiliated.
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I. Introduction

Tax expenditures are special tax rules in the form of deductions, exclusions, credits, and favorable rates that benefit selected activities, industries, or groups of taxpayers. Since Stanley Surrey originally popularized the concept in the 1970s, tax policy experts have recognized that special tax benefits represent a form of public spending disguised as tax reductions. Because of this, it is often easier to enact tax breaks to promote policy agendas than to enact equivalent direct spending programs that are more transparent. As a result, many tax expenditures are poorly targeted, distort economic choices of households and businesses, and make the tax law more complicated. Reducing or eliminating many of them to pay for lower rates, deficit reduction, or higher priority spending programs has long been a goal of tax reformers.

Tax expenditure reduction has proven politically difficult, however. The most costly tax expenditures, including the exclusion for employer sponsored health insurance, itemized deductions for home mortgage interest, charitable contributions, and state and local taxes, and the exemption of interest on municipal bonds benefit many taxpayers and have the support of powerful constituencies. As an alternative, policymakers and commentators have expressed interest in approaches, analogous to direct spending caps, to limit the costs of tax expenditures without targeting single provisions.

This paper examines the effects of alternative ways of imposing global limitations on groups of tax expenditures that benefit individual taxpayers. We begin by providing some general background on the adverse effects of tax expenditures and past efforts of tax reform proposals to reduce them. We then present data on the overall budgetary cost of individual income tax expenditures and the distribution of their benefits among income groups. We review existing limits on tax expenditures – the alternative minimum tax and the limitation on itemized deductions – and discuss alternative and more comprehensive limitations that would be preferable to existing ones. We then provide estimates of the effects of alternative global limitations on federal revenues and on how much tax rates could be reduced while maintaining revenue neutrality. We estimate the effects of alternative limitations on the distribution of tax burdens, marginal tax rates on capital and labor income, and incentives to engage in tax-subsidized activities. A final section concludes.

II. Background[1]

The tax expenditure concept dates back to 1967 when Treasury Assistant Secretary Stanley Surrey directed his staff to compile lists of "government spending for favored activities or groups, effected through the tax system rather than through direct grants, loans, or other forms of government assistance." (Surrey and McDaniel, 1985)

Some critics object to the notion that letting taxpayers keep more of their own money could be construed as spending. But most economists can readily see the duality between tax expenditures and traditional spending programs in the sense that they have nearly identical effects on the budget, resource allocation, relative prices, and the distribution of income. The only difference, typically, is in who administers the program.

The late economist, David Bradford (2003), famously illustrated this point by proposing, with tongue firmly in cheek, a Weapons Supply Tax Credit, which would allow arms manufacturers to sell their ordinance to the Pentagon in exchange for tax credits rather than cash. Instantly, the Defense Department's budget would decline by the amount of transformed spending. Tax revenues would fall by a similar amount (or more, if weapons suppliers demanded a premium on account of the complexities and uncertainties associated with the tax credit mechanism). But government would be doing exactly the same thing. Only the accounting would change.

A more substantive debate relates to the baseline against which tax expenditures are measured. (Donald Marron (2011) has an especially lucid discussion of the baseline and measurement issues.) Surrey thought a very comprehensive income tax should be the baseline, but others have pointed out that, against that yardstick, tax incentives for saving and "bonus depreciation" (partial expensing) provisions are counted as tax expenditures when those provisions would be the norm under a consumption-based tax system. Since the US income tax is really a hybrid combining aspects of income and consumption taxes—and many economists favor a consumption tax on efficiency grounds—it is not clear which baseline is more appropriate. Donald Marron and Eric Toder (2012), however, have estimated that about 70 percent of tax expenditures would be treated as such against either baseline. At 2016 levels, that would amount to almost $1 trillion of spending that most economists would agree should be subject to the same scrutiny as direct outlays.

While the principal function of the tax code is to raise revenue to finance the government, there may be good reasons to run some programs through the IRS. For example, when information on eligibility is already reported on tax returns or easily obtainable by the tax authorities, a tax expenditure might be easier to administer and comply with than a traditional

[1] Significant portions of sections 2 and 4 draw from Burman (2013).

spending program. Running targeted assistance programs like the earned income tax credit through the tax code also has the advantage that individuals do not need to apply in welfare offices, which may be especially burdensome for low-wage workers for whom time away from the job is impossible during normal working hours. Also, the anonymity of tax filing avoids welfare stigma.

However, there are numerous drawbacks of tax expenditures. And some forms of tax expenditures raise special problems. Itemized deductions are only of value for the minority of tax filers with more deductions than the standard deduction. Even for filers whose deductions just barely exceed the threshold for itemizing, the benefits are miniscule. The value of both deductions and exclusions rises with marginal tax rates—a $100 deduction is worth $10 at a 10% tax rate but $40 at a 40% rate—and thus income. This means that tax expenditures designed to encourage certain behaviors, such as home-ownership, charitable giving, or participating in a health insurance or retirement saving plan, provide much bigger incentives to higher- than to lower-income families. Often, lower-income people get little or no benefit from such upside down subsidies.

Political scientists argue that a key drawback is that tax expenditures are mostly hidden from public view. Political scientist Chris Howard (1997) aptly named them "The Hidden Welfare State." Another political scientist, Suzanne Mettler (2011), referred to "The Submerged State." Mettler contends that the relative invisibility of tax expenditures undermines democracy because their relative obscurity makes it more difficult for citizens to understand how government programs affect them. Lobbyists can sneak expensive ineffective subsidies into the tax code that would never pass muster as direct spending programs—for example, ethanol tax credits. Moreover, even relatively worthwhile programs (Mettler cites the Affordable Care Act) may be less understood when important provisions are run through the tax code.

Notwithstanding their drawbacks, the use of tax expenditures has increased dramatically over time. Burman and Phaup (2012) report that the number grew from 140 in 1987 to 202 in 2009, a 44 percent increase in a little over two decades. All told, estimated tax expenditures total about $1.4 trillion in fiscal year 2016.

Burman and Phaup (2012) argue that tax expenditures may have proliferated because voters do not fully perceive their cost. This results in a government that is larger and less efficient than would prevail if citizens had full information Tax expenditures have a privileged status in the budget process. A new tax credit or deduction is considered a "tax cut," and thus relatively immune from the "tax and spend" critique that would apply to a similar spending program. Tax expenditures are scored as reductions in revenues rather as new spending programs. As a result, both spending and taxes are understated. In a political context where both are considered bad, this clearly creates a bias in favor of tax expenditures over traditional spending.

Nonetheless, proposals for reform abound. Income tax reform proposals would virtually all trim tax expenditures. All of the recent deficit reduction commissions proposed radical paring of tax expenditures. This would surely make the late Stanley Surrey smile. When he invented the term tax expenditure, he instructed the Treasury Department to compile a list and tally up their cost. He viewed cuts in tax expenditures as the "pathway to tax reform," and in 1973 made the case in a book of that title.

Surrey and latter-day reformers are surely right that cutting tax expenditures could raise revenue while reducing the economic cost of the tax system and making it simpler and fairer. The primary drawback is political: voters like tax expenditures, the biggest of which are the mortgage interest deduction and the tax exclusion for employer-sponsored health insurance. Simply eliminating people's favorite tax breaks is unlikely to win much public support.

As a result, many reform proposals take an indirect approach to limiting them. Governor Romney, in his 2012 presidential bid, discussed limiting the total value of tax expenditures to a fixed dollar amount, an idea based on an earlier proposal by Martin Feldstein, Daniel Feenberg and Maya Macguineas (2011) to limit the tax benefits from selective tax expenditures to two percent of income. President Obama has proposed to limit the value of itemized deductions and selected other deductions and exemptions to 28 percent of the amount deducted or excluded. (U.S. Treasury 2015). He has also proposed a minimum tax on millionaires' income—called the Buffett Rule—which would raise the top effective tax rate on capital gains and dividends and cut the value of deductions and exclusions.

This paper explores the policy, revenue, and distributional issues associated with such indirect approaches to limiting tax expenditures.

III. How Big are Individual Tax Expenditures and Who Benefits from Them?

In this section we present updated estimates of the size and distribution of "non-business" tax expenditures claimed on individual income tax returns.[2] We report the latest estimates by the Treasury Department for the individual provisions and then use the TPC micro-simulation model to estimate the total cost of the non-business tax expenditures claimed on individual tax returns, taking account of interactions among provisions.[3]

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[2] For previous estimates of the size of individual tax expenditures and their distribution, see Rogers and Toder (2011), Burman, Geissler, and Toder (2008), and Baneman and Toder (2012).

[3] Non-business tax expenditures exclude benefits individual taxpayers receive as owners of their own businesses or as recipients of income from partnerships and subchapter S corporations and report on Schedules C, E, and F. It does, however, include as non-business tax expenditures the benefits individuals receive from the

A. How Much Do Tax Expenditures Cost?

Tax expenditures received by individuals are large and growing. In its latest tax expenditure calculations, prepared for the forthcoming fiscal year 2017 budget, the Treasury Department lists tax expenditure provisions that add up to over $1.4 trillion in fiscal year 2016 (Table 1), about 7.5 percent of GDP and about 67 percent of fiscal year 2016 individual income and corporate tax receipts that the Administration projected in last year's budget. If the tax expenditures had been added back to receipts and then scored as outlays, the total budgetary cost would have amounted to 40 percent of grossed-up receipts.[4] Put another way, it is as if 2/5 of individual and corporate income tax receipts were spent on programs financed by tax breaks instead of direct outlays. Most of this cost is accounted for by non-business tax expenditures claimed by individuals, which summed to $1.3 trillion in fiscal year 2015, slightly less than 7 percent of GDP. Treasury projects that non-business tax expenditures will rise faster than GDP over the coming decade, increasing to $2.1 trillion, or 7.5 percent of GDP by fiscal year 2025. TPC has simulated the revenue cost of non-business tax expenditures claimed by individual taxpayers, using the TPC micro-simulation model and accounting for interactions among provisions.[5] We estimate that the cost from adding up all the separate revenue losses is $1.1048 trillion, if we compute the cost of each tax expenditure provision as if it were the only change in the tax code from current law, which is what the Treasury and JCT do.[6]

In comparison, we estimate that all provisions taken together cost $1.1678 trillion, or about 5.7 percent more than the sum of the costs of each provision. Thus, failing to take account of interactions among provisions understates the total cost of individual tax expenditures, but by a relatively modest amount.

We group tax expenditures into six separate categories. Among these, the largest category is exclusions from income ($499.2 billion including interactions), followed by special benefits for capital gains and dividends ($300.6 billion), itemized deductions ($151.5 billion) and refundable credits ($140.4 billion). The largest exclusions are those for employer contributions to health insurance premiums (including deductible employee premiums) and income accrued

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exclusion of interest on tax-exempt bonds, even though corporate taxpayers (principally banks) also claim some of those benefits.

[4] If tax expenditures = 0.67 (relative to direct expenditures), then tax expenditures / (direct expenditures + tax expenditures) = 0.67/1.67 = 0.40.

[5] For earlier simulations with similar calculations, see Burman, Geissler and Toder (2008) and Baneman and Toder (2012).

[6] Our estimates differ somewhat from Treasury's, in part because we don't include all provisions that Treasury counts as tax expenditures. A major difference between our estimates and the Treasury estimates is that we do not include the revenue cost of the exemption of imputed rental income from owner-occupied housing (Treasury estimates it as $97.9 billion in fiscal year 2015, but the Joint Committee on Taxation does not count it as a tax expenditure.)

within qualified retirement plans.[7] Benefits for capital gains and dividends include the special lower rates on long-term capital gains and qualified dividends and the exemptions of capital gains transferred at death and most capital gains on owner-occupied housing. The largest itemized deductions are those for home mortgage interest, state and local non-business income and property taxes, and charitable contributions. The estimated $140 billion cost of refundable credits counts both the refundable and non-refundable portions of these provisions, the largest of which are the earned income tax credit and the child tax credit.

The relatively modest difference between the sum of the cost of all tax expenditures and the total cost of tax expenditures masks large differences within groups of tax expenditures. Interactions raise the estimated cost of benefits for capital gains and dividends by 32.8 percent and reduce the cost of itemized deductions by 28 percent. For capital gains and dividends, when estimates are done provision by provision, the cost of the exemption of some gains (gains transferred at death and most gains on housing) is the revenue forgone at special capital gains rates. Taxing capital gains at ordinary income rates raises the revenue loss from these exemptions, making the cost of all the provisions taken together much larger than the sum of the separate estimates.

In contrast, taking account of interactions substantially reduces the cost of itemized deductions. As itemized deductions are successively eliminated, more taxpayers switch to taking the standard deduction, so that removing each additional deduction raises less revenue (because taxpayers claiming the standard deduction are unaffected and those with itemized deductions only just above the standard deduction get relatively little benefit).

In general, eliminating provisions that reduce taxable income will drive taxpayers into higher marginal rate brackets, creating positive interactions between them. These effects are relatively modest, however. For example, the total cost of exclusions estimated simultaneously is only 1.7 percent larger than the sum of the costs of all exclusions.

Note that all these estimates are static, reflecting the revenue loss from tax expenditures with no changes in taxpayer behavior. Eliminating or reducing selective tax expenditures could raise less or more money than the cost of the tax expenditure, depending on behavioral responses. For example, eliminating special rates for realized capital gains would raise much less revenue than the tax expenditure amount because taxpayers would realize fewer gains in response to higher tax rates. In contrast, reducing the subsidy rate for charitable contributions could raise more money than the static gain as taxpayers lower their contributions in response to a reduced subsidy rate.

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[7] Our estimates are only for income tax expenditures. Premiums for employer-sponsored health insurance and employer contribution towards retirement accounts are also excluded from payroll tax, but the payroll tax expenditure is not included in our estimates. The net benefit of the payroll tax expenditure is difficult to compute because additional wages subject to payroll taxes raise employees' future Social Security retirement and disability benefits. See Smith and Toder (2014).

B. Who Benefits From Tax Expenditures?

All income groups benefit from tax expenditures but the highest income groups benefit the most (Table 3). TPC estimates that benefits from individual income tax expenditures average slightly over 8 percent of pre-tax income (Table 3).[8] Tax expenditures reduce tax liability by over 13.4 percent of income for taxpayers in the top 1 percent of the income distribution and by much smaller amounts in other income groups.[9]

The highest income group receives a larger share of the benefit of tax expenditures (27.5 percent) than their share of pretax income (16.6 percent), but almost the same share of benefits as their share of total taxes paid (27.9 percent).[10] Shares of benefits received are lower than shares of pretax income for all groups in the bottom 99 percent of the population. As a result of the progressive income tax system, however, shares of benefits from tax expenditures exceed shares of federal income tax burdens for all groups in the bottom four quintiles of the distribution.

While these figures are suggestive of how tax expenditures may redistribute tax burdens and after-tax income, the actual effect of these provisions on the after-tax distribution of income is unknowable because we cannot identify what tax rate schedules Congress would have enacted in their absence. If for example, Congress is targeting an effective tax rate distribution instead of a statutory rate schedule, then in the absence of tax expenditures, they would cut taxes most as a share of income at the very top of the income distribution in exchange for eliminating tax breaks, thereby preserving the original income distribution. This type of trade-off characterized the 1986 Tax Reform Act, which eliminated preferences mostly used by the highest income taxpayers, such as preferential rates for capital gains and accelerated depreciation of buildings, while reducing the top marginal tax rate more than other rates.

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[8] T P C ranks tax units (including non-filers) by a broad measure of economic income that TPC calls expanded cash income (ECI). ECI adds a number of items to adjusted gross income, including tax-exempt interest, the non-taxable portion of Social Security benefits, employee contributions to qualified retirement plans, and imputations for corporate income taxes, the employer share of payroll taxes, the value of employer-sponsored health insurance , and employer contributions to and income accrued within qualified retirement plans. For a discussion of TPC's income measure, see Rosenberg (2013).

[9] We only include non-business individual income tax expenditures. If business tax expenditures were added and we used TPC's methodology (Nunns, 2012) for allocating the burden of the corporate income tax (60 percent to equity income, 20 percent to all capital income, and 20 percent to labor income), we would expect to find a somewhat larger concentration of the benefits of tax expenditures in the highest income group.

[10] Taxes paid include individual income taxes, corporate income taxes, payroll taxes, the estate and gift tax, and federal excise taxes. TPC allocates individual income taxes and the employee share of payroll taxes to individual taxpayers who remit them, the employer share of payroll taxes to employees, corporate income taxes to shareholders (60 percent), all recipients of capital income (20 percent) and all recipients of labor income (20 percent), estate and gift taxes to potential decedents based on imputed assets and the probability of dying, and excise taxes to labor income and super-normal returns to capital, adjusted for differences in the relative consumption of taxable and tax-free goods. For a discussion of TPC's methods of distributing corporate income taxes and federal excise taxes, see Nunns (2012) and Rosenberg (2013).

The benefits of the different types of tax expenditures differ substantially by income group. Preferences for capital gains and dividends reduced tax burdens by 7.3 percent of income in the top 1 percent of the income distribution, compared with 1.9 percent of income for other taxpayers in the top 5 percent of the income distribution and a diminishing share of income in lower income groups. The higher share of benefits of all tax expenditures as a share of income that the top 1 percent receives compared with other groups is almost entirely due to the very large share of benefits they receive from preferences for capital gains and dividends (and the fact that gains and dividends make up the majority of their income). The top 1 percent also receives the highest benefits as a share of income from itemized deductions, mainly from deductions for state and local income taxes and charitable contributions. The benefits of exclusions as a share of income are largest in the 80-99th percentiles of the income distribution and also substantial in the third and fourth quintiles. This largely reflects the distribution of preferences for employer-supplied health insurance and retirement saving. The benefit from exemption of employer-provided health insurance as a share of income rises with income through the middle and upper-middle portions of the distribution as coverage rates rise and higher marginal tax rates increase the value of exempt income, but then declines as health care costs rise less than in proportion to income. The benefit of retirement savings preferences is concentrated in the top fifth of the distribution where coverage rates and dollar contributions to plans are highest, but then declines as a share of income in the top 1 percent because of statutory limits on amounts that can be contributed to qualified plans.

In contrast, benefits from refundable credits – mainly the earned income credit and the child credit, but also the American Opportunity Tax Credit (AOTC) for education – are concentrated in the bottom two quintiles of the distribution. The child credit also provides substantial benefits in the middle of the distribution, but phases out at higher income levels.

In comparison to their shares of pre-tax income, taxpayers in the bottom two quintiles receive a larger share of the benefits from refundable credits and taxpayers in the second quintile receive a larger share of the benefits from non-refundable credits, while both groups receive a smaller share of all other types of tax expenditures (Table 5). Taxpayers in the middle quintile receive a relatively larger share in comparison to their income share of refundable and non-refundable credits and above the line deductions and about the same share of benefits from exclusions. Taxpayers in the fourth quintile receive a relatively larger share of benefits from above the line deductions and only slightly smaller shares of exclusions and non-refundable credits. Taxpayers in the 80th-99th percentiles receive a larger share than their share of income of exclusions and itemized deductions. Finally, taxpayers in the top 1 percent receive a larger share of capital gains and dividends (58 percent), itemized deductions (32 percent) and non-refundable credits (24 percent) than their share of pretax income (19 percent), but relatively smaller shares of the tax benefits from above-the-line deductions (14 percent), exclusions (13 percent) and refundable credits (zero).

In conclusion, tax benefits overall are more generous to the highest income taxpayers (as a share of income) than to other taxpayers. The distributional effects of proposals to limit tax expenditures, however, depend on which tax expenditures are eliminated or cut back and on how the revenue from removing tax expenditures is used. The very highest income taxpayers benefit the most from the special rates for capital gains and dividends and the exemption of gains transferred at death. Upper middle-income taxpayers benefit the most from exclusions and itemized deductions. The lowest income taxpayers benefit the most from refundable credits.

IV. Limiting Tax Expenditures: General Principles

There is no shortage of tax reform ideas. President George W. Bush put together a blue ribbon panel to propose fundamental tax reform. The panel (President's Advisory Panel on Federal Tax Reform 2005) proposed two alternative packages that would have each been simpler and more efficient than the existing tax code. One option would have radically simplified the tax code by eliminating many tax expenditures and converting many of the remaining tax deductions to flat credits. One insight of the Bush tax reform panel was that while tax experts view the standard deduction as a simplification—because people who do not itemize don't need to keep records on charitable contributions, mortgage payments, taxes, etc.—most people think it's unfair that high income people can deduct those items while lower income people can't. The proposal would have dispensed with itemization.

The "simplified income tax" under the Bush panel's scheme would have reduced the number of tax brackets and cut top rates, eliminated the individual and corporate alternative minimum taxes (AMT), consolidated savings and education tax breaks to reduce "choice complexity" and confusion, simplified the earned income and child tax credits, simplified taxation of social security benefits, and simplified business accounting. It would have reduced a number of major tax expenditures. For example, the mortgage interest deduction would have been replaced by a 15 percent non-refundable credit and the amount of debt eligible for the subsidy reduced. The amount of tax-exempt employer-sponsored health insurance benefits would have been subject to a dollar cap, reducing the subsidy for the most generous health insurance plans.

The alternative "growth and investment" tax plan would have limited many of the same expenditures as the simplified income tax plan. It would also have allowed firms to expense capital investments, while eliminating interest deductibility – a move towards a consumption-based instead of an income-based tax. It would, however, have retained a low rate of tax on dividends, interest, and capital gains of individual taxpayers.

The Bipartisan Policy Center (2010) Debt Reduction Task Force designed a tax reform plan aimed at simplifying the tax code enough so that half of households would no longer have to file income tax returns. That plan would have limited the value of some tax expenditures to the basic 15 percent tax rate and eliminated others and created a new value-added tax, cut top individual and corporate income tax rates to 27 percent, and provided more generous refundable credits to low-earning households, including households with children.

President Obama empaneled another commission, commonly called the Bowles-Simpson Commission (after its two heads) with the mandate to reform the tax code and reduce the deficit.[11] (The Bush panel had been instructed to produce a revenue-neutral plan.) Bowles-Simpson would have eliminated even more tax expenditures than the Bipartisan Policy Center Task Force, allowing it to cut tax rates substantially and raise revenue without the need for a new VAT or other revenue source.

Senators Ron Wyden (D-OR) and Dan Coats (R-IN) produced a more incremental tax reform plan (Wyden and Coats 2011), designed to be revenue-neutral and preserve the most popular tax breaks. It would have eliminated the AMT and cut the corporate tax rate to 24 percent while capping individual income tax rates at 35 percent. The cost of these provisions would have been offset by closing or scaling back various tax expenditures. The proposal would have raised tax rates on high-income taxpayers' long-term capital gains and dividends to 22.75 percent. It would have revised the formula the federal government uses to adjust tax parameters for inflation, generally cutting the cost of annual inflation adjustments. The plan would also have reduced businesses' interest deductions. It would have consolidated and simplified individual tax breaks for saving and education. The most radical change is that the plan would have required the IRS to prepare pre-filled tax returns for lower-income filers.

Most recently, retired Ways and Means Committee chairman, Dave Camp (R-MI) produced a sweeping tax reform draft (Committee on Ways and Means, 2014) that would have eliminated many tax expenditures and simplified others. One of its most innovative features would have set a top ordinary income tax rate of 25 percent, but included an income surtax on high-income taxpayers. The surtax would have applied to income before most deductions and also would have applied to certain forms of excluded income. In consequence, the Camp plan effectively capped the value of most tax expenditures at 25 percent—a similar and arguably more elegant variant of President Obama's tax expenditure limitation.

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[11] President Obama also commissioned a tax reform study under the direction of former Federal Reserve Board chairman Paul Volcker. (President's Economic Recovery Advisory Board, 2010) The report laid out a laundry list of options the Administration might consider as part of a tax reform plan, but did not actually produce such a plan itself. According to the report, "The Board was not asked to recommend a major overarching tax reform, such as the 1986 tax reform, the tax plans proposed by the 2005 Tax Reform Panel, or proposals for introducing a value-added tax in addition to or in lieu of the current income tax system." (p. v)

A. Cutting Popular Tax Expenditures

The common thread in all of these proposals is that they would significantly cut tax expenditures—subsidy programs run through the income tax. This continues a long tradition. In 1973, Stanley Surrey, a Harvard law professor and former Treasury assistant secretary who invented the concept of a tax expenditure budget, published *Pathways to Tax Reform*, which argued that eliminating or reforming tax expenditures is the secret to tax reform. Almost four decades later, would-be reformers still view this as the best path, but it is fraught with political difficulties. While there are many tax expenditures and they often represent a dubious use of federal revenues, the biggest ones are very popular.

Reformers point to the 1986 tax reform, which eliminated or reined in numerous tax subsidies, but most of the savings came from cutting large business tax breaks such as the investment tax credit and accelerated depreciation and preferences for capital income of individuals, such as special rates for capital gains and universal eligibility for contributions to individual retirement accounts. The most popular individual income tax expenditures survived largely unscathed. They include items such as the tax exclusion for employer-sponsored health insurance ($342 billion in FY2016, including lost payroll taxes) and the deductions for mortgage interest ($62 billion), charitable contributions ($54 billion) and state and local income and property taxes ($84 billion). (U.S. Treasury 2015) Ronald Reagan stipulated few parameters to the Treasury Department in 1984 when he commissioned the study that ultimately led to the Tax Reform Act of 1986, but one was to preserve tax incentives for homeownership. (Birnbaum and Murray, 1987) The ultimate law did slightly trim the tax break for homeownership, but only for those with mortgages over $1 million.[12] President Bush gave similar instructions to members of his tax reform commission. And the Affordable Care Act championed by President Obama did not directly limit the health insurance tax exclusion, although the excise tax on "Cadillac health plans" is intended to indirectly cap the tax break, but not until 2018. Former Joint Committee on Taxation Chief of Staff John Buckley (2011) argues forcefully that raising significant revenue from eliminating individual income tax expenditures would be politically difficult, if not impossible.

The appeal of cutting tax expenditures is quite apparent. First, they represent a lot of money – over $1 trillion a year.[13] Second, as noted, eliminating tax expenditures raises revenue

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[12] The law also limited the use of mortgage debt to finance other, non-housing spending and capped the deduction for home equity lines of credit and second mortgages at $100,000. The IRS has since ruled that the two mortgage limits may be combined, so homeowners may deduct interest on a mortgage up to $1.1 million if they don't deduct other mortgage debt. (Ebeling 2010)

[13] Buckley (2011) argues that the revenue potential of eliminating tax expenditures is vastly overstated because they do not account for behavioral responses. For example, if the mortgage interest deduction were eliminated, some homeowners would take cash out of taxable accounts to reduce mortgage principal amounts. Thus,

without requiring higher tax rates. Indeed, if enough tax expenditures are eliminated, tax rates could be reduced significantly while raising net revenues. Third, paring tax expenditures might garner bipartisan support. Insofar as tax expenditures represent spending hidden in the tax code, curtailing them should appeal to conservatives who would otherwise object to raising taxes. And, since most of the benefits accrue to those with higher incomes, putting tax expenditures on the chopping block should appeal to liberals eager to spare safety net programs from the budget ax. (Burman and Phaup 2012)

B. Lessons from Bowles-Simpson

Several approaches have been suggested to make significant tax expenditure cuts feasible. The Bowles-Simpson plan would explicitly trade off lower tax rates against fewer tax expenditures. The co-chair's report (technically, there is no plan since the required super-majority never ratified it) would eliminate most tax expenditures in exchange for a top tax rate of 28%.

The plan has received qualified endorsements from various corners. President Obama said in the 2012 State of the Union address that the plan had many good ideas. Paul Ryan argued at the 2012 Republican convention that the president should have endorsed the plan to move the cause of budget reform forward. And Mitt Romney excoriated the president at the first presidential debate for not supporting the Bowles-Simpson blueprint.

But the president never adopted any of the Bowles-Simpson recommendations, Paul Ryan voted against the plan at a time when his vote might have forced the plan onto the legislative agenda (assuming he could have brought some of the other Republicans on the panel along), and Mitt Romney said that he favored his own unspecified budget plan.

Voters might be unenthusiastic about a simple trade-off of their favorite tax breaks for lower tax rates. Any revenue-neutral swap would result in some, and perhaps many, households owing more tax after the reform. Despite all the theoretical clamor for simplicity and fairness, it's not clear that voters are willing to pay much for those salutary attributes.

And if the tax reform is intended to increase revenues, as Bowles-Simpson would, tax filers as a group will owe more tax after than before reform. Possibly they can be convinced that this is worthwhile to avoid a debt catastrophe or for the sake of our children, but the idea of shared sacrifice is likely to run into resistance if many people decide that their share is greater than that of their neighbors (who didn't take as much advantage of tax subsidies).

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the Treasury would lose the tax revenue that would otherwise have been collected on the income that would have been earned on those taxable accounts.

C. Conversion of Tax Subsidies into Refundable Tax Credits

Batchelder, Goldberg, and Orszag (2006) suggest a different approach. Rather than cashiering tax expenditures wholesale, the authors suggest converting most individual income tax expenditures into refundable tax credits. The paper argues that completely aside from distributional concerns, the change would be desirable on efficiency grounds because the justification for most subsidies would imply an equal subsidy rate regardless of the income of the recipient. Providing subsidies by means of deductions or exclusions introduces substantial variation in subsidy rates because the effective subsidy varies with the marginal income tax bracket, which rises with income. Itemized deductions introduce another source of variation. Those deductions are only valuable to the extent that total itemized deductions exceed the standard deduction. For high-income people with large deductions for state and local taxes, mortgage interest, and charity, the marginal subsidy rate is approximately the income tax rate bracket. However, for middle-income households with modest deductions, the value of the itemized deduction can be reduced or even eliminated. Indeed, 70 percent of tax units do not itemize deductions and get no tax benefit from them. Even for those who do itemize, the effective subsidy rate can be substantially reduced because only the amount of itemized deductions in excess of the standard deduction reduces tax liability.[14]

Nonrefundable tax credits are more uniform because their face value does not vary with the income tax rate or itemization status, but those credits are of little or no benefit to households that do not owe income tax. Making those credits refundable would eliminate the variation in value among taxpayers in different tax situations. (When refundable credits exceed tax liability, they are "refunded" to taxpayers.)

Beyond the efficiency argument refundable credits are more progressive than deductions or nonrefundable credits. Faricy and Ellis (2013) find evidence that such a change could be popular. Self-identified Democrats and liberals care about the progressivity of tax expenditures whereas Republicans appear to be indifferent to distributional arguments. In addition, the credit rate could be set well below the top income tax rate and still provide as much or more benefit to most taxpayers than a deduction. The Tax Policy Center estimates that more than 80 percent of tax units (including nonfilers) were in the 15-percent tax bracket or lower in 2015.[15] Since the benefits of most individual income tax expenditures accrue mostly to those with high incomes (because they are in the highest tax brackets and tend to make larger charitable contributions, have larger mortgages, and pay more in taxes), a flat refundable tax credit can redirect the

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[14] For example, suppose the standard deduction for a married couple is $12,000 and that they would have $10,000 of itemized deductions before including charitable contributions. If they make less than $2,000 of charitable contributions, they would get no benefit from itemizing deductions. If they donate $4,000 to charity, the contributions would lower their taxable income by $1,000 (the portion in excess of the $12,000 standard deduction). The effective tax subsidy rate is one-third of the statutory rate. If the household is in a 25 percent tax bracket, the contributions will save them $250 in federal income tax, or 8.3 percent of the $3,000 in contributions.

[15] Tax Policy Center table T15-0032.

subsidy to lower and middle-income households while actually reducing the cost to the Treasury. In addition, to the extent that the subsidies are aimed at encouraging activities such as homeownership or health insurance coverage, most high-income people need *less* subsidy to be induced to participate than those with more modest incomes. Thus a flat refundable tax credit may be able to achieve the objectives of the subsidy at much lower cost.

Refundable tax credits can also be much simpler than current law. Indeed their value could generally be determined without doing any tax calculations since they do not vary with tax status.[16] However, that can also be a drawback since some people may have to file a tax return solely for the purpose of the claiming the credit.[17] This creates costs for the IRS and for the new tax filers and may also create new avenues for fraud.

Moreover, there could be many more filers who do not owe income tax if deductions and exclusions are converted to credits. Some observers are concerned about the effects of the substantial share of the population that does not owe income tax. The Tax Policy Center (Johnson, et al, 2011) estimated that 46 percent of tax units did not owe income tax in 2011. Part of that total is senior citizens who primarily rely on Social Security, which only becomes subject to tax at higher income levels, and part attributable to those with very low incomes. But many lower-middle income families with children avoid income tax because of the availability of the child tax credit and the EITC (as well as the standard deduction and personal exemptions). The concern is that the households who do not owe income tax would happily support income tax increases on the taxpaying share of the population to fund expansions in government since they do not bear any of the resulting tax burden.

It is likely that if many individual income tax subsidies are converted into refundable tax credits, the number of households that owe no income tax—and the number that get refunds over and above income tax liability—will increase.[18] If the Batchelder, et al, proposal were enacted, the tax credits might be explicitly considered spending programs rather than tax reductions. This would be an advantage for transparency of the tax and spending functions of the US government. And it's possible that making this explicit would lead to more rational budgeting decisions—allowing trade-offs between traditional cash outlays and tax expenditures and making it easier to control the size of government. However, advocates for these programs might not view that as an advantage.

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[16] Note that this is not true for the EITC and the partially refundable child tax credit since they phase out at higher income levels.

[17] This is generally not true for the EITC and the refundable portion of the child tax credit, since they are only available to families with earnings, and most workers must file to claim refunds of withheld income taxes even if they do not owe any income tax.

[18] The number who owe no income tax would depend on the rate of the tax credits. For example, if the credit rate were set at 10 percent, it would be worth less than non-itemized deduction for most taxpayers (because they are in higher tax brackets). Credits at 20 percent would be worth more than deductions for most taxpayers. And credits at any rate are more valuable than itemized deductions for the seventy percent of filers that do not itemize.

D. Aggregate Limitations on Tax Expenditures

Rather than repealing or reforming tax expenditures outright, another approach is to apply aggregate limits. For decades, the Congressional Budget Office has included an option to cap the value of itemized deductions at 15 percent in its periodic Deficit Reduction volumes. (See Congressional Budget Office, 2011, for example.) President Obama has proposed a more modest limit—capping the value of certain tax expenditures at 28 percent—but he would apply the limit to a much broader list of items, including employer-sponsored health insurance, interest on municipal bonds, and employee contributions to retirement accounts. (U.S. Department of the Treasury, 2012) The proposal certainly would not qualify as a simplification as it would require calculating tax liability with and without the specified deductions and exclusions and limiting the tax savings to 28 percent. Taxpayers with relatively modest amounts of deductions and exclusions would also have to compare their tax calculated this way with the tax they'd owe if they claimed the standard deduction. While tax software could perform these calculations, many taxpayers would likely be even more confused about the income tax than they are at present.

The intent of the proposal is to limit the disparity in the value of the selected tax expenditures. The maximum value would be 28 percent, compared with 39.6 percent under current law. There would still be a marginal subsidy on the proscribed activities, but it would be capped at 28 percent.[19]

The President has also proposed something he calls the Buffett Rule, which would set a minimum average tax rate for millionaires of 30 percent of gross income.[20] Like the cap on deductions, this proposal would complicate tax compliance as taxpayers would have to calculate the floor on taxes due and pay that amount if it is higher than the tax calculated under the normal rules. It would also make it hard for taxpayers close to the threshold to predict their marginal effective tax rate or the value of deductions. The marginal tax rate on some kinds of income would rise and others fall precipitously when the cap is reached. The marginal tax rate on capital gains would rise from the lower capital gains tax rate (currently capped at 20 percent) to 30 percent whereas the marginal tax rate on ordinary income (such as wages and salaries) would fall from the top individual income tax rate to 30 percent. Meanwhile, the marginal value of tax preferences (with the exception of charitable contributions, which are exempt from the Buffett Rule) would fall to zero as long as ordinary income tax is less than the Buffett Rule threshold.

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[19] This may not strictly be true, depending on how the cap is implemented; the effective marginal tax rate can be significantly higher than the statutory tax rate because of phase-outs. The most notable example is the phase-out of the AMT exemption based on an expanded measure of taxable income (before the AMT deduction), which nets out items such as charitable deductions (although not state and local taxes or miscellaneous itemized deductions). This phase-out raises effective tax rates from the two AMT statutory brackets of 26 and 28 percent to 32.5 and 35 percent, respectively.

[20] The President has called the Buffett Rule a principle for tax reform rather than a specific proposal, but Sen. Sheldon Whitehouse (D-RI) made a specific proposal, which the President endorsed.

Proposals that provide complicated rules to limit tax expenditures depending on circumstances of an individual taxpayer are not in the spirit of base-broadening income tax reform. They may reflect strategic first steps insofar as they reduce the value of tax expenditures, which might diminish the intensity of resistance to base-broadening measures, but they are similar to the complicated limits under current law and often supplement instead of replacing them. The Buffett Rule is really just a somewhat simpler (and more draconian) AMT. And there already is a limit on itemized deductions, which phase out at higher income levels.[21] These measures have complicated the tax system without necessarily increasing efficiency and fairness.[22]

E. Simpler Aggregate Limitations: The Feldstein and Romney Proposals

Compared to the complexity of the Buffett rule, the current law AMT, and Pease, a simpler way to limit tax expenditures is simply to place a ceiling on how much any taxpayer can use them. Martin Feldstein, Daniel Feenberg, and Maya MacGuineas (2011) have proposed one type of global limit – a ceiling of 2 percent of AGI on the maximum tax saving any taxpayer can gain from tax expenditures. The authors argue that this approach could raise substantial revenue, improve economic efficiency—by reducing distortions caused by "wasteful tax spending"—and significantly simplify the tax system for most taxpayers, all in a progressive way. They also argue that there are significant political economy benefits:

> 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. (p. 10)

In other words, the claimed advantage of this approach is that it is indiscriminate. The proposal would retain the standard deduction, which simulations suggest would be a more advantageous option for most taxpayers—only 9 percent would elect to itemize deductions under the proposal. For those who do continue to itemize, the calculation of tax liability would be very complex, although presumably manageable with the aid of tax preparation software.

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[21] The phase-out of itemized deductions is sometimes called Pease, after the Congressman who came up with the idea. Since an additional of itemized deductions at a given level of AGI continues to reduce taxable income by a dollar, Pease actually does not reduce the marginal value of deductions for most taxpayers. It instead acts as a surtax of up to 1.2 percentage points of income, depending on the tax bracket, for itemizers above a certain level of AGI.

[22] See Burman, Gale, and Rohaly (2003) for a critique of the AMT.

In 2012, presidential candidate, Mitt Romney, floated a variant of the Feldstein, et al, proposal. Tax expenditures would be capped at a fixed dollar amount (the exact amount suggested ranged from $17,000 to $50,000). Governor Romney also proposed to eliminate the AMT, which would make his version much simpler than the Feldstein et. al. proposal.[23] (He would use the revenue raised from the cap to finance tax rate cuts; thus, the proposal would not directly lead to deficit reduction.)

If the cap on tax expenditures could be enacted, it would facilitate broader tax reform because the vast majority of taxpayers would receive little or no incentive from the subsidies subject to the limit –either because their current itemizable expenses are so low that they are better off claiming the standard deduction or because they are high enough to exceed the limitation. . So it could be a stepping stone to the kind of simplification that Surrey envisioned. However, the political feasibility rests on the assumption that taxpayers and interest groups that benefit from taxpayer behavior that the subsidies promote don't really understand the proposal.[24] Otherwise, one might expect nearly as much opposition to it as to the sweeping cuts in tax expenditures under Bowles-Simpson.

An alternative is to try to take advantage of myopia to induce taxpayers to allow the tax expenditures to be phased out over time. One of us has suggested (Burman 2011) that instead of offering a limit on tax expenditures, the proposal be simplified by deeming tax reductions equal to the minimum of a set percentage of AGI or the value of the standard deduction (converted into a credit). The goal would be to end up with a deemed tax expenditure credit of 2 percent of AGI or 15 percent of the current law standard deduction, whichever is greater. (This option would still allow the earned income tax credit and the child tax credit.)) But initially the credit would be much larger—say, the larger of 10 percent of AGI or 30 percent of the standard deduction—and phased down over 5 years. There is substantial evidence that many taxpayers are myopic, so they might take this trade, even though they would pay higher taxes over the long run. This option also has the virtue of providing a net tax cut in the short term, which might speed recovery from the Great Recession. Although taxpayers might like this option, however, it too would garner strenuous opposition from beneficiaries of the activities that tax expenditures encourage because it would convert all the subsidies to fixed grants.

The fundamental question, though, is whether Congress would succumb to pressure to delay or stop the phase-down of the credit. And there would be pressure over time for Congress to move popular tax breaks outside of the capped category, which would undermine the intent to quarantine tax expenditures.

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[23] Professor Feldstein advised the Romney campaign, as reported by various media outlets.

[24] For example, limitations on itemized deductions would be vigorously opposed by charitable organizations, home builders, and political representatives from high-tax states.

V. Simulations of Effects of Global Limits on Selected Tax Expenditures

As discussed in the previous section, there have been a number of proposals to impose global limits on the use of groups of tax expenditures. In this section, we simulate the effects of different global tax expenditure limits on federal receipts, the distribution of the tax burden, marginal tax rates on capital and labor income, and the incentive to donate to charities.

Most of the tax expenditure limitation proposals under consideration in the current political debate would limit the use of itemized deductions, certain exclusions from income, and/or tax credits. The issue of what tax rates to impose on capital gains and dividends and whether to retain, reduce, or increase their preferential treatment is generally addressed outside of the context of global limits on tax expenditures. In addition, most proposals to impose global limits on tax expenditures leave undisturbed tax benefits for low-income earners and families, such as the earned income tax credit and the child credit.

In the illustrative simulations below, we include among the tax expenditures subject to the limits (referred to below as selected tax expenditures) the following provisions:

- All itemized deductions, but with some variants that exclude from the limits the deductions for charitable contributions and home mortgage interest;
- The exemption of employer-provided health insurance benefits;[25]
- The exemption of interest on state and local bonds; and
- Tax benefits for higher education, including tuition credits and the deductibility of student loan interest

We simulate the effects of three ways of limiting these provisions:

- Limiting the tax savings from the provisions to a fixed percentage of modified adjusted gross income (AGI), a design similar to one originally proposed by Feldstein, Feenberg and MacGuineas (2011), except that the income limit is modified to add back preferential income that may become taxable. Modified AGI is AGI plus employer-provided health benefits and interest on state and local bonds.
- Imposing a fixed dollar ceiling on the total amount by which the provisions can reduce taxable income. This limitation method does not apply to tax credits, only to deductions and exclusions.
- Limiting the tax saving per dollar of exemption or deduction. We consider a variation of the approach, discussed in the previous section, that is similar to one included in the tax reform plan that Representative Dave Camp drafted in 2014. Our version would impose a

[25] This also includes deductible employee contributions to health insurance plans under cafeteria plans.

surtax on modified AGI in excess of the current threshold for the 33 percent rate bracket, combined with a reduction in marginal tax rates. Because the base of the surtax would not allow itemized deductions and would include the exclusions we are limiting, it would effectively reduce the marginal rate at which taxpayers can benefit from the preferences.

As discussed in the previous section, all three of the limitation methods have been featured prominently in political debates. Candidate Jeb Bush has included a variant of the Feldstein, Feenberg, and MacGuineas proposal to limit the tax savings from certain tax expenditures to a maximum percentage of AGI in his tax reform plan. President Obama, as noted above, has included a limit on the tax saving per dollar of certain deductions and exemptions in his budget proposals and Dave Camp's proposal for a high income AGI surtax would have had a similar effect. The 2012 Republican Presidential candidate, Mitt Romney, floated the idea of a fixed dollar limitation on itemized deductions in the last Presidential campaign.

We also simulate three ways of using the revenue raised by limiting tax expenditures:

- An across the board constant percentage cut in marginal income tax rates
- An across the board constant percentage point cut in marginal tax rates (i.e., a constant rate cut as a percentage of income).
- A reduction in the top marginal income tax rates only.

In all of the options we consider, we eliminate the individual alternative minimum tax (AMT) and the current law limitation on itemized deductions (Pease). Thus, the options we consider would substitute improved ways of limiting tax expenditures for the highly flawed existing methods.

A. Revenue Effects of Alternative Limits

Replacing the individual alternative minimum tax (AMT) and the current law limitation on itemized deductions (Pease)[26] with full elimination of selected tax expenditures would increase individual income tax liabilities by $366 billion (Table 6).[27] (Repealing AMT and Pease alone would lose $46 billion.) The net revenue gain from eliminating selected tax

[26] The limitation on itemized deductions (Pease), reduces itemized deductions in tax year 2015 by 3 cents for every dollar of adjusted gross income (AGI) in excess of $258,250 for single returns and $309,900 for joint returns, up to a maximum of 80 percent of itemized deductions. The thresholds are indexed to changes in the consumer price index (CPI).

[27] TPC's revenue estimates assume no macro-economic effects but do incorporate behavioral responses. TPC generally assumes a taxable income elasticity of 0.25, but that elasticity is reduced if tax preferences are eliminated because there would then be fewer ways for taxpayers to adjust their behavior to reduce their tax liability.

expenditures would decline to $328 billion if the charitable deduction were retained and to $282 billion if the deductions for charitable contributions and mortgage interest were retained.

If instead of full elimination, the tax saving from the selected tax expenditures were limited to 2 percent of modified AGI, tax liabilities would increase by $205 billion. The revenue pickup would drop to $169 billion if the charitable deduction were retained and to $128 billion if the deductions for charitable contributions and mortgage interest were retained.

Finally, replacing the AMT and Pease with a proposal to limit the tax benefit per dollar of reduced table income from the selected tax expenditures to 28 percent would reduce tax liability by about $14 billion.

B. Distributional Effects of Replacing the AMT and Pease with Full Repeal of Selected Tax Expenditures

Eliminating the selected tax expenditures, while repealing the AMT and Pease, would raise average tax rates the most for upper-middle income taxpayers, who gain substantial benefits from deductions and exemptions (Table 7). Tax rates would increase by 3.27 percent in the 80-90th percentiles and by 3.11 percent in the 90-95th percentiles, compared with 2.60 percent for all taxpayers. Net tax increases are less in the top 5 percent because these taxpayers benefit the most as a share of their income from elimination of the AMT and Pease. The overall distributional pattern is similar for proposals that exclude the charitable and mortgage interest deductions, but the relative tax increases among groups differ somewhat. Taxpayers in the top 1 percent of the distribution benefit the most from retaining the charitable deduction, while taxpayers in the 80-99th percentiles benefit the most from retaining the mortgage interest deduction

C. Distributional Effects of Full Repeal and a Percentage of AGI Limit with Alternative Ways of Cutting Marginal Rates

Many reform proposals would limit tax expenditures to help pay for reducing marginal income tax rates. The net effects of these proposals on the distribution of the tax burden depend on how the rates are cut. Simply repealing AMT and Pease would lose revenue and therefore require offsetting tax rate increases to achieve budget balance. Taxpayers in the top 5 percent of the distribution receive a disproportionate share of the benefits from repealing AMT and Pease, so they would come up net winners if repeal were paid for by increasing marginal tax rates across the board by 3.68 percent (Table 8). If, in contrast, only the top marginal rate were increased, the rate would have to rise to 44.6 percent. Taxpayers in the 95-99th percentiles (who bear the biggest burdens from the individual AMT) would be the biggest winners (because they are mostly below the top rate bracket), while taxpayers in the top 1 percent would be the biggest losers.

Repeal of the AMT, Pease, and all the selected tax expenditures could pay for an across the board cut in marginal tax rates of 22.4 percent (lowering the top rate from 39.6 to 30.7 percent). Taxpayers in the top 10 percent of the distribution would see their average tax rates decline, while average tax rates would increase for the bottom 90 percent (Table 9). The biggest average tax rate cut would go to taxpayers in the top 1 percent of the income distribution. If, in contrast, all marginal tax rates were cut by the same number of percentage points, the top rate would fall by only 4.7 percentage points, to 34.9 percent. Higher income taxpayers would still fare better than lower-income taxpayers, but the differences in tax rate changes among income groups would be much smaller. Finally, if only the top rate were reduced, subject to the constraint that rates could not decline with income, then all marginal rates now at 25 percent or over would drop to 20.4 percent. That is, the rate schedule would be 10, 15, and 20.4 percent. Only taxpayers in the top 5 percent would see tax cuts, with the average tax rate for the top 1 percent dropping by 7.8 percent.

The pattern of winners and losers would be similar if the charitable deductions or both charitable and mortgage interest deductions were retained, but the rate reductions would be smaller (Table 9a and 9b). The highest income groups would fare better than others, especially if tax rates were capped or all rates were cut by the same percent. Low- and middle-income tax filers would do best when all rates were cut by the same number of percentage points, although they still tend to face higher taxes under any of the options.

D. Distributional Effects of Alternative Ways of Limiting Tax Expenditures, Combined with a Constant Percentage Cut in Marginal Tax Rates

We now turn to a comparison of the distributional effects of different ways of limiting tax expenditures. This comparison is most meaningful if we compare options with the same effects on federal receipts.

First, however, we show the distributional effects of replacing the AMT and Pease with two ways of limiting tax expenditures – the Obama approach of limiting the benefit per dollar of exemption or deduction and the Feldstein et. al approach of limiting the tax saving to a fixed percentage of adjusted gross income. The Obama approach with a 28 percent limit and the tax expenditures we select for inclusion loses revenue and reduces tax burdens on average (Table 10), while the Feldstein approach with the same tax expenditures limited to 2 percent of modified adjusted gross income raises revenue.[28] The 28 percent limit option provides the largest net tax cut as a share of income to taxpayers in the 95th-99th percentiles because this group benefits much more than others from elimination of the individual AMT and because the 28 percent limit

[28] The actual Obama budget proposal raised considerable revenue because it retained AMT and Pease and included some tax expenditures (primarily contributions to qualified retirement saving plans) which are not included in our simulations.

does not raise their taxes enough to offset that benefit. The constant percentage of AGI limit, in contrast, is generally progressive although the average tax increase is somewhat higher for taxpayers in the 80-95th percentiles of the distribution than for those in the top 5 percent. Tax burdens at the very top, however, fall substantially if the charitable deduction is not subject to the 2 percent of AGI limit. And if both charitable and mortgage deductions are excluded from the limit, the tax rate increase is largest for taxpayers in the 80-90th percentiles, with both lower and higher income groups experiencing smaller increases in average tax rates.

If revenue from the 2 percent of modified AGI limit on tax expenditures is used to reduce marginal tax rates, the net distributional effects depend on how rates are cut (Table 11). With all selected tax expenditures subject to the limit, using the revenue to reduce marginal tax rates across the board by 12.8 percent (setting the maximum rate at 34.5 instead of 39.6 percent and the bottom rate at 8.7 percent instead of 10 percent) results in a net tax increase for groups in the bottom 90 percent of the distribution and a net tax cut for groups in the top 10 percent, with the biggest tax rate cut going to the top 1 percent (1.45 percent of income). If the revenue is used to reduce marginal tax rates by 2.7 percentage points (lowering the top rate from 39.6 to 36.9 percent and the bottom rate from 10 to 7.3 percent), taxpayers in the bottom four quintiles and the top 10 percent are net winners, with only the group In the 80-90th percentiles seeing a very small tax increase. All groups see a tax change of no more than 0.4 percent of income. Finally, if the revenue is used to reduce all rates that are currently 25 percent or higher to a maximum rate of 24.8 percent (with no changes in the lower brackets), then only taxpayers in the top 5 percent see tax cuts, with the top 1 percent receiving an average cut in tax burdens of 6.2 percent of income. Retaining the charitable and mortgage interest deductions does not change the pattern of winners and losers for the scenarios where the revenue is used to cut marginal rates across the board or only reduce the top rate (Tables 11a and 11b), but does change the pattern when marginal rates are reduced by a constant number of percentage points. In that scenario, average tax rates increase in the middle of the distribution, but decline more for the top 5 percent than when all the selected tax expenditures are included in the limitation.

To compare the 2 percent of AGI limit with alternative ways of limiting tax expenditures, we set the parameters of the other tax expenditure limitation approaches so that all three methods would be revenue neutral if combined with elimination of the AMT and Pease and a 12.8 percent across the board cut in marginal tax rates (Table 12). We substitute a surtax on AGI for high income taxpayers for the Obama limit on the rate at which tax expenditures can be claimed. The base of the surtax is modified adjusted gross income, as defined above, but excluding long-term capital gains and qualified dividends. The surtax proposal, similar to the other limitations, does not change the marginal tax rate on long-term capital gains and dividends because the rate cuts

that the tax expenditure limits finance apply only to ordinary income, not to the preferential rates on gains and dividends.[29]

Among the three approaches, not surprisingly the most progressive one is the surtax on modified AGI. An 11.4 percent surtax on modified AGI in excess of the income for the current law 33 percent rate bracket, combined with a 12.8 percent cut in marginal tax rates, would raise taxes on average by 2.8 percent of income for taxpayers in the top 1 percent of the income distribution, while cutting tax rates for all groups below the top 5 percent. The least progressive is the percent of AGI limit; it would reduce tax rates by 1.5 percent for the top 1 percent, while raising tax rates for all groups in the bottom 90 percent of the distribution. The cap on tax expenditures falls in between, it would reduce tax rates slightly in the bottom four quintiles, increase them by an even smaller percent of income in the 80th-95th percentiles and cut the average tax rate the most (but even then by less than 0.6 percent of income) for taxpayers in the 95th-99th percentiles. This relatively large (though still modest) tax cut reflects the benefit taxpayers in the 95th-99th percentiles receive from elimination of the individual AMT.

E. Effects of Alternative Ways of Limiting Tax Expenditures on Marginal Tax Rates on Income and on the Incentive for Charitable Contributions

The three ways of limiting tax expenditures also have different effects on incentives to work, save, realize capital gains, and engage in activities eligible for deductions and exemptions (Table 13). We represent the latter as the effect on the incentive for charitable contributions, because it is much easier for taxpayers to change their charitable deductions in the short run in response to altered incentives than it is for them to change their state of residence (and thus their net expenses for state and local taxes) or the size of house they live in (and thus their net mortgage expenses).

The percent of AGI limit and the dollar cap on deductions and exclusions have little effect on the incentive to realize capital gains, lowering the marginal rate on gains slightly (Table 13a). The main source of change is the elimination of Pease and the individual AMT, which reduces the marginal tax rate on gains for many higher-income taxpayers. The effects of the three limitations on the marginal tax rate on dividends are similar to the effects on marginal tax rates on gains (Table 13b).

The 2 percent of AGI limit and the cap on tax deductions and exclusions reduce the marginal tax rate on interest income, when combined with elimination of the AMT and Pease

[29] All the revenue-neutral tax expenditure limitation proposals, however, indirectly reduce the tax expenditure for capital gains and dividends. By reducing marginal tax rates on ordinary income only, they reduce the differential between the rates on ordinary income and the rates on tax-preferred gains and dividends.

and cut in marginal income tax rates (Table 13c). The option with the 11.4 percent of AGI surtax also reduces the marginal tax rate on interest income for the bottom 95 percent of the income distribution, but raises it for the top 5 percent. Because of the concentration of taxable interest income at the top of the distribution, the overall marginal tax rate on interest income increases with the surtax proposal.

Marginal income tax rates on wages also decline for the revenue-neutral changes that impose a percentage of AGI limit on tax expenditures or a fixed dollar limit on deductions and exclusions (Table 13d). They increase at the top of the distribution for the high income AGI surtax, but the average marginal tax on wages for all taxpayers is slightly reduced compared with current law.

The various limits differ in how they affect the incentives to participate in tax-subsidized activities. Removing incentives that distort taxpayer choices increase economic efficiency and may be one reason to limittax expenditures. Policymakers may, however, instead want to reduce the incentives without removing them entirely in order to mute political opposition by groups that benefit from taxpayer or voter responses to federal subsidies, such as charities, home builders, or states and localities.

Assuming that charitable contributions are most responsive in the short run to changes in tax incentives, we simulate how the various limitations affect the tax incentive to contribute to charities (Tables 13e and 13f). We define the tax price of giving as one minus marginal rate at which contributions can be deducted. A taxpayer in the 28 percent bracket who itemizes faces a tax price of 72 cents of per dollar of additional contribution amounts because every dollar of giving reduces her tax liability by 28 cents.

The simulated results depend on whether we are examining the incentive to give an extra dollar above what is contributed under current law (the last dollar marginal rate, shown in Table 13e) or the incentive to give the first dollar, assuming all other deductions and exemptions are unchanged (the first dollar marginal rate, shown in Table 13f). The former governs the incentive to increase or reduce giving from current levels (i.e., the intensive margin), whereas the latter is more relevant to the incentive to make any donations (i.e., the extensive margin).

Under current law, the average last dollar marginal price of giving is 79 cents, with tax returns weighted by their amount of contributions. The price of giving is almost a dollar in the lowest quintile where very few taxpayers itemize, falling to 68 cents for the top one percent.

The 2 percent of AGI limit and dollar cap on tax expenditures both virtually eliminate the tax incentive to give an additional dollar to charity for all income groups. The tax price ranges from 0.98 to 1.00. This occurs because the large givers who have high weights in the calculation almost all make contributions in excess of the limitations and so get no deduction for additional contributions. The high-income surtax option also raises the tax pricing of giving by reducing

ordinary marginal income rates, but the increase is relatively modest, rising on average for all taxpayers from 0.79 to 0.82.

The results for the percentage of AGI limitation differ somewhat when one looks at the incentives to give the first dollar to charity. The tax price still increases substantially but a 10 percent subsidy remains in place for the highest income taxpayers. This occurs because, as AGI increases, the limit of the benefit from tax expenditures also increases, so that some very high-income taxpayers remain below the limitation on their first dollar of charitable contributions. The absolute dollar cap, however, still eliminates the incentive to give for most taxpayers because high-income taxpayers almost all have tax expenditures other than charity above the absolute dollar limit on tax deductions and exclusions.

These calculations of incentive effects are only illustrative. The calculations take account of factors other than statutory rates that help determine effective marginal rates, such as phase-outs of certain preferences among income limits and the phase-out of the taxpayer exemption and first-rate bracket under the individual AMT. They do not, however, account for the beneficial effect on incentives to work and save that those tax incentives provide by lowering the cost of increases in certain goods and services (such as more housing services) that taxpayers would consume with additional labor or capital income. They therefore fail to account for the disincentive to work and save produced by eliminating tax incentives for goods whose consumption rises with income.

VI. Conclusions

Tax expenditures have been growing over time. All told, they add up to about $1.4 trillion or about 7.5 percent of GDP in 2016.

They represent a tempting target for tax reform. Many tax expenditures are poorly targeted, providing the largest benefits to high-income households. Sometimes, taxpayers may not even understand how the subsidies work, undermining their effectiveness. Many complicate the tax code and create a suspicion among taxpayers that they aren't getting their fair share of benefits, which may undermine voluntary compliance. They create opportunities for inefficient tax avoidance as taxpayers try to find creative ways use the tax preferences for unintended purposes. And, like direct spending programs, they require tax rates to be higher than they would otherwise be, which exacerbates the efficiency cost of taxation.

Tax expenditures, however, benefit many taxpayers and have the support of influential interest groups. Thus, policymakers and tax experts have looked to indirect ways to limit them as a group without singling out specific provisions. President Barack Obama has repeatedly proposed to limit the value of itemized deductions to 28 percent. Harvard economist Martin Feldstein and coauthors have proposed to limit the value of selected tax expenditures to two percent of adjusted gross income; 2012 presidential candidate Mitt Romney tweaked this proposal by suggesting a fixed dollar limit. Former House Ways and Means Committee Chairman Dave Camp (R-MI) proposed an innovative alternative to President Obama's limitation by combining rate reduction with a surtax on high-income taxpayers, which would also apply to certain income items that would otherwise be excluded from tax. The result is that the tax benefit per dollar of most exclusions, exemptions, and deductions would be limited to the highest tax rate excluding the surtax.

This paper begins by examining the revenue and distributional effects of non-business individual income tax expenditures—which make up more than 90 percent of all tax expenditures. We examine the effect of interactions on the total cost of groups of tax expenditures and confirm earlier estimates that the interactions are modest (about 6 percent of the total) in the aggregate, even though they are much more significant for sub-groups of tax expenditures. We also show that the benefits of tax expenditures accrue disproportionately to taxpayers with the highest incomes, but that is largely a result of the distribution of the benefits of special rates for capital gains and dividends. In contrast, refundable credits largely benefit taxpayers at the bottom of the distribution. Tax benefits from preferences other than the tax breaks for gains and dividends are largest as a share of income for upper-middle income taxpayers. These are the tax benefits most likely to be affected by proposals for global limitations, which generally leave untouched both the special rates for capital gains and dividends and provisions such as the earned income credit and child credit that largely benefit lower income families.

We find that repealing major individual income tax expenditures would raise substantial revenue--$282 to $366 billion in 2016 depending on the provisions. The two-percent of AGI limit would raise on the order of half as much--$128 to $205 billion..

We examine the distribution of tax burdens under different assumptions about how the revenue from limiting tax expenditures would be returned to individual taxpayers. Among the options we examine, offsetting the limits with equal percentage point cuts in marginal tax rates would leave the distribution of tax burdens roughly unchanged. In contrast, offsetting them with equal percentages cuts in rates or by reducing the top rate or rates only would make the tax system generally less progressive. All the options are less progressive when the limitations exclude the deductions for charitable contributions and home mortgage interest.

We also examine the effects of three alternative methods of limiting tax expenditures, combined with an equal across the board percentage rate cut that keeps federal tax receipts

constant. Among the three methods, we examine, the surtax approach has the most progressive distribution of the tax burden and the fixed percentage of AGI approach the least progressive, with the fixed dollar cap falling in between.

We conclude by looking at how revenue-neutral tax expenditure limits would affect marginal tax rates and incentives to realize capital gains, work, or donate to charity. We find that most of the limitations, if the revenue from them is used to reduce marginal tax rates, would lower marginal effective tax rates on capital gains, dividends, interest, and wages. The high-income surtax approach, which indirectly caps the benefit of tax expenditures, would raise marginal tax rates on interest and wage income for upper-income taxpayers, who are the ones affected by the surtax.

We also examine the effect of limitations on incentives to donate to charity. We find that the high-income surtax reduces but does not eliminate the incentive to donate to charity as compared with current law, because it lowers the marginal rate on deductible contributions without imposing a ceiling on them. The percent of AGI caps or fixed dollar limitations, however, would eliminate the tax incentive to make additional donations to charity, and sharply increase the first-dollar tax price for most filers. The exception is that the two percent of AGI limit retains a first-dollar incentive to donate for very high-income households because, absent charitable contributions, their tax savings from itemized deductions are often less than 2 percent of the expanded AGI measure we use in our policy options.

Overall we find that the effects of tax expenditure limits are very sensitive to what limitation method is used, what tax expenditures are subject to the limitation, and how the revenues they generate are returned to taxpayers. Tax expenditure limitations combined with rate reductions can be designed that make the tax system more progressive, reduce marginal tax rates on work and saving, and maintain some support for the activities the tax expenditures intend to promote. Not all options, however, would have these desired effects.

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Table 1

Sum of Tax Expenditures, Fiscal Years, 2016-25*
(in billions of dollars, percent of GDP in parenthesis)

Totals	2016	2025	2016-25
All tax expenditures:	1,422.3 (7.5%)	2,360.3 (8.4%)	18,818.1 (8.1%)
Non-business tax expenditures	1,308.5 (6.9%)	2,112.3 (7.5%)	16,906.1 (7.2%)
Other tax expenditures	113.8 (0.6%)	248.0 (0.9%)	1,912.0 (0.8%)

*Includes outlay effects. Total cost of all tax expenditures may not equal sum of separate provision because of Interactions (See Table 2).

Source: U.S. Treasury, Tax Expenditures, FY 2017, at:

http://www.treasury.gov/resource-center/tax-policy/Documents/Tax-Expenditures-FY2017-Revised.pdf

and authors' calculations.

Table 2

Effects of Interactions on Estimates of the Cost of Non-Business Tax Expenditures, calendar year 2015 (in billions of dollars)

Type of Provision	Total Cost without Interactions	Total Cost with Interactions	Percent Change due to Interactions
Exclusions	491.0	499.2	1.7%
Above the Line Deductions	11.2	11.2	0.1%
Benefits for Capital Gains and Qualified Dividends	226.3	300.6	32.8%
Itemized Deductions	210.5	151.5	-28.0%
Non-refundable Credits	12.6	14.0	10.0%
Refundable Credits	140.4	140.4	0.0%
Miscellaneous Provisions	12.9	12.9	Not estimated
Sum of All Categories	1,104.8	1,129.9	2.3%
Total, All Provisions*	1,104.8	1,167.8	5.7%

*Sum of all provisions excludes some tax expenditures estimated by Treasury, most notably the exclusion of imputed rental income on owner-occupied housing, which is counted as a tax expenditure provision by the Treasury Department but not by the Joint Committee on Taxation.

Source: TPC Micro-simulation model. Off-model provisions based on tax expenditure estimates from U.S. Treasury Department, Office of Tax Analysis, adjusted for changes in marginal tax rates due to elimination of tax expenditures that were simulated with the TPC model.

Table 3. Distribution of Nonbusiness Individual Income Tax Expenditures under Current Law, 2015

Cash Income Percentile	Benefit as Share of Pretax Income	Share of Tax Benefit	Share of Income	Share of Tax Liability
Lowest quintile	6.7%	3.6%	4.3%	0.8%
2nd quintile	7.5%	7.9%	8.5%	3.4%
3rd quintile	6.3%	10.8%	13.9%	9.2%
4th quintile	6.3%	15.8%	20.4%	17.5%
80-90th percentiles	7.2%	12.6%	14.2%	14.3%
90-95th percentiles	7.6%	9.3%	9.9%	10.8%
95-99th percentiles	7.9%	12.2%	12.5%	15.9%
Top 1 percent	13.4%	27.5%	16.6%	27.9%
Total	**8.1%**	**100.0%**	**100%**	**100.0%**

Source: Tax Policy Center Micro-simulation Model.

Table 4. Benefit as a Share of Pretax Income for Various Categories of Individual Income Tax Expenditures, 2015

Cash Income Percentile	Ex-clusions	Capital gains and dividends	Itemized de-ductions	Above-the-line de-ductions	Non-refund-able credits	Refundable credits	Other	Total
Lowest quintile	0.6%	0.2%	0.0%	0.0%	0.1%	5.4%	0.0%	**6.7%**
2nd quintile	2.7%	0.4%	0.1%	0.1%	0.2%	4.0%	0.0%	**7.5%**
3rd quintile	3.5%	0.6%	0.4%	0.1%	0.1%	1.5%	0.0%	**6.3%**
4th quintile	3.3%	0.9%	0.7%	0.1%	0.1%	0.6%	0.0%	**6.3%**
80-90th percentiles	4.0%	1.3%	1.2%	0.1%	0.1%	0.3%	0.1%	**7.2%**
90-95th percentiles	4.4%	1.4%	1.5%	0.1%	0.1%	0.0%	0.1%	**7.6%**
95-99th percentiles	4.3%	1.9%	1.7%	0.1%	0.0%	0.0%	0.1%	**7.9%**
Top 1 percent	2.7%	7.3%	2.1%	0.1%	0.1%	0.0%	0.3%	**13.4%**
Total	**3.4%**	**2.1%**	**1.1%**	**0.1%**	**0.1%**	**0.9%**	**0.1%**	**8.1%**

Source: Tax Policy Center Micro-simulation model.

Note: Separate Categories do not add up to total because of interactions among provisions.

Table 5. Distribution of Benefits of Various Categories of Individual Income Tax Expenditures

Cash Income Percentile	Ex-clusions	Capital gains and dividends	Itemized de-ductions	Above-the-line de-ductions	Non-refund-able credits	Refundable credits	Other	Share of pretax income
Lowest quintile	0.8%	0.3%	0.1%	1.0%	3.1%	24.3%	0.4%	**4.3%**
2nd quintile	6.7%	1.4%	0.8%	6.7%	14.0%	36.1%	3.3%	**8.5%**
3rd quintile	14.2%	4.1%	4.6%	17.3%	18.5%	21.2%	5.0%	**13.9%**
4th quintile	19.9%	8.5%	14.3%	21.4%	18.9%	13.4%	7.4%	**20.4%**
80-90th percentiles	16.8%	8.8%	15.2%	13.7%	10.7%	4.2%	8.6%	**14.2%**
90-95th percentiles	12.8%	6.8%	13.5%	9.3%	6.0%	0.4%	7.9%	**9.9%**
95-99th percentiles	15.8%	11.7%	19.3%	16.8%	5.1%	0.0%	10.2%	**12.5%**
Top 1 percent	13.0%	57.9%	32.3%	13.6%	23.6%	0.0%	57.2%	**18.6%**
Total	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**

Source: Tax Policy Center Micro-simulation model.

Table 6
Tax Expenditure Options
Baseline: Current Law
Impact on Tax Revenue, 2016 Calendar Year [1]

Proposal	2016 Calendar Year
Option 1: Repeal AMT and limitation on itemized deductions (Pease)	-46.2
Option 2: Option 1 plus repeal certain tax expenditures [2]	366.2
Option 3: Option 2 but allow deduction for charitable contributions	327.7
Option 4: Option 2 but allow deductions for charitable contributions and mortgage interest	281.7
Option 5: Option 1 plus limit tax benefit of certain tax expenditures to 2 percent of modified AGI [3]	204.7
Option 6: Option 5 but allow full benefit of deduction for charitable contributions	168.7
Option 7: Option 5 but allow full benefit of deductions for charitable contributions and mortgage interest	128.2
Option 8: Option 1 plus limit benefit of certain tax expenditures to 28 percent [4]	-14.3

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0515-2).

1. Estimates assume a micro-dynamic response using a taxable income elasticity of 0.25.

2. Proposal would repeal all itemized deductions, the exclusion for employer-sponsored health benefits, the exclusion of state and local bond interest; education credits, and the deduction for student loan interest.

3. Proposal would limit the tax benefit of all itemized deductions, the exclusion of employer-sponsored health benefits, the exclusion of interest on state and local bonds, education credits, and the deduction for student loan interest. Modified AGI is AGI plus employer-sponsored health benefits and tax-exempt interest.

4. Proposal would limit the benefit of all itemized deductions, the exclusion of employer-sponsored health benefits, the exclusion of interest on state and local bonds, and the deduction for student loan interest.

Table 7

Replacing the Alternative Minimum Tax and the Limitation on Itemized Deductions (Pease) with Elimination of Selected Tax Expenditures: Change in Average Tax Rates*

Calendar Year 2016

Income Group	Repeal AMT and Pease	Repeal AMT, Pease, and Selected Tax Expenditures	Repeal AMT, Pease and Selected Tax Expenditures Except Charitable Deduction	Repeal AMT, Pease, and Selected Tax Expenditures Except Charitable and Mortgage Interest Deductions
Bottom quintile	0.00%	0.55%	0.55%	0.54%
Second quintile	0.00%	1.47%	1.45%	1.40%
Third quintile	0.00%	2.39%	2.31%	2.12%
Fourth quintile	-0.01%	2.75%	2.60%	2.21%
80-90th percentiles	-0.05%	3.27%	3.09%	2.57%
90-95th percentiles	-0.19%	3.11%	2.94%	2.40%
95th-99th percentiles	-0.96%	2.74%	2.50%	1.90%
Top 1 percent	-1.16%	2.69%	1.81%	1.58%
All	**-0.34%**	**2.60%**	**2.34%**	**1.99%**

*Proposal repeals all itemized deductions (except where otherwise stated), the exclusion for employer-sponsored health benefits, the exclusion of state and local bond interest, education credits, and the deduction for student loan interest.

Table 8

Revenue Neutral Repeal of AMT and Pease: Change in Average Tax Rates

Calendar Year 2016

Income Group	Increase all marginal tax rates by 3.68 percent	Increase all marginal tax rates by 0.74 percentage points	Increase top two rates to 39.6% and 46.0 percent	Increase top rate to 44.6%
Lowest quintile	0.02%	0.04%	0.00%	0.00%
Second quintile	0.09%	0.16%	0.00%	0.00%
Middle quintile	0.20%	0.29%	0.00%	0.00%
Fourth quintile	0.29%	0.38%	-0.01%	-0.01%
80-90th percentiles	0.33%	0.38%	-0.05%	-0.05%
90-95th percentiles	0.28%	0.27%	-0.18%	-0.18%
95-99th percentiles	-0.35%	-0.45%	-0.82%	-0.87%
Top 1 percent	-0.41%	-0.73%	1.43%	1.56%
All	**0.06%**	**0.04%**	**0.11%**	**0.13%**

Note: Revenue estimates include micro-dynamic responses, but distributional estimates are static. Because proposal on balance raises marginal tax rates and therefore has negative revenue feedback, aggregate tax burdens must rise to keep revenue constant.

Table 9

Revenue Neutral Repeal of AMT, Pease and Selected Tax Expenditures*: Change in Average Tax Rates

Calendar Year 2016

Income Group	Reduce all marginal tax rates by 22.4 percent	Reduce all marginal tax rates by 4.73 percentage points	Reduce all marginal rates 25% and above to 20.4%
Lowest quintile	0.37%	0.17%	0.55%
Second quintile	0.70%	0.12%	1.47%
Middle quintile	0.77%	-0.02%	2.16%
Fourth quintile	0.40%	-0.31%	2.05%
80-90th percentiles	0.28%	-0.07%	1.70%
90-95th percentiles	-0.38%	-0.33%	0.51%
95-99th percentiles	-1.58%	-0.79%	-2.46%
Top 1 percent	-2.61%	-0.40%	-7.82%
All	**-0.37%**	**-0.25%**	**-0.47%**

*Proposal repeals all itemized deductions, the exclusion for employer-sponsored health benefits, the exclusion of state and local bond interest, education credits, and the deduction for student loan interest.

Note: Revenue estimates include micro-dynamic responses, but distributional estimates are static. Because proposal on balance reduces marginal tax rates and therefore has positive revenue feedback, aggregate tax burdens decline with revenue held constant.

Table 9a

Revenue Neutral Repeal of Selected Tax Expenditures Except Charitable Deduction: Change in Average Tax Rates

Calendar Year 2016

Income Group	Reduce all marginal tax rates by 20.6 percent	Reduce all marginal tax rates by 4.28 percent of income	Reduce all marginal rates 25% and above to 21.1%
Lowest quintile	0.38%	0.20%	0.55%
Second quintile	0.74%	0.24%	1.44%
Middle quintile	0.84%	0.16%	2.13%
Fourth quintile	0.47%	-0.13%	2.03%
80-90th percentiles	0.37%	0.10%	1.79%
90-95th percentiles	-0.23%	-0.15%	0.71%
95-99th percentiles	-1.43%	-0.66%	-2.19%
Top 1 percent	-2.90%	-0.90%	-7.88%
All	**-0.34%**	**-0.21%**	**-0.42%**

*Proposal repeals all itemized deductions except the deduction for charitable contribution and also repeals the exclusion for employer-sponsored health benefits, the exclusion of state and local bond interest, education credits, and the deduction for student loan interest.

Note: Revenue estimates include micro-dynamic responses, but distributional estimates are static. Because proposal on balance reduces marginal tax rates and therefore has positive revenue feedback, aggregate tax burdens decline with revenue held constant.

Table 9b

Revenue Neutral Repeal of AMT, Pease and Selected Tax Expenditures Except Charitable and Mortgage Interest Deductions: Change in Average Tax Rates*

Calendar Year 2016

Income Group	Reduce all marginal tax rates by 18.3 percent	Reduce all marginal tax rates by 3.79 percent of income	Reduce all marginal rates 25% and above to 22.1%
Lowest quintile	0.39%	0.24%	0.54%
Second quintile	0.78%	0.34%	1.40%
Middle quintile	0.85%	0.25%	2.00%
Fourth quintile	0.39%	-0.14%	1.81%
80-90th percentiles	0.25%	0.00%	1.65%
90-95th percentiles	-0.32%	-0.26%	0.73%
95-99th percentiles	-1.48%	-0.84%	-2.00%
Top 1 percent	-2.56%	-0.79%	-7.40%
All	**-0.33%**	**-0.22%**	**-0.40%**

*Proposal repeals all itemized deductions except the deductions for charitable contributions and mortgage interest and also repeals the exclusion for employer-sponsored health benefits, the exclusion of state and local bond interest, education credits, and the deduction for student loan interest.

Note: Revenue estimates include micro-dynamic responses, but distributional estimates are static. Because proposal on balance reduces marginal tax rates and therefore has positive revenue feedback, aggregate tax burdens decline with revenue held constant.

Table 10. Distributional Effects of Alternative Limits on Tax Expenditures

Repeal AMT and Pease; Limit Benefits of Tax Expenditures*: Change in Average Tax Rates

Calendar Year 2016

Income Group	Limit benefit of certain tax expenditures to 28 percent rate**	Limit benefit of certain tax expenditures to 2% of modified AGI***	Limit benefit of entire group except charitable to 2% of modified AGI	Limit benefit of all except charitable and mortgage interest to 2% of modified AGI
Lowest quintile	0.00%	0.16%	0.16%	0.15%
Second quintile	0.00%	0.56%	0.55%	0.50%
Middle quintile	0.00%	1.16%	1.13%	0.98%
Fourth quintile	-0.01%	1.63%	1.55%	1.27%
80-90th percentiles	-0.05%	1.94%	1.82%	1.43%
90-95th percentiles	-0.16%	1.91%	1.73%	1.19%
95-99th percentiles	-0.42%	1.58%	1.24%	0.51%
Top 1 percent	-0.09%	1.60%	0.71%	0.49%
All	**-0.09%**	**1.48%**	**1.23%**	**0.91%**

*Proposal limits benefits of all itemized deductions except where otherwise noted and also limits tax benefits from the exclusion for employer-sponsored health benefits, the exclusion of state and local bond interest, education credits, and the deduction for student loan interest. Modified AGI is AGI plus employer-sponsored health benefits plus state and local bond interest income.

**Limits tax saving from selected deductions and exclusions to 28 percent of amount deducted or excluded, as described in President's budget for Fiscal Year 2016.

***Limits the tax saving from certain tax preferences to 2 percent of modified adjusted gross income, based on proposal by Feldstein, Feenberg and MacGuineas (2011)

Table 11

Repeal AMT and Pease; Limit Benefits of Selected Tax Expenditures to 2 Percent of Modified AGI* with Alternative Revenue Offsets: Change in Average Tax Rates

Calendar Year 2016

Income Group	No offset	Reduce all individual income tax rates by 12.8 percent	Reduce all individual income tax rates by 2.7 percentage points	Reduce 25% and higher individual rates to 24.8 percent
Lowest quintile	0.16%	0.06%	-0.05%	0.16%
Second quintile	0.56%	0.13%	-0.19%	0.56%
Middle quintile	1.16%	0.25%	-0.19%	1.15%
Fourth quintile	1.63%	0.30%	-0.10%	1.57%
80-90th percentiles	1.94%	0.27%	0.06%	1.76%
90-95th percentiles	1.91%	-0.04%	-0.03%	1.30%
95-99th percentiles	1.58%	-0.87%	-0.42%	-1.06%
Top 1 percent	1.60%	-1.45%	-0.18%	-6.23%
All	**1.48%**	**-0.21%**	**-0.07%**	**-0.27%**

*Limits the tax saving from certain tax preferences to 2 percent of modified adjusted gross income. Tax preferences subject to limit are all itemized deductions, exclusions for employer-sponsored health benefits and exclusion of state and local bond interest, education credits, and the deduction for student loan interest. Modified AGI is AGI plus employer-sponsored health benefits and state and local bond interest income.

Note: Revenue estimates include micro-dynamic responses, but distributional estimates are static. Because revenue-neutral variants of the proposal on balance reduce marginal tax rates and therefore have positive revenue feedback, aggregate tax burdens decline with revenue held constant.

Table 11a

Repeal AMT and Pease; Limit Benefits of Selected Tax Expenditures Excluding the Charitable Deduction to 2 Percent of Modified AGI* with Alternative Revenue Offsets: Change in Average Tax Rates

Calendar Year 2016

Income Group	No offset	Reduce all individual income tax rates by 10.9 percent	Reduce all individual income tax rates by 2.2 percentage points	Reduce 28% and higher individual rates to 25.9 percent
Lowest quintile	0.16%	0.07%	-0.02%	0.16%
Second quintile	0.55%	0.18%	-0.08%	0.55%
Middle quintile	1.13%	0.35%	0.01%	1.13%
Fourth quintile	1.55%	0.42%	0.12%	1.53%
80-90th percentiles	1.82%	0.39%	0.26%	1.74%
90-95th percentiles	1.73%	0.07%	0.12%	1.36%
95-99th percentiles	1.24%	-0.83%	-0.41%	-0.86%
Top 1 percent	0.71%	-1.79%	-0.71%	-6.12%
All	**1.23%**	**-0.19%**	**-0.10%**	**-0.23%**

*Limits the tax saving from certain tax preferences to 2 percent of modified adjusted gross income (AGI). Tax preferences subject to limit are all itemized deductions except the deductions for charitable contributions and home mortgage interest, exclusions for employer-sponsored health benefits and exclusion of state and local bond interest, education credits, and the deduction for student loan interest. Modified AGI equals AGI plus employer-sponsored health benefits and state and local interest income.

Note: Revenue estimates include micro-dynamic responses, but distributional estimates are static. Because revenue-neutral variants of the proposal on balance reduce marginal tax rates and therefore have positive revenue feedback, aggregate tax burdens decline with revenue held constant.

Table 11b

Repeal AMT and Pease; Limit Benefits of Selected Tax Expenditures Excluding the Charitable and Mortgage Interest Deductions to 2 Percent of Modified AGI* with Alternative Revenue Offsets: Change in Average Tax Rates

Calendar Year 2016

Income Group	No offset	Reduce all individual income tax rates by 8.4% percent	Reduce all individual income tax rates by 1.7 percentage points	Reduce 28% and higher individual rates to 27.9 percent
Lowest quintile	0.15%	0.08%	0.02%	0.15%
Second quintile	0.50%	0.22%	0.02%	0.50%
Middle quintile	0.98%	0.39%	0.12%	0.98%
Fourth quintile	1.27%	0.41%	0.17%	1.27%
80-90th percentiles	1.43%	0.34%	0.23%	1.42%
90-95th percentiles	1.19%	-0.06%	-0.03%	1.14%
95-99th percentiles	0.51%	-1.04%	-0.74%	-0.70%
Top 1 percent	0.49%	-1.42%	-0.61%	-5.16%
All	**0.91%**	**-0.17%**	**-0.11%**	**-0.20%**

*Limits the tax saving from certain tax preferences to 2 percent of modified adjusted gross income. Tax preferences subject to limit are all itemized deductions except the deduction for charitable contributions, exclusions for employer-sponsored health benefits and exclusion of state and local bond interest, education credits, and the deduction for student loan interest. Modified AGI is AGI plus employer-sponsored health benefits and exclusion of state and local bond interest.

Note: Revenue estimates include micro-dynamic responses, but distributional estimates are static. Because revenue-neutral variants of the proposal on balance reduce marginal tax rates and therefore have positive revenue feedback, aggregate tax burdens decline with revenue held constant.

Table 12. Comparison of Alternative Revenue-Neutral Ways of Limiting Tax Expenditures

Repeal AMT and Pease, Limit Tax Expenditures*, and Reduce All Marginal Individual Income Tax Rates by 12.8 Percent: Change in Average Tax Rates

Calendar Year 2016

Income Group	Limit benefit of certain tax expenditures to 2% of modified AGI**	Cap certain tax expenditures at $16,300***	Impose 11.4% surtax on modified AGI excluding capital gains and dividends****
Lowest quintile	0.06%	-0.07%	-0.07%
Second quintile	0.13%	-0.29%	-0.33%
Middle quintile	0.25%	-0.36%	-0.68%
Fourth quintile	0.30%	-0.16%	-1.03%
80-90th percentiles	0.27%	0.09%	-1.34%
90-95th percentiles	-0.04%	0.01%	-1.49%
95-99th percentiles	-0.87%	-0.55%	0.14%
Top 1 percent	-1.45%	-0.26%	2.82%
All	**-0.21%**	**0.01%**	**-0.18%**

*Tax preferences subject to limit are all itemized deductions, exclusions for employer-sponsored health benefits and state and local bond interest, education credits, and the deduction for student loan interest.

**Limit tax saving from selected tax preferences to 2 percent of adjusted gross income plus employer-sponsored health benefits and state and local bond interest.

***Limit sum of dollar amount of itemized deductions and selected exclusions to $16,300.

****Impose an 11.4 percent surtax on adjusted gross income plus employer-sponsored health benefits and state and local bond interest, excluding long-term capital gains and qualified dividends. The tax only applies to income is excess of the threshold for the 33 percent rate under current law.

Table 13a

Effective Marginal Tax Rates on Long-Term Capital Gains under Current Law and Alternative Revenue-Tax Expenditure Limits Combined with 12.8 Percent Cut in All Marginal income Tax Rates*

Calendar Year 2016

Income Group	Current Law	Limit benefit of certain tax expenditures to 2% of modified AGI**	Impose Cap of $16,300 on Certain Tax Expenditures***	Impose 11.4 Percent High Income Surtax on modified AGI excluding capital gains and dividends****
Lowest quintile	0.8%	0.7%	0.7%	0.7%
Second quintile	1.3%	1.2%	1.0%	1.0%
Middle quintile	6.0%	7.4%	6.5%	5.7%
Fourth quintile	9.5%	10.3%	10.2%	9.2%
80-90th percentiles	12.1%	12.4%	13.2%	11.8%
90-95th percentiles	13.4%	12.1%	12.9%	12.5%
95-99th percentiles	19.3%	16.2%	17.1%	16.7%
Top 1 percent	23.9%	22.4%	23.5%	23.4%
All	**20.6%**	**19.3%**	**20.3%**	**20.0%**

*Tax preferences subject to limit are all itemized deductions, exclusions for employer-sponsored health benefits and state and local bond interest, education credits, and the deduction for student loan interest.

**Limit tax saving from selected tax preferences to 2 percent of adjusted gross income plus employer-sponsored health benefits and state and local bond interest.

***Limit sum of dollar amount of itemized deductions and selected exclusions to $16,300.

****Impose an 11.4 percent surtax on adjusted gross income plus employer-sponsored health benefits and state and local bond interest, excluding long-term capital gains and qualified dividends. The tax only applies to income is excess of the threshold for the 33 percent rate under current law.

Table 13b

Effective Marginal Tax Rates on Qualified Dividends under Current Law and Alternative Revenue-Neutral Tax Expenditure Limits Combined with 12.8 Percent Cut in All Marginal income Tax Rates *

Calendar Year 2016

Income Group	Current Law	Limit benefit of certain tax expenditures to 2% of modified AGI**	Impose Cap of $16,300 on Certain Tax Expenditures***	Impose 11.4 Percent High Income Surtax on modified AGI less capital gains and dividends****
Lowest quintile	0.3%	0.3%	0.3%	0.3%
Second quintile	0.9%	0.8%	0.8%	0.8%
Middle quintile	6.6%	7.6%	6.9%	6.3%
Fourth quintile	10.8%	11.4%	11.4%	10.6%
80-90th percentiles	14.1%	14.0%	15.0%	13.7%
90-95th percentiles	16.1%	14.4%	15.4%	15.0%
95-99th percentiles	22.3%	18.1%	19.4%	18.2%
Top 1 percent	24.0%	22.1%	23.6%	23.2%
All	**18.7%**	**17.2%**	**18.3%**	**17.7%**

*Tax preferences subject to limit are all itemized deductions, exclusions for employer-sponsored health benefits and state and local bond interest, education credits, and the deduction for student loan interest.

**Limit tax saving from selected tax preferences to 2 percent of adjusted gross income plus employer-sponsored health benefits and state and local bond interest.

***Limit sum of dollar amount of itemized deductions and selected exclusions to $16,300.

****Impose an 11.4 percent surtax on adjusted gross income plus employer-sponsored health benefits and state and local bond interest, excluding long-term capital gains and qualified dividends. The tax only applies to income is excess of the threshold for the 33 percent rate under current law.

Table 13c

Effective Marginal Tax Rates on Interest Income under Current Law and Alternative Revenue-Neutral Tax Expenditure Limits Combined with 12.8 Percent Cut in All Marginal income Tax Rates *

Calendar Year 2016

Income Group	Current Law	Limit benefit of certain tax expenditures to 2% of modified AGI**	Impose Cap of $16,300 on Certain Tax Expenditures***	Impose 11.4 Percent High Income Surtax on modified AGI excluding capital gains and dividends****
Lowest quintile	2.0%	2.2%	1.8%	1.8%
Second quintile	5.6%	6.2%	5.3%	5.0%
Middle quintile	17.1%	16.2%	15.8%	14.9%
Fourth quintile	21.6%	20.6%	20.4%	18.9%
80-90th percentiles	25.0%	22.1%	22.9%	21.4%
90-95th percentiles	28.1%	23.9%	24.3%	25.7%
95-99th percentiles	35.0%	31.0%	32.1%	37.9%
Top 1 percent	37.3%	34.8%	36.5%	42.3%
All	**26.9%**	**24.9%**	**25.7%**	**28.1%**

*Tax preferences subject to limit are all itemized deductions, exclusions for employer-sponsored health benefits and state and local bond interest, education credits, and the deduction for student loan interest.

**Limit tax saving from selected tax preferences to 2 percent of adjusted gross income plus employer-sponsored health benefits and state and local bond interest.

***Limit sum of dollar amount of itemized deductions and selected exclusions to $16,300.

****Impose an 11.4 percent surtax on adjusted gross income plus employer-sponsored health benefits and state and local bond interest, excluding long-term capital gains and qualified dividends. The tax only applies to income is excess of the threshold for the 33 percent rate under current law.

Table 13d

Effective Marginal Income Tax Rates on Wages under Current Law and Alternative Revenue-Neutral Tax Expenditure Limits Combined with 12.8 Percent Cut in All Marginal income Tax Rates *

Calendar Year 2016

Income Group	Current Law	Limit benefit of certain tax expenditures to 2% of modified AGI**	Impose Cap of $16,300 on Certain Tax Expenditures***	Impose 11.4 Percent High Income Surtax on modified AGI excluding capital gains and dividends****
Lowest quintile	1.6%	1.7%	1.0%	1.0%
Second quintile	15.5%	14.8%	14.2%	14.1%
Middle quintile	19.0%	17.8%	17.4%	16.9%
Fourth quintile	19.8%	18.1%	18.1%	17.3%
80-90th percentiles	25.4%	22.1%	23.1%	22.3%
90-95th percentiles	27.2%	23.3%	23.9%	25.3%
95-99th percentiles	33.1%	28.5%	29.5%	38.4%
Top 1 percent	38.9%	32.3%	33.9%	45.0%
All	**24.4%**	**21.4%**	**21.9%**	**24.2%**

*Tax preferences subject to limit are all itemized deductions, exclusions for employer-sponsored health benefits and state and local bond interest, education credits, and the deduction for student loan interest.

**Limit tax saving from selected tax preferences to 2 percent of adjusted gross income plus employer-sponsored health benefits and state and local bond interest.

***Limit sum of dollar amount of itemized deductions and selected exclusions to $16,300.

****Impose an 11.4 percent surtax on adjusted gross income plus employer-sponsored health benefits and state and local bond interest, excluding long-term capital gains and qualified dividends. The tax only applies to income is excess of the threshold for the 33 percent rate under current law.

Table 13e

Tax Price of Last Dollar of Charitable Giving* Under Current Law and Alternative Revenue-Neutral Tax Expenditure Limits Combined with 12.8 Percent Cut in All Marginal income Tax Rates

Calendar Year 2016

Income Group	Current Law	Limit benefit of certain tax expenditures to 2% of modified AGI**	Impose Cap of $16,300 on Certain Tax Expenditures***	Impose 11.4 Percent High Income Surtax on modified AGI less capital gains and dividends****
Lowest quintile	0.99	1.00	0.99	0.99
Second quintile	0.96	1.00	098	0.97
Middle quintile	0.92	1.00	0.98	0.93
Fourth quintile	0.88	1.00	0.99	0.89
80-90th percentiles	0.81	1.00	1.00	0.84
90-95th percentiles	0.77	1.0-	1.00	0.80
95-99th percentiles	0.70	0.99	1.00	0.75
Top 1 percent	0.68	0.99	1.00	0.71
All	**0.79**	**1.00**	**0.99**	**0.82**

*Tax price of giving an extra dollar to charitable organizations above current law contribution levels, which equals one minus the marginal tax rate at which contributions can be deducted.

**Limit tax saving from selected tax preferences to 2 percent of adjusted gross income plus employer-sponsored health benefits and state and local bond interest.

***Limit sum of dollar amount of itemized deductions and selected exclusions to $16,300.

****Impose an 11.4 percent surtax on adjusted gross income plus employer-sponsored health benefits and state and local bond interest, excluding long-term capital gains and qualified dividends. The tax only applies to income is excess of the threshold for the 33 percent rate under current law..

Table 13f

Tax Price of First Dollar of Charitable Giving* Under Current Law and Alternative Revenue-Neutral Tax Expenditure Limits Combined with 12.8 Percent Cut in All Marginal income Tax Rates

Calendar Year 2016

Income Group	Current Law	Limit benefit of certain tax expenditures to 2% of modified AGI**	Impose Cap of $16,300 on Certain Tax Expenditures***	Impose 11.4 Percent High Income Surtax on modified AGI excluding capital gains and dividends****
Lowest quintile	0.99	1.00	0.99	0.99
Second quintile	0.96	1.00	0.98	0.98
Middle quintile	0.92	1.00	0.98	0.96
Fourth quintile	0.88	1.00	0.99	0.93
80-90th percentiles	0.81	1.00	0.99	0.88
90-95th percentiles	0.77	0.99	1.00	0.83
95-99th percentiles	0.70	0.99	1.00	0.76
Top 1 percent	0.68	0.90	1.00	0.69
All	0.79	0.97	0.99	0.84

*Tax price of giving the first dollar to charitable organizations at current law levels of other itemized deductions, which equals one minus the marginal tax rate at which contributions can be deducted.

**Limit tax saving from selected tax preferences to 2 percent of adjusted gross income plus employer-sponsored health benefits and state and local bond interest.

***Limit sum of dollar amount of itemized deductions and selected exclusions to $16,300.

****Impose an 11.4 percent surtax on adjusted gross income plus employer-sponsored health benefits and state and local bond interest, excluding long-term capital gains and qualified dividends. The tax only applies to income is excess of the threshold for the 33 percent rate under current law.