

EVALUATING BROAD-BASED APPROACHES FOR LIMITING TAX EXPENDITURES

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This paper evaluates six options to achieve across-the-board reductions to a group of major exclusions and deductions in the income tax: (1) limiting their tax benefit to a maximum percentage of income; (2) imposing a fixed dollar cap; (3) reducing them by a fixed-percentage amount; (4) limiting their tax saving to a maximum percentage of their dollar value; (5) replacing preferences with fixed rate refundable credits; and (6) including them in the base of the existing Alternative Minimum Tax (AMT). We discuss issues of design, implementation, and administration, and simulate the revenue, distributional, and incentive effects of the various options.

Keywords: tax expenditures, itemized deductions, exclusions, alternative minimum tax, distributional effects, incentive effects

JEL Codes: H22, H24

I. INTRODUCTION

In recent years, there have been a number of proposals to scale back tax expenditures. The President has proposed to limit the value of certain tax deductions and exclusions to 28 percent of the deduction or exclusion amount. Other proposals would apply a fixed dollar limit to certain tax preferences, limit their total tax benefit to a fixed percentage of income, or replace deductions and exemptions with refundable or non-refundable credits. Current law already has some broad limitations — the alternative minimum tax and the overall limitation on itemized deductions (the Pease limitation).

This paper examines various ways of designing across-the-board limits on the use of tax expenditures to replace or supplement limitations already in the income tax. We simulate the effects on the distribution of tax burdens among income groups and on

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incentives to engage in the subsidized activities of alternatives that impose the same overall increase in tax burden.

Section II of the paper provides background information on the magnitude and distribution of tax expenditures. Section III discusses the prominent role tax expenditures have played in recent tax reform debates and the differences between targeted reforms and broad-based or across-the-board limits. Section IV presents the general issues involved in designing broad-based tax expenditure limits. Section V presents the simulation methodology and results of six different options for imposing tax expenditure limits, and Section VI concludes.

II. BACKGROUND ON TAX EXPENDITURES

Tax expenditures are defined in the Congressional Budget Act of 1974 as “revenue losses attributable to provisions of the federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.” Tax expenditure estimates are produced annually by both the Joint Committee on Taxation (JCT) and the Treasury’s Office of Tax Analysis (OTA).

The most recent report from the JCT (2013) lists more than 200 separate tax expenditures, which combine to account for more than \$1 trillion in lost revenue. The single largest tax expenditure is the exclusion of employer provided health benefits, which will reduce federal income tax revenues by more than \$750 billion between 2013 and 2017 (Table 1).¹ That is followed by the net exclusion of employer-based retirement benefits (i.e., defined benefit and defined contribution pensions and Keogh plans) and the preferential tax rates applied to qualified dividend income and long-term capital gains. The itemized deductions for state and local taxes (income, sales, personal property, and real property taxes) and mortgage interest paid round out the top five. All together, the top 20 preferences account for roughly 90 percent of all individual income tax expenditures.

Tax expenditures benefit taxpayers at all income levels, but on average the benefits are higher as a share of income for upper-income taxpayers than for lower-income taxpayers. Toder and Baneman (2012) provide an update of Burman, Toder, and Geissler (2008) and report the distribution of benefits for seven broad classes of tax expenditures, finding significant variation in the distribution of benefits across tax expenditures. The top income quintile accounts for nearly all the tax benefits from preferential treatment of capital gains and dividends, 80 percent of the benefits of itemized deductions, and two-thirds of the benefits from exclusions (including investment income earned within tax-preferred retirement accounts). At the other extreme, 80 percent of the benefits from refundable credits go to taxpayers in the bottom 60 percent of the income distribution, with just 7 percent going to the top quintile.

¹ The Joint Committee estimate does not include the effect of the exclusion of employer provided health benefits from compensation on payroll tax receipts.

Table 1
Major Individual Tax Expenditures, Ranked by Total 2013–2017
(Revenue Cost)

Rank	Provision	Amount (\$Billion)
1	Exclusion of employer health insurance	760.4
2	Net exclusion of employer pensions ¹	611.9
3	Preferential rates on dividends and capital gains ²	532.4
4	Deduction of state and local taxes (including property)	430.5
5	Deduction for mortgage interest	379.0
6	Exclusion of Medicare benefits	358.0
7	Earned income credit (EITC)	325.9
8	Subsidies for health exchanges	307.7
9	Child credit	291.6
10	Exclusion of capital gains at death	258.0
11	Deduction for charitable contributions	238.8
12	Exclusion of benefits under cafeteria plans ³	192.3
13	Exclusion of interest on state and local bonds	191.3
14	Exclusion of Social Security benefits	179.6
15	Exclusion of inside buildup within life insurance	157.6
16	Exclusion of capital gains on principal residences	129.8
17	Credits for higher education expenses	126.4
18	Individual retirement accounts	96.8
19	Deduction for medical expenses	71.6
20	Exclusion of veterans' benefits	39.3
	Subtotal	5,678.9

¹ This estimate includes defined benefit, defined contribution, and Keogh plans.

² This estimate is net of the surtax on net investment income.

³ This estimate includes employer health insurance purchased through cafeteria plans, which are also included in line 1.

Source: Joint Committee on Taxation (2013)

III. THE ROLE OF TAX EXPENDITURES IN TAX REFORM DEBATES

Both political parties have endorsed the concept of reforming the tax system by reducing special tax preferences, although they differ on how the additional revenue so raised would be used. The budget resolution for fiscal year 2014 by the U.S. House of Representatives promised to eliminate tax breaks to pay for deep cuts in individual and corporate tax rates and elimination of the individual alternative minimum tax (AMT). The Tax Policy Center (TPC) has estimated these proposed rate cuts and the elimination of the AMT would reduce federal receipts by \$5.7 trillion from fiscal years 2014–2023. In contrast, the fiscal year 2014 Senate budget resolution would use the revenues from reducing tax expenditures to raise \$950 billion more over 10 years than

the receipts projected in the Congressional Budget Office (CBO) baseline. One point both budget resolutions have in common is that neither specify what tax preferences they would remove to meet their revenue targets. The House is completely silent on the matter, while the Senate promises to cut tax expenditures that benefit corporations and the top 2 percent of individual income taxpayers and suggests across-the-board limitations as a possible way to do this.

Recent tax reform proposals by independent and bipartisan panels have been more specific on how they would reduce tax expenditures to pay for different combinations of individual and corporate tax rate cuts, AMT relief, and higher revenues:

- (1) The President's Advisory Panel on Federal Tax Reform (2005) appointed by President Bush and chaired by former U.S. Sens. Connie Mack (R-FL) and John Breaux (D-LA) proposed to eliminate the deduction for state and local income and property taxes, convert the mortgage interest deduction to a non-refundable credit at the basic income tax rate, place a floor under charitable contributions, place caps on the size of debt eligible for a mortgage interest subsidy based on average housing values in geographic regions, cap the amount of employer-sponsored health insurance (ESI) that is exempt from taxable compensation, and eliminate almost all business tax incentives. Revenues would have been used to pay for modest cuts in individual and corporate income tax rates and elimination of the (then un-indexed) AMT. But the panel also proposed to expand (and consolidate) incentives for retirement saving and retain preferential treatment of capital gains and qualified dividends;
- (2) The National Commission on Fiscal Responsibility and Reform (2010), chaired by former White House Chief of Staff Erskine Bowles and former U.S. Sen. Alan Simpson (R-WY), proposed to eliminate most tax expenditures, with a few exceptions. The Commission's illustrative tax plan contained in their final report proposed to retain the child credit and the earned income tax credit, convert the mortgage interest deduction to a non-refundable credit at the basic income tax rate (12 percent), cap and then slowly phase out the exclusion of ESI benefits, retain with lower contribution limits tax preferences for retirement saving, and eliminate the exclusion of state and local bond interest for newly issued bonds. The Commission also proposed to tax capital gains and dividends as ordinary income. Revenues from lowering tax expenditures would have been used to pay for lowering marginal income tax rates, eliminating the AMT, and raising additional revenues; and
- (3) The Debt Reduction Task Force of the Bipartisan Policy Center (2010), chaired by former OMB Director Alice Rivlin and former U.S. Sen. Pete Domenici (R-NM), also proposed to eliminate numerous tax expenditures. The Bipartisan Policy Center (BPC) proposal would restructure benefits for low-income taxpayers, cap and phase out the ESI exclusion, replace the deductions for charitable contributions and home mortgage interest with a 15 percent refundable credit, retain the deduction of medical expenses in excess of 10 percent of AGI, eliminate deductibility of state and local non-business taxes, and eliminate many other indi-

vidual and corporate preferences. It would exempt the first \$1,000 of long-term capital gains from tax, but otherwise tax capital gains and qualified dividends as ordinary income. BPC would use the revenues from paring back tax expenditures and the introduction of a new national sales tax to eliminate the AMT and lower individual and corporate tax rates, while raising federal revenue.

All of these proposals identified tax expenditure provisions they would eliminate, provisions they would retain, and provisions they would modify.

A. Limiting Tax Expenditures: Targeted Reforms versus Global Approaches

If one views tax expenditures as substitutes for direct spending programs, then they should be evaluated on their merits just as we would evaluate direct spending. For each tax expenditure provision, we should ask whether the provision produces broad social benefits in excess of private benefits that make it worthy of public subsidy and if so, whether the tax incentive is structured in a way that provides the most cost-effective way of promoting its objectives. We should also ask whether the goals are best achieved through a tax subsidy or a direct spending program. For example, all three advisory panels on tax reform accepted the view that charitable organizations provide benefits worth subsidizing through the tax code, but took the position that the subsidy would be more effective if made available to all taxpayers, not just those claiming itemized deductions, at a uniform subsidy rate. Two of the panels also proposed that a floor be placed under the subsidy for administrative reasons and to minimize the tax benefit for contributions that might have been made without the incentive. All the advisory panels favored maintaining tax incentives for retirement saving, but two of the three proposed reducing the contribution limits so as to reduce the level of retirement benefit that the incentive would subsidize. All government subsidies, whether conveyed by direct spending or tax incentives, are supported by organized constituency groups, and politicians are therefore reluctant to cut them. To circumvent these pressures, Congress has at times chosen to impose across-the-board limits on spending. These types of limits may make it politically easier to sustain spending cuts. Overall limits on spending or tax expenditures are suboptimal ways to reduce deficits because they equally cut high-value and low-value activities. No well-functioning organization, either private or governmental, would reduce its costs in this manner. But overall limits may nonetheless be the only way our political system can achieve short-term or medium-term budgetary savings. And if tax expenditures more often than not misallocate resources, overall limits on them could yield a net improvement in the tax system and budgetary policy, even while falling far short of the ideal.

B. Tax Expenditure Limits in Current Law

The federal income tax already includes two broad-based or generic limitations on tax expenditures — the individual AMT and the overall limitation on itemized deductions. The individual AMT is imposed on a tax base with fewer tax preferences than under the regular income tax, applies a different structure of marginal tax rates, and allows different exemptions. Individuals pay the higher of their tentative AMT (computed by

applying the AMT rate schedule to the AMT base) or their regular income tax. AMT liability is the difference between tentative AMT and regular income tax liability and is added to the regular tax in computing total tax liability. In 2015, TPC estimates that roughly 4 million taxpayers will pay \$28.7 billion in individual AMT.

The individual income tax also contains an overall limitation on itemized deductions, named the Pease limitation after the author of the provision, the late U.S. Rep. Donald Pease (D-OH). The 2001 tax cuts phased out the Pease limitations. These tax cuts, including elimination of Pease, originally expired at the end of 2010 but were then extended through the end of 2012. The American Tax Relief Act of 2012 (ATRA) reinstated Pease for high-income taxpayers. Under current law, the Pease provision reduces itemized deductions by 3 cents for every additional dollar of AGI in excess of \$300,000 for married taxpayers and \$250,000 for single taxpayers. The maximum limitation is equal to 80 percent of itemized deductions. For most taxpayers whom Pease affects, there is no change in the incentives provided by itemized deductions. For example, a taxpayer in the 39.6 percent bracket would lose 3 cents worth of itemized deductions for every dollar of additional earnings. Effectively, a dollar of earnings would raise her taxable income by \$1.03, and therefore raise her tax liability by 40.8 cents (39.6 percent of \$1.03). So Pease effectively raises the top marginal tax rate on itemizers to 40.8 percent. But Pease does not alter the marginal tax savings from itemized deductions because an additional dollar of claimed deductions still saves the taxpayer 39.6 cents in federal income tax. So while Pease reduces the total value of itemized deductions, it does not reduce the incentive at the margin for additional deductible expenditures (e.g., donating to charity).

IV. ISSUES IN LIMITING TAX EXPENDITURES

In designing proposals for a uniform cut in tax expenditures, there are three main design choices that need to be made. The first is which tax expenditure provisions to include in the overall limitation. The second is what formula to use to limit the benefits of these provisions. The third is whether to use these new limitations to replace or supplement existing limitations.

A. Which Tax Expenditures to Include in the Limitation?

Tax expenditures take different forms, including exclusion of certain types of income from the tax base (e.g., the exclusion of employer contributions to health insurance from taxable compensation), deductions of personal consumption expenditures (e.g., the deduction for home mortgage interest),² deferral of recognition of income — equivalent to a zero interest loan to the taxpayer (e.g., the deduction for contributions to individual

² Under an income tax, interest expense is normally deductible as a cost of earning income, but because the return to owner-occupied housing in the form of housing services (imputed rent) is tax-free, the deduction of mortgage interest allows the portion of those consumption services that are debt-financed to escape income tax. Both the JCT and Treasury include the mortgage interest deduction as a tax expenditure; Treasury also includes the exemption of the return on equity (the net imputed rent) as a tax expenditure.

retirement accounts, which is later recaptured as income when amounts in the account are distributed), taxation of certain forms of income at favorable rates (e.g., the preferential rates of tax imposed on realized long-term capital gains and qualified dividends), and tax credits for certain expenditures and categories of taxpayer (e.g., the child credit and earned income credit).³

Some proposals for tax expenditure limitations target provisions that provide individual consumption benefits (such as most itemized deductions and the exclusion for health insurance). Some proposals exclude provisions benefiting low-income families, such as the child credit and the earned income credit. Others exclude provisions benefiting investment income. Some would exclude the charitable deduction.

Because tax expenditures reduce tax liability in a variety of ways (some of which depend on a taxpayer's marginal tax rate and some that do not), it can be difficult to design a single limit that applies uniformly to both preferences that change the tax base (i.e., deductions and exclusions) and others such as credits and special rates. For example, a 20 percent reduction in the value of a deduction raises tax liability by 2 percent of qualifying expenditures for a taxpayer in the 10 percent rate bracket and by 7.92 percent of qualifying expenditures for a taxpayer in the 39.6 percent bracket. But a 5 percent cut in the value of a credit raises tax liability by 5 percent of the qualifying expenditures for all taxpayers with positive liability. If one were trying to design a cutback in a credit that was equivalent to a 20 percent cutback in a deduction, the 5 percent credit cutback would be too high for someone in the 10 percent bracket, but too low for someone in the 39.6 percent bracket.

For simplicity, in this paper we restrict our analysis to a subset of deductions and exclusions for our overall tax expenditure limits. The options we simulate limit all itemized deductions, the exclusion of employer provided health insurance, and the exclusion of interest on state and local bonds. These items are chosen to provide a fairly simple set of calculations of how overall limitations would work and are not meant to represent the exact items we think should be included in a tax expenditure limitation proposal.

B. Method of Limiting Tax Expenditures

We simulate the effects of five alternative ways of limiting tax expenditures.⁴ For all of these simulations, we select parameters that produce the same overall increase in tax burdens.

- (1) *Limit Tax Savings to a Percentage of Adjusted Gross Income (AGI Limit)*. This option would limit tax savings from the specified deductions and exclusions to a maximum percentage of AGI. It is similar in structure to a proposal by Feldstein, Feenberg, and MacGuineas (2011) that would limit the tax savings from certain tax expenditures to 2 percent of AGI.

³ The tax benefits from contributions to individual retirement accounts also include the exclusion of income accrued within the accounts.

⁴ Similar analyses were conducted in Baneman, et al. (2012) and Baneman, et al. (2011).

- (2) *Limit Deductions and Exemptions to a Flat Absolute Dollar Amount (Fixed Dollar Cap)*. This option would limit the total annual amount of specified deductions and exclusions to a maximum dollar amount. It is similar in structure to a proposal discussed by Gov. Romney in the 2012 Presidential election campaign to place a dollar cap on itemized deductions.
- (3) *Place Limit on Rate to Apply to Exclusions or Deductions (Rate Limit)*. This option would limit the tax saving from the specified deductions and exclusions to a fixed percentage of the amount of deduction and exclusions. It is similar in its structure to a proposal in the President's fiscal year 2014 budget that limits tax savings to 28 percent of the value of certain deductions and exclusions.
- (4) *Reduce All Deductions and Exemptions by the Same Percentage (Haircut)*. This option would reduce each specified deduction or exclusion by a fixed percentage of the amount spent on the tax-preferred activity or amount of excluded income. It would be the most direct and straightforward way to reduce the subsidy that tax expenditures provide in a uniform manner.
- (5) *Replace Deductions and Exemptions with a Fixed Rate Refundable Credit (Refundable Credit)*. This option would replace each specified deduction or exclusion with a refundable credit equal to a fixed percentage of the deduction or exclusion amount. It would provide uniform incentives to all users of the tax benefit and has been suggested in a paper by Batchelder, Goldberg, and Orszag (2006). It is also similar to a portion of the BPC proposal, which recommended converting the mortgage interest and charitable deductions to 15 percent refundable credits.

As an alternative to these five options, we also simulate a proposal to add all the specified preferences to the base of the AMT. While we don't necessarily favor the AMT as good tax policy, it nonetheless is already part of the income tax and so an alternative way of scaling back tax expenditures is simply to add more of them to the AMT base.

C. Replace or Supplement Existing Tax Expenditure Limitations

The new options could be accompanied either by repeal or retention of the individual AMT or Pease. Using one of the options to replace these existing limitations would arguably improve the income tax by substituting for them a method of limiting tax benefits that applies to a much larger set of provisions and limits them in a more rational way. In addition, imposing new limits on the existing structure would, for some of the options, add significant complexity to the computation of income tax liabilities.

The arguments for retaining the existing limitations are that their impact falls mostly on the very highest income taxpayers and that removing them would require more stringent limitations in the other options to raise the same net amount of additional revenue. Some recent publicized proposals, including the AGI limit proposed by Feldstein, Feenberg, and MacGuineas (2011), are silent about repealing or explicitly retaining the

AMT and Pease. But Governor Romney, who suggested the fixed dollar cap, would have repealed the AMT and Pease, as would all three of the reform proposals by the bipartisan panels discussed above.

D. Other Issues

Other issues to be considered in designing tax expenditure limitations include whether to impose the limitations only on high-income individuals and how to think about the administrative and complexity issues that the additional limitations might create.

1. Reducing Tax Expenditures for High-Income Individuals Only

The idea of removing individual tax expenditures only for the highest income individuals and leaving middle-income groups unaffected is often a staple of tax reform rhetoric. For example, the Senate Budget Committee proposed to limit tax expenditures only for corporations and the top 2 percent of income recipients.

Designing limits so that they only affect the highest income taxpayers is complicated (Baneman et al., 2011). Suppose, for example, that high income is defined as AGI of \$250,000 for married couples and \$200,000 for individuals, the definition the Obama Administration used in previous budget proposals. Then, for example, the AGI limit would only apply to taxpayers with income above those threshold amounts. So, if the AGI limit is 2 percent, and a married couple had \$8,000 of tax benefits, they would owe no additional tax if their income was \$249,999. An additional dollar of income, however, would place them above the 2 percent limit of \$5,000 and the income threshold and would thereby cost them an extra \$3,000 in taxes.

To prevent this cliff effect, the threshold for applying tax expenditure limits would have to be phased in. For example, if the percentage of AGI limit was phased in smoothly for incomes between \$250,000 and \$500,000, taxpayers with incomes of \$250,000 would pay none of the additional tax attributable to the limit, taxpayers with incomes of \$300,000 would pay 20 percent of the additional tax, taxpayers with income of \$400,000 would pay 60 percent of the tax, and taxpayers with income over \$500,000 or more would pay the entire additional tax. The phase-in would work differently for different types of limits. For example, with a haircut, if the target reduction is a 40 percent cut in deductions and exemptions, taxpayers with incomes of \$300,000 would lose 8 percent of their deductions and exemptions, and taxpayers with incomes of \$400,000 would lose 24 percent of their deductions and exemptions.

Phase-ins of the tax expenditure limitations would raise marginal tax rates in the phase-in ranges and reduce the revenue gain from the tax expenditure limitation. The effects on marginal tax rates would vary with the type of limitation and with the extent to which the use of preferences and exclusions rises with income. For example, as incomes rise above the threshold level, individuals will pay more state and local income taxes, but may not increase their use of the exclusion for employer-provided health care. The phase-ins would make tax computations significantly more complex and make the tax system even less transparent than it is now.

We have not simulated any income limitations on the tax expenditure reductions. Most of the proposed limitations have a progressive distribution (see below) even without limiting them to high income people because high income people are affected the most by preference limitations. Placing an income floor under the limitations would make the tax law much more complex, increase marginal tax rates substantially in the phase-in range, reduce the revenue pickup from the limitations, and continue to provide inefficient subsidies to many taxpayers. If the goal is to make the tax law more progressive and minimize the amount that tax incentives distort individual behavior, changing the rate structure may have a much lower efficiency cost than imposing arbitrary-income based limitations on the use of selected incentives.

2. Complexity

Some of the tax expenditure limitation methods make the tax law more complicated, while others are very simple to apply. The haircut option is the simplest; all the taxpayer would have to do is to multiply deductions by a fixed percentage and include a fixed proportion of the specified excluded income items in AGI. Replacing the deductions and exemptions with a refundable credit is also very straightforward. Taxpayers would not claim the deductions, include the entire exempt amount in AGI, and then claim a credit equal to 15 percent of the specified deductions and exemptions.

The calculation of tax liability with the fixed dollar cap is only slightly more complicated. Taxpayers would first add up their exemptions and deductions to see if they exceed the dollar cap. If not, they simply would pay the same tax as under current law. If the preferences exceed the cap, they would add back the difference between the preferences and the cap amount to their taxable income and then calculate their tax liability.

Other ways of limiting tax expenditures are more complicated because they would require two separate computations of tax liability, with taxpayers paying the higher of the two alternative taxes as they do with the current law AMT:

- (1) Under the rate limit, taxpayers would first compute their tax liability under current law. Then they would add back the specified deductions and exemptions, calculate their tax liability at the new income level, and claim a tax credit equal to the allowable percentage of deductions and exemptions. They would pay the higher of their tax liability under current law and the tax liability with the percentage limitation. (Taxpayers facing a marginal tax rate under current law that is lower than the percentage limitation rate would not have to make this additional calculation.)
- (2) Under the AGI limit, taxpayers would also first compute their tax liability (X) under current law. They would then compute their tax liability (Y) with all the specified preferences eliminated. If $(Y - X)$ is less than the specified percentage of AGI, then their tax liability stays at the current law level (X). Otherwise they would pay the excess as additional tax liability. For example, if the AGI limit were set at 3 percent and $(Y - X)$ exceeded 3 percent of AGI, their tax liability would be equal to $Y - (0.03 \times \text{AGI})$.

The complexities of these proposals, especially the AGI limit, would multiply if the current AMT were also retained. With an AGI limit and an AMT, many taxpayers would have to calculate tax liabilities under four different scenarios — two assuming they are on the individual AMT schedule, and two assuming they are on the regular income tax schedule. They would pay tax on the highest of those four computed liabilities.

V. SIMULATING TAX EXPENDITURE LIMITS

A. Methodology

We use TPC’s microsimulation model to estimate the revenue, distributional, and incentive effects of imposing the five different new across-the-board tax expenditure limits discussed above and the option to broaden the AMT base. We perform simulations on two different bases of the tax expenditure limits: Base (1) includes only personal itemized deductions, and Base (2) includes itemized deductions, a portion of the exclusion of employer provided health insurance, and the exclusion of interest on state and local bonds.

While there are many other tax expenditures that could (and arguably should) be included in such a limit, we restrict ourselves here for several reasons. The first is that these preferences are large, widely-used, and because they are reported on existing tax forms they are relatively easy to implement and administer. Many of the other large tax expenditures — such as credits for low-income workers and children, the exclusions of Social Security and Medicare benefits, those for retirement savings, and preferential rates on capital income — are likely to be “off-the-table” for either political or administrative reasons.

Specifically, we include:

- (1) *All itemized deductions.* Personal itemized deductions include several of the largest individual tax expenditures, including the deductions for mortgage interest, state and local taxes paid, and charitable contributions. Consistent with many existing proposals (e.g., the Administration’s 28 percent limit), we treat all itemized deductions as tax preferences in our simulations. By contrast, the Pease limitation recognizes that some itemized deductions are more justifiable as a proper adjustment to income, and therefore excludes certain deductions (e.g., medical expense, investment interest expense, casualty and theft losses, and net gambling losses).
- (2) *The exclusion of a portion of contributions to employer-sponsored health insurance (ESI).* The ESI exclusion is the single largest tax expenditure reported by JCT and many proposals have suggested phasing it out or eliminating it altogether. However, rather than treat the entire excluded amount as a preference subject to the limits, we only include the portion of ESI in excess of the 75th percentiles of the distributions of premium levels for single and family plans. The rationale for this choice is that the ESI exclusion is a major government subsidy that supports the entire employer-based health insurance market. Given that the

recently enacted healthcare reform — the Patient Protection and Affordable Care Act (PPACA) — maintains that basic structure, it seems unwise to make major reforms to the ESI exclusion outside the context of broader reforms to the national health insurance market. In addition, there might be concerns about interactions between the subsidized private insurance market that will begin in 2014 under the PPACA and any proposal that contains a significant curtailment of the ESI exclusion (Gillette et al., 2010). The applicable 75th percentile thresholds are set in 2015 dollars at \$6,500 for single plans and \$18,000 for other (individual-plus-one or family) plans, and they are indexed for inflation in all years.

- (3) *The exclusion of interest on state and local bonds.* We treat the reported amount of tax-exempt interest as a preference for the purpose of the overall limits. While that is consistent with incidence assumptions used in conventional distributional analysis, it ignores the effect that the exemption has on pretax returns. If, in the absence of the exemption, yields on tax-exempt and taxable bonds would otherwise be equal, the lower rate of return investors accept on tax-exempt bonds acts as an implicit tax on tax-exempt bondholders, with a corresponding subsidy to holders of taxable bonds. The presence of such an implicit tax likely means that the tax preference for state and local bond interest will likely be reduced proportionally more than other preferences.⁵

Overall, these included tax preferences represent about \$1 trillion in additional potential taxable income or roughly 14 percent of baseline taxable income (Figure 1). Itemized deductions in excess of the standard deduction account for nearly 90 percent of the total base of the limits —ranging from just over 9 percent of taxable income for the bottom three quintiles and nearly 15 percent for the 95th to 99th income percentiles. ESI above the threshold represents a fairly constant percentage of taxable income through the bottom 95 percent of the income distribution, while tax-exempt interest is an important preference only in the top 5 percent of tax units.

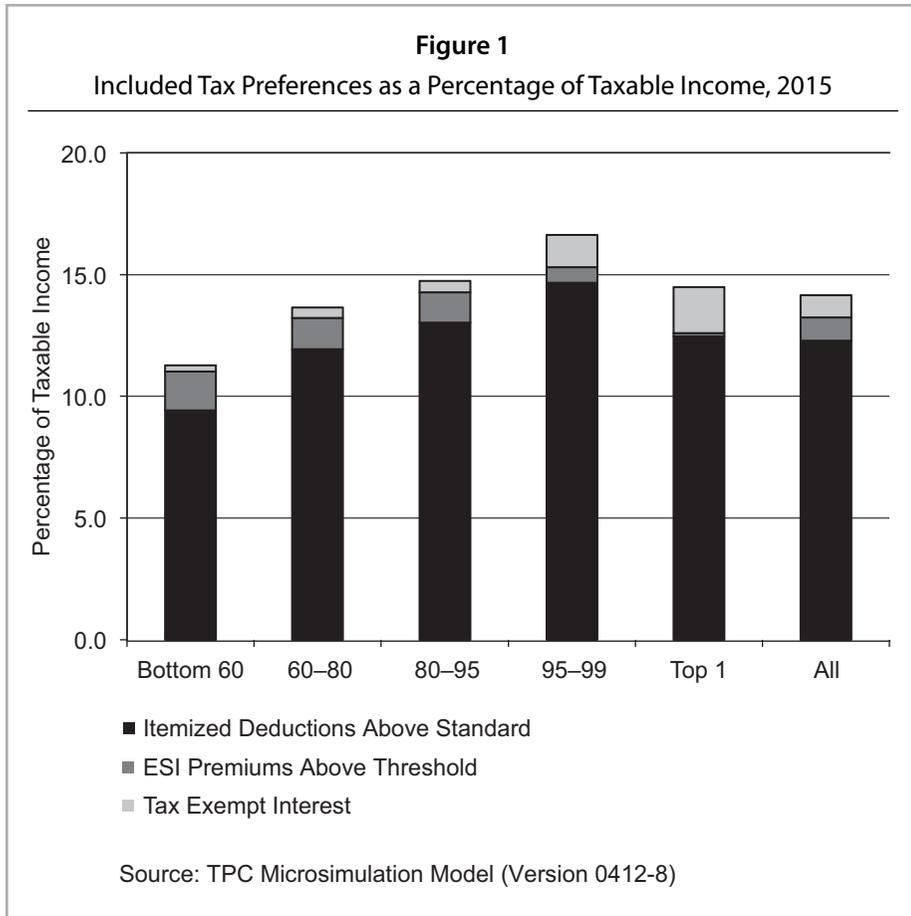
In all the simulations, we treat the standard deduction as a “normal” part of the income tax, and thus assume that taxpayers can elect to claim the standard deduction at their full marginal tax rate. In addition, for simplicity and consistency across options, we do not alter the baseline definition of AGI. For the options that partially eliminate exclusions, we treat the included income as a “between-the-line” adjustment to income — meaning that it is added to taxable income, but not AGI.

B. Results

1. Parameters of the Proposals and Revenue Effects

In order to facilitate comparisons across bases and methods, we start by simulating a single benchmark option: imposition of a 3 percent AGI limit applied to all itemized

⁵ Galper et al. (2013) provide a more thorough treatment of the incidence of, and implication of reducing or eliminating, the exclusion of interest on state and local bonds.



deductions in place of the individual AMT and the current law limitation on itemized deductions (Pease). That option imposes a net increase in tax burden of roughly \$95 billion in 2015. We calibrate the parameters of the other options to equalize that (static) tax burden change in 2015 for options that replace the AMT and Pease (Table 2, Panel A) and for options that retain the AMT and Pease (Table 2, Panel B). For the AGI limit, rate limit, haircut, and refundable credit options, that calibration simply amounts to solving for the relevant constant percentage value. For the fixed dollar cap, we base the allowable amount on filing status, with the cap for married filing jointly returns at twice the level of individuals (and with head of household returns set halfway in between). For the option that broadens the base of the current AMT, we adjust the two AMT rates — currently 26 and 28 percent — proportionally to hit our calibration target.

All of the options raise roughly \$1.1 trillion over the full 2014–2023 budget window (Tables 3a and 3b). Slight differences arise due to differential micro-dynamic behavioral responses and differential patterns over time. For example, since the fixed dollar cap

Table 2
Simulation Parameters

Panel A: Replace AMT and Pease

Option	Base 1: Itemized Deductions	Base 2: Itemized Deductions Plus Exclusions
1. AGI Limit	3% of AGI	3.5% of AGI
2. Fixed Dollar Cap	\$13,000 (S) \$26,000 (MFJ)	\$16,500 (S) \$33,000 (MFJ)
3. Rate Limit	15%	16.3%
4. Haircut	46%	41%
5. Refundable Credit	13%	14.5%
6. Broaden AMT ¹	27.2% / 29.3%	26.2% / 28.2%

Panel B: Retain AMT and Pease

Option	Base 1: Itemized Deductions	Base 2: Itemized Deductions Plus Exclusions
1. AGI Limit	3.8% of AGI	4.4% of AGI
2. Fixed Dollar Cap	\$16,640 (S) \$33,279 (MFJ)	\$22,104 (S) \$44,207 (MFJ)
3. Rate Limit	17.6%	19.2%
4. Haircut	33.3%	29.5%
5. Refundable Credit	14.8%	15.9%
6. Broaden AMT	27.2% / 29.3%	26.2% / 28.2%

¹ This option retains Pease as in current law.

Source: Tax Policy Center Microsimulation Model (Version 0412-8)

is indexed by the consumer price index, the revenue gain will grow more rapidly over time than the revenue gain from options in which the limits are effectively indexed by the growth in income instead of prices (e.g., the AGI limit) and therefore become relatively less stringent in later years.

2. Distributional Effects

In general, the six options raise taxes on average, and do so in a progressive manner in the sense that they increase tax burdens as a share of income relatively more for higher income tax units. Overall, the increase in burden is equal to about 0.7 percent of pretax income.

While all the options are progressive assuming both elimination and retention of AMT and Pease, some proportionally affect the highest income taxpayers much more than

Table 3A
Impact on Tax Revenue of Options that Replace AMT and Pease, 2014–2023
 (Fiscal Year, Current \$Billions)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2014–23
<i>Base 1: All Itemized Deductions</i>											
1. AGI Limit	58.1	82.8	90.9	98.1	104.5	110.7	116.5	122.0	127.5	132.9	1,043.8
2. Fixed Dollar Cap	58.1	84.5	95.1	104.6	113.2	122.4	130.0	138.1	147.7	155.6	1,149.4
3. Rate Limit	57.2	82.0	91.0	98.9	106.0	112.6	119.1	125.0	131.1	137.3	1,060.2
4. Haircut	60.2	85.5	93.4	100.1	106.3	111.9	117.9	123.4	129.0	135.1	1,062.8
5. Refundable Credit	56.9	82.0	91.6	100.2	106.9	113.9	121.1	127.9	134.9	142.2	1,077.7
6. Broaden AMT ¹	56.2	80.9	89.4	97.8	105.1	111.6	116.5	121.3	127.0	131.4	1,037.3
<i>Base 2: All Itemized Deductions Plus Certain Exclusions</i>											
1. AGI Limit	56.5	81.9	93.0	103.9	113.7	123.0	132.4	141.3	150.7	161.0	1,157.4
2. Fixed Dollar Cap	57.2	84.2	96.9	109.3	120.3	131.8	141.4	151.2	162.7	172.9	1,228.1
3. Rate Limit	56.3	81.6	92.0	101.8	110.8	119.2	127.8	135.9	144.5	153.7	1,123.7
4. Haircut	59.4	85.2	94.6	103.3	111.4	119.3	128.0	136.6	145.6	155.8	1,139.3
5. Refundable Credit	55.2	80.8	92.5	103.7	112.8	122.2	132.1	141.4	151.5	162.5	1,154.6
6. Broaden AMT ¹	57.0	82.8	93.2	103.9	112.9	120.8	127.6	134.0	141.5	148.6	1,122.1

¹This option retains Pease as in current law.

Source: Tax Policy Center Microsimulation Model (Version 0412-8).

Table 3B
Impact on Tax Revenue of Options that Retain AMT and Pease, 2014–2023
 (Fiscal Year, \$Billions Current)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2014–23
<i>Base 1: All Itemized Deductions</i>											
1. AGI Limit	57.3	81.9	89.9	97.1	103.6	110.0	116.1	122.1	128.2	134.4	1,040.5
2. Fixed Dollar Cap	58.2	84.4	94.4	103.9	112.4	121.6	129.2	137.2	146.5	154.7	1,142.5
3. Rate Limit	59.8	86.0	94.9	102.9	110.1	117.0	123.6	129.8	136.1	142.6	1,101.8
4. Haircut	60.0	85.2	92.8	99.4	105.5	111.3	117.3	122.9	128.6	134.9	1,057.9
5. Refundable Credit	55.8	80.8	90.7	99.7	106.7	114.0	121.6	128.6	135.8	143.6	1,077.3
6. Broaden AMT	56.2	80.9	89.4	97.8	105.1	111.6	116.5	121.3	127.0	131.4	1,037.3
<i>Base 2: All Itemized Deductions Plus Certain Exclusions</i>											
1. AGI Limit	56.3	81.5	91.6	101.4	110.1	118.4	126.4	133.9	141.7	150.4	1,111.7
2. Fixed Dollar Cap	57.5	83.9	95.4	107.0	117.4	128.2	137.1	146.0	156.5	166.1	1,195.4
3. Rate Limit	57.8	83.4	93.3	102.5	110.8	118.7	126.2	133.1	140.2	148.0	1,114.0
4. Haircut	59.5	85.0	93.5	101.1	108.2	115.0	122.2	128.8	135.7	143.6	1,092.6
5. Refundable Credit	54.4	79.7	91.3	102.2	110.8	119.6	128.7	136.9	145.3	154.8	1,123.7
6. Broaden AMT	57.0	82.8	93.2	103.9	112.9	120.8	127.6	134.0	141.5	148.6	1,122.1

Source: Tax Policy Center Microsimulation Model (Version 0412-8)

others, and some impose significant burdens on taxpayers in the 60th to 95th percentiles of the income distribution. In addition, the options are generally more progressive when the AMT and Pease are retained because these limitations affect mainly taxpayers in the top 5 percent of the income distribution.

With the AMT and Pease eliminated, the fixed dollar limit has the largest effect on the very highest income taxpayers (Tables 4a and 5a). The top 1 percent of tax units bears slightly over half of the additional tax burden when the limit is applied to itemized deductions only and over 60 percent when the exclusions are limited also (Table 5a), amounting to increases in the overall effective tax rate of 2 and 2.4 percentage points, respectively (Table 4a).

The broadened AMT option has the largest effect on the top 5 percent of taxpayers, with most of the increase hitting taxpayers in the 95th to 99th percentiles of the distribution. It would roughly triple the number of taxpayers subject to the AMT and impose a tax increase of nearly 3 percent of pretax income on taxpayers in the 95th to 99th percentiles. The pattern of taxpayers subject to AMT would be similar to the existing AMT.⁶

The tax increases from the refundable credit and rate limit options are also concentrated in the top quintile of the distribution, but are spread more evenly throughout the top quintile than the broadened AMT and the dollar cap. In contrast, the AGI limit and the haircut impose the largest burdens as a percent of income on the upper middle income groups (i.e., the 60th to 95th percentiles). For these two options, the increase in average tax rates in the fourth quintile and the bottom half of the top quintile of the distribution is larger than that for the population as a whole. But the tax rate increase is less than average for the top 1 percent. The AGI limit is relatively less progressive than other options because it imposes a tighter absolute limit on preferences for taxpayers with lower incomes. The haircut option is distributed much the same way as the baseline distribution of the affected preferences through most of the distribution because it is basically a proportional reduction in preferences. But the combination of the haircut with elimination of AMT and Pease results in a net tax rate increase in the top 5 percent that is smaller than the tax rate increase for the population as a whole.

The bottom two quintiles are largely unaffected by all options, other than seeing a net benefit (tax decrease) in the refundable credit option, which makes available some preferences that they previously could not receive either because they claim the standard deduction or because their tax liability without these preferences is too low for them to benefit from the additional deductions and exclusions. The middle income quintile is hit with a smaller than average tax increase (as a share of income) from all the options, but pay relatively much more additional tax under the AGI limit and haircut than under the other options.

⁶ The AMT tends to affect the highest proportion of taxpayers in the \$200,000 to \$500,000 income range, mostly due to disallowed state and local tax deduction and the relatively low marginal rate structure under the regular tax. The higher marginal tax rates tend to pull taxpayers off the AMT as their regular tax rises faster than their tentative AMT liability.

Table 4A
Impact on Effective Tax Rates of Options that Replace AMT and Pease, 2015
(Percentage Point Change in Effective Tax Rate)

	Quintile					Top Quintile				
	Lowest	Second	Middle	Fourth	Top	All	80-90	90-95	95-99	Top 1
<i>Base 1: All Itemized Deductions</i>										
1. AGI Limit	0.1	0.2	0.6	0.9	0.9	0.8	1.3	1.4	0.8	0.4
2. Fixed Dollar Cap	0.0	0.1	0.2	0.4	1.3	0.8	0.5	0.9	1.0	2.0
3. Rate Limit	0.0	0.0	0.2	0.5	1.1	0.7	1.1	1.4	1.0	1.0
4. Haircut	0.0	0.2	0.5	0.9	0.9	0.7	1.2	1.4	0.8	0.5
5. Refundable Credit	-1.1	-0.3	0.2	0.6	1.3	0.7	1.3	1.6	1.2	1.2
6. Broaden AMT ¹	0.0	0.0	0.1	0.2	1.3	0.7	0.3	1.2	2.8	0.9
<i>Base 2: All Itemized Deductions Plus Certain Exclusions</i>										
1. AGI Limit	0.1	0.2	0.6	0.8	0.9	0.7	1.2	1.3	0.8	0.7
2. Fixed Dollar Cap	0.0	0.0	0.1	0.3	1.3	0.8	0.4	0.7	0.9	2.4
3. Rate Limit	0.0	0.0	0.2	0.4	1.1	0.7	1.0	1.3	1.0	1.2
4. Haircut	0.0	0.2	0.5	0.9	0.9	0.7	1.2	1.4	0.7	0.5
5. Refundable Credit	-1.4	-0.5	0.1	0.5	1.4	0.7	1.3	1.5	1.3	1.4
6. Broaden AMT ¹	0.0	0.0	0.1	0.2	1.3	0.7	0.3	1.1	2.6	1.0

¹ This option retains Pease as in current law.

Source: Tax Policy Center Microsimulation Model (Version 0412-8)

Table 4B
Impact on Effective Tax Rates of Options that Retain AMT and Pease, 2015
 (Percentage Point Change in Effective Tax Rate)

	Quintile					Top Quintile			
	Lowest	Second	Middle	Fourth	Top	All	80-90	90-99	Top 1
<i>Base 1: All Itemized Deductions</i>									
1. AGI Limit	0.1	0.2	0.5	0.7	0.9	0.7	1.0	1.0	0.8
2. Fixed Dollar Cap	0.0	0.0	0.1	0.3	1.2	0.7	0.3	0.6	1.0
3. Rate Limit	0.0	0.0	0.1	0.4	1.2	0.7	0.9	1.1	1.3
4. Haircut	0.0	0.1	0.4	0.7	0.9	0.7	1.0	1.1	0.8
5. Refundable Credit	-1.4	-0.5	0.1	0.5	1.3	0.7	1.2	1.4	1.5
6. Broaden AMT	0.0	0.0	0.1	0.2	1.3	0.7	0.3	1.2	0.9
<i>Base 2: All Itemized Deductions Plus Certain Exclusions</i>									
1. AGI Limit	0.1	0.2	0.4	0.6	1.0	0.7	0.9	1.0	0.9
2. Fixed Dollar Cap	0.0	0.0	0.0	0.2	1.3	0.7	0.2	0.4	0.9
3. Rate Limit	0.0	0.0	0.1	0.3	1.2	0.7	0.7	1.0	1.3
4. Haircut	0.0	0.1	0.4	0.7	1.0	0.7	0.9	1.1	0.9
5. Refundable Credit	-1.6	-0.6	-0.1	0.4	1.4	0.7	1.1	1.4	1.7
6. Broaden AMT	0.0	0.0	0.1	0.2	1.3	0.7	0.3	1.1	2.6

Source: Tax Policy Center Microsimulation Model (Version 0412-8)

Table 5A
Shares of Total Tax Change of Options that Replace AMT and Pease, 2015
 (Percent of Tax Increase)

	Quintile					Top Quintile				
	Lowest	Second	Middle	Fourth	Top	All	80-90	90-95	95-99	Top 1
<i>Base 1: All Itemized Deductions</i>										
1. AGI Limit	0.3	3.0	12.1	23.8	61.0	100.0	22.2	15.9	12.1	10.7
2. Fixed Dollar Cap	0.0	0.7	3.3	9.6	86.3	100.0	8.4	10.6	15.6	51.7
3. Rate Limit	0.0	0.0	4.5	13.4	82.1	100.0	19.7	17.0	17.4	27.9
4. Haircut	0.2	2.4	10.2	22.8	64.4	100.0	21.4	17.4	12.9	12.7
5. Refundable Credit	-6.6	-4.5	4.1	16.5	91.1	100.0	21.7	18.6	19.9	30.9
6. Broaden AMT ¹	0.0	0.0	1.0	4.5	94.5	100.0	5.7	14.6	48.8	25.4
<i>Base 2: All Itemized Deductions Plus Certain Exclusions</i>										
1. AGI Limit	0.3	2.8	11.1	21.6	64.3	100.0	19.8	14.9	12.4	17.3
2. Fixed Dollar Cap	0.0	0.4	2.0	6.7	91.0	100.0	5.8	8.1	13.7	63.4
3. Rate Limit	0.0	0.0	3.8	11.7	84.5	100.0	18.4	16.0	17.3	32.8
4. Haircut	0.2	2.5	10.1	22.7	64.4	100.0	21.2	17.0	12.4	13.9
5. Refundable Credit	-7.8	-6.2	2.1	14.3	98.4	100.0	21.6	18.5	20.9	37.3
6. Broaden AMT ¹	0.0	0.0	1.0	4.6	94.5	100.0	6.1	14.1	45.2	29.0

¹ This option retains Pease as under current law.

Source: Tax Policy Center Microsimulation Model (Version 0412-8)

Table 5B
Shares of Total Tax Change of Options that Retain AMT and Pease, 2015
 (Percent of Tax Increase)

	Quintile					All	Top Quintile			
	Lowest	Second	Middle	Fourth	Top		80-90	90-95	95-99	Top 1
<i>Base 1: All Itemized Deductions</i>										
1. AGI Limit	0.3	2.7	10.3	19.5	67.1	100.0	23.2	12.9	14.3	22.1
2. Fixed Dollar Cap	0.0	0.4	2.0	6.9	90.8	100.0	5.7	7.9	16.8	60.4
3. Rate Limit	0.0	0.0	2.9	9.7	87.4	100.0	15.4	13.8	22.1	36.1
4. Haircut	0.1	1.9	8.1	18.9	71.0	100.0	17.4	14.0	16.3	23.3
5. Refundable Credit	-8.1	-6.7	1.1	13.0	101.3	100.0	20.5	17.7	22.1	41.0
6. Broaden AMT	0.0	0.0	1.0	4.5	94.5	100.0	5.7	14.6	48.8	25.4
<i>Base 2: All Itemized Deductions Plus Certain Exclusions</i>										
1. AGI Limit	0.3	2.4	8.7	17.1	71.5	100.0	15.5	11.9	15.4	28.8
2. Fixed Dollar Cap	0.0	0.1	0.9	4.1	94.9	100.0	3.6	5.1	14.8	71.4
3. Rate Limit	0.0	0.0	2.3	8.0	89.7	100.0	13.2	12.4	22.9	41.1
4. Haircut	0.2	1.9	7.9	18.3	71.7	100.0	16.9	13.5	16.4	24.9
5. Refundable Credit	-9.3	-8.3	-0.9	10.6	108.9	100.0	20.2	17.5	23.3	47.9
6. Broaden AMT	0.0	0.0	1.0	4.6	94.5	100.0	6.1	14.1	45.2	29.0

Source: Tax Policy Center Microsimulation Model (Version 0412-8)

When Pease and AMT are retained, the distributional effects of all the options become more progressive (Tables 4a and 5b). The fixed dollar cap and broadening the base of the AMT continue to impose the largest tax increase on the top 5 percent, with the increase from the fixed dollar cap focused on the top 1 percent, while broadening the AMT base has the largest effects on taxpayers in the 95th to 99th percentiles. The AGI limit and the haircut continue to impose the largest burdens among all the options on the third and fourth quintiles of the distribution and continue to impose slightly smaller tax rate increases on the top 5 percent than on others within the top quintile of the distribution. The refundable credit option continues to reduce the average tax rate in the bottom two quintiles, but now also slightly reduces taxes in the middle quintile because retention of the AMT and Pease permits a higher matching rate on the credit.

3. Incentive Effects

One issue of concern related to these types of across-the-board limits is the potential effect they have on the incentive to engage in (currently) subsidized behaviors. The most obvious example is the case of charitable contributions. While there may be a strong policy argument for limiting a preference like the mortgage interest deduction at the margin (i.e., if at the margin it primarily subsidizes larger homes for the relevantly affluent), to the extent that the purpose of the charitable deduction is to encourage donations, it is desirable to retain the incentive at the margin, while reducing the subsidy that applies to “infra-marginal” giving.

Under current law, the marginal tax benefit for charitable contributions is, on average, 21.1 percent, meaning that an additional \$100 of charitable contributions generates a tax savings of \$21.10 (Table 6).⁷ The marginal benefit of giving increases with income. The relatively low rates in the lower quintiles reflect the fact that most taxpayers in those groups do not itemize or, if they do, face low marginal rates (many are in the 15 percent bracket), and therefore receive little or no tax benefit from their contributions. The marginal benefit from additional contributions rises as income rises, reflecting the “upside-down” nature of subsidies delivered through exclusions and deductions, where the subsidy rate rises with the taxpayer’s marginal rate.

We estimate the effect on the marginal incentive to contribute of the tax expenditure limitation options, assuming that they replace the AMT and Pease. All of the tax expenditure limitations significantly reduce the overall marginal benefit of contributing to charity, but do so in ways that differ across specific groups of taxpayers (Table 6). The options that reduce the incentive to give the most on average are the AGI limit and the fixed dollar cap. Both of these incentives completely eliminate the marginal incentive to give for taxpayers subject to the limits. The AGI limit effectively eliminates the marginal incentive to give for most income groups, while the fixed dollar cap has more modest effects in the lower and middle quintiles, but nearly completely eliminates the incentive

⁷ Another way of looking at this is that the tax price of giving \$100 to charity is only \$78.90 because the taxpayers gets to save \$21.10 in federal income taxes.

Table 6
Marginal Tax Benefit of Charitable Contributions Deduction of Options that Replace AMT and Pease, 2015
 (Effective Subsidy Rate in Percent)

	Quintile					All	Top Quintile				
	Lowest	Second	Middle	Fourth	Top		80-90	90-95	95-99	Top 1	
<i>Base 1: All Itemized Deductions</i>											
1. AGI Limit	0.0	0.1	0.2	1.0	2.7	1.8	1.2	2.1	2.9	3.5	
2. Fixed Dollar Cap	0.6	2.7	5.6	7.1	3.3	4.2	8.8	6.0	2.2	0.0	
3. Rate Limit	0.7	3.8	7.5	9.7	12.7	10.8	9.6	11.7	13.0	14.5	
4. Haircut	0.3	1.2	3.0	4.8	14.3	10.1	7.8	10.6	14.6	18.7	
5. Refundable Credit	9.3	7.2	7.5	8.0	10.9	9.7	7.4	9.4	11.2	12.9	
6. Broaden AMT ¹	0.7	3.9	9.0	12.1	9.7	9.6	14.5	7.5	1.0	12.2	
<i>Base 2: All Itemized Deductions Plus Certain Exclusions</i>											
1. AGI Limit	0.0	0.3	0.7	1.9	3.5	2.6	2.5	3.3	3.7	4.0	
2. Fixed Dollar Cap	0.7	3.6	7.7	10.0	5.8	6.6	13.7	11.3	5.3	0.1	
3. Rate Limit	0.7	3.9	8.0	10.8	14.3	12.0	11.4	13.4	14.7	16.0	
4. Haircut	0.3	1.6	3.7	5.9	16.0	11.5	9.3	12.4	16.3	20.6	
5. Refundable Credit	10.6	8.3	8.9	9.5	12.4	11.2	9.1	11.2	12.7	14.3	
6. Broaden AMT ¹	0.7	3.9	9.1	12.0	10.2	9.8	14.5	8.3	1.3	13.1	
<i>Memo: Current Law</i>	0.7	3.9	9.4	14.0	27.9	21.1	19.5	24.0	29.7	32.6	

Notes: The marginal tax benefit is calculated by increasing the charitable contributions deduction by \$100 and computing the resulting reduction in tax liability. Rates are aggregated by weighting by the amount of the reported deduction.

Source: Tax Policy Center Microsimulation Model (Version 0412-8)

¹ This option retains Pease as under current law.

for the top 1 percent. The rate limit and refundable credit have similar effects in the top quintile, reducing the marginal benefit by roughly 50 percent. However, while the rate limit would not affect taxpayers in the low and middle quintiles, the refundable credit would substantially increase the incentive to give in the bottom two quintiles, relative to current law. The haircut would reduce the incentive by about the same percentage reduction in all income groups. The broadened AMT would completely remove the marginal incentive from taxpayers subject to the expanded AMT, who would mostly fall in the 95th to 99th percentiles, but leave the incentives to give in most other income groups largely unaffected.

VI. CONCLUSION

Political leaders from both parties have promised to reduce tax expenditures, either to pay for lower marginal individual and corporate tax rates or to raise more revenue from high income individuals and corporations. But both the House and Senate budget resolutions, while endorsing cutbacks in tax preferences, have failed to identify the provisions they would cut back or eliminate. There has been increasing interest, however, in proposals to provide across-the-board cuts in tax expenditures, without singling out specific provisions.

This paper has examined six ways of providing across-the-board cutbacks in tax expenditures. We find that these methods differ substantially in their effects on both income distribution and incentives to use deductions and exclusions such as the charitable deduction, if it is subject to the limits. Fixed dollar limits and broadening the base of the AMT are the most progressive ways of reducing tax expenditures, while a proportional cutback or haircut in preferences and a fixed percentage of AGI limit are the least progressive options. The fixed dollar cap and the percent of AGI limit (one relatively more progressive, the other relatively less progressive) produce the largest reductions in the incentive to give to charity, with the former virtually eliminating any tax incentive for the highest income taxpayers. Expanding the AMT base would virtually wipe out the incentive to give for taxpayers who will be on the AMT, who are heavily concentrated in the 95th to 99th percentiles of the income distribution, but would leave incentives for most income groups unaffected. Replacing current preferences with a lower rate refundable credit would, in contrast, raise after-tax income for taxpayers in the bottom two quintiles and provide an incentive for them to give to charity.

We agree that across-the-board limitations of tax expenditures are inferior to policies that address each tax expenditure provision on its merits. Yet, these policies may be the most politically feasible way of reducing tax preferences. This paper is an effort to describe the very different ways in which alternative approaches would work.

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