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# HOW HARD IS IT TO CUT TAX PREFERENCES TO PAY FOR LOWER TAX RATES?

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## ABSTRACT

Some political leaders have proposed to lower individual income tax rates and make up the lost revenue by eliminating tax preferences. To help inform the discussion of such proposals, we examine illustrative revenue-neutral combinations of lower rates and cuts in tax preferences and their effects on the distribution of tax burdens. We conclude that paying for lower rates would require substantial reductions in broadly-used and popular preferences. In addition, requiring that changes maintain the current progressivity of the federal income tax would make it much harder to find a politically acceptable mix of preferences to curtail.

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## HOW HARD IS IT TO CUT TAX PREFERENCES TO PAY FOR LOWER TAX RATES?

High tax rates reduce incentives to work, save and invest, encourage tax evasion and avoidance, and magnify the distortions caused by the myriad tax preferences in the current income tax. An enduring goal of tax reforms has consequently been to broaden the income tax base to pay for lowering tax rates. Some tax reform proposals are intended to be revenue neutral, offsetting the revenue lost from lower rates with equivalent revenue gains from cutting tax preferences. Other proposals, such as those made by the Bowles-Simpson commission and the Domenici-Rivlin task force, would raise revenue by cutting tax preferences enough to more than offset the revenue loss from lower rates.

Tax reforms appear to have significant flexibility in paying for lowering rates through base broadening due to the large number and enormous cost of current tax preferences—officially known as tax expenditures. Marron notes, for example, that if you simply add up the income tax expenditures identified by the Department of Treasury, the estimated total exceeds $1.4 trillion in 2015.[1] Such aggregate figures may illustrate the sheer magnitude of tax preferences, but they significantly overstate the actual potential for tax reforms to achieve lower rates through base broadening, for four key reasons:

1. Lower rates reduce the value of most tax preferences. Nearly all tax expenditures are in the form of deductions, exclusions, exemptions, deferrals, or preferential rates, all of which are valuable only to the extent they allow taxpayers to avoid regular statutory tax rates. If tax rates are cut, the value of these tax preferences goes down as well. Thus, cutting tax rates reduces the amount of offsetting revenue that cutting tax preferences can raise.
2. Some tax preferences may be hard to curtail for political or administrative reasons. For example, cutting back widely used and popular preferences such as the deductions for mortgage interest and charitable contributions may be politically difficult. And it would be administratively impractical to require homeowners to include in their income each year the rental value of their homes, although leaving that income untaxed is a tax expenditure (with a sizable cost associated with it). If such preferences can't be curtailed as part of a realistic tax reform, it becomes harder to find the revenue needed to pay for lower tax rates.
3. Cutting back on tax preferences may alter the distribution of the tax burden in ways that are deemed unacceptable. Finding a combination of lower rates and cutbacks in tax preferences with acceptable distributional effects can prove quite difficult.
4. A tax reform that includes wholesale, immediate repeal of a significant portion of tax preferences would significantly disrupt existing economic arrangements in ways that might be deemed unfair. Instead, some preferences might be only partially curtailed, and some cutbacks might phase in, possibly over an extended period of time. In addition, taxpayers would likely change their behavior to lessen the impact of these cutbacks. All of these "real world" effects would likely reduce, perhaps substantially, the revenue gains from cutting tax preferences.

[1] Donald Marron, "How Large are Tax Expenditures? A 2012 Update." *Tax Notes* (April 9, 2012): 235. Available at http://www.taxpolicycenter.org/UploadedPDF/1001602-TN-How-Large-Are-Tax-Expenditures-2012-Update.pdf.

To help inform the tax reform discussion, this study examines how tax preferences might be cut to pay for lower rates, and how the combined reforms would affect the distribution of tax burdens. Our estimates of revenue and distributional effects are only illustrative; they do not represent estimates for a specific tax reform proposal. So we do not try to estimate the effects of specific designs and phase-ins for cutbacks in preferences or possible behavioral responses to the combination of cutbacks and lower rates, all of which would depend on the details of an actual tax reform proposal.

We examine the impact on income tax revenues and the distribution of tax burdens of alternative ways of cutting tax preferences in combination with the tax rates that would apply under three actual or proposed tax laws:[2]

- Current Law. The tax law scheduled to be in effect in 2013, which has top rates of 39.6 percent on ordinary income (including dividends) and 20 percent on capital gains;
- Current Policy. The law in effect in 2012, with top rates of 35 percent on ordinary income and 15 percent on capital gains and qualified dividends, and with the alternative minimum tax (AMT) exemption amounts indexed for inflation;[3] and
- Current Policy with Reduced Rates. Current Policy with tax rates on ordinary income cut by 20 percent, yielding a top rate of 28 percent, the 15 percent top rate on capital gains and dividends retained, and the AMT repealed. These provisions represent a portion of the tax proposals that presidential candidate Mitt Romney has offered.

We consider specific ways of broadening the income tax base by repealing or limiting tax preferences. We divide the 173 tax expenditures listed in the Budget into four groups that roughly reflect the prevalence of proposals for—and administrative feasibility of—repealing or limiting the provisions.[4] Our analysis covers only the individual income tax base and rates; it does not examine any corporate or non-corporate business tax expenditures, and it does not take account of possible changes in payroll tax revenues.[5]

The analysis focuses on two alternative targets for individual income tax revenues:

1. Maintain Current Policy Revenues. Repeal or limit tax expenditures under the Current Policy with Reduced Rates scenario by enough to raise the same amount of individual income tax revenues projected for 2015 under Current Policy[6]; and
2. Maintain Current Law Revenues. Repeal or limit tax expenditures under Current Policy and Current Policy with Reduced Rates enough to raise the amount of individual income tax revenue projected for 2015 under Current Law.

[2] All of these tax laws assume that Congress will not extend the temporary payroll tax cut in place during 2011 and 2012, and that the tax provisions of the Patient Protection and Affordable Care Act, including the 3.8 percent surcharge on net investment income, go into effect in 2013 as scheduled. We omit the 3.8 percent surcharge rate when citing top statutory rates because it does not affect comparisons across the three tax laws.

[3] Congress has not yet enacted higher AMT exemption levels for 2012, but Current Policy assumes that Congress will index the 2011 amounts for inflation for 2012 and all subsequent years.

[4] The 2013 Budget lists tax expenditures in chapter 17 of "Analytical Perspectives," available at http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/receipts.pdf.

[5] For example, repeal of the income tax exclusion of employer-provided health insurance from wages could extend to the payroll tax base, thereby increasing payroll tax revenues.

[6] Current Law revenues exceed revenue under Current Policy, so this target does not apply to Current Law.

As noted above, the revenue cost of most tax expenditures depends on the level of tax rates. As a result base broadening yields smaller revenue gains under the lower rates in Current Policy than under Current Law and smaller gains in Current Policy with Reduced Rates than under both Current Law and Current Policy. This means that as rates are lowered, it becomes increasingly difficult to achieve any given revenue target through base broadening.

Current Policy with Reduced Rates could meet the Current Policy revenue target with a significant curtailment of some of the largest tax expenditures, such as mortgage interest, charitable contributions, and employer-provided health insurance. However, these are widely used and popular provisions, so sharply limiting their value could prove difficult. Further, this combination of lower rates and a broader base would cut taxes substantially for high income taxpayers, resulting in a less progressive tax system than under Current Policy.

With sufficient base broadening, tax rates under both Current Policy and Current Policy with Reduced Rates could raise the same amount of individual income tax revenue as Current Law. However, meeting that goal under Current Policy would require a sharp curtailment of mortgage interest, charitable contributions, and employer-provided health insurance. Hitting that revenue target under Current Policy with Reduced Rates would be even harder. It would require curtailment of these same popular tax expenditures as well as substantial reductions of additional tax expenditures, such as the special rates for capital gains and dividends, the exclusions for retirement contributions and earnings, and possibly such items as the earned income tax credit (EITC), the Child Tax Credit, and the exclusion of some or all Social Security benefits for low- to moderate-income beneficiaries. From a political perspective, matching Current Law revenue would be difficult, if not impossible.

### Groups of Tax Expenditures

Our analysis divided all non-business individual income tax expenditures into four groups that reflect our rough judgment of which provisions are most administratively and politically feasible. In order of declining feasibility, they are:[7]

1. Itemized and Above-the-Line Deductions, Non-retirement Fringe Benefits, and Small Credits. These highly visible tax expenditures are the ones most often included in base broadening proposals. Other than exclusions for employer fringe benefits, these provisions are already reported on individual tax returns and none of them are aimed at helping low-income families or encouraging saving. This group does, however, include popular and widely used preferences that could prove politically difficult to curtail:
    - itemized deductions for home mortgage interest, charitable contributions, state and local taxes, and medical expenses
    - above-the-line deductions
    - exclusion of employer-provided health insurance and other fringe benefits (other than contributions for retirement)
    - education, energy, and other credits, except those related to children and earnings of low-income families and individuals
    - smaller tax expenditures such as the exclusion for income earned abroad and special provisions for the elderly (other than the exclusion of some Social Security benefits).

[7] Appendix Table A-1 lists all tax expenditure provisions, divided into the four groups used in this study.

2. Investment and Retirement Income. This group includes all provisions that favor saving and investment by individual taxpayers. Paring back these provisions might be difficult because presidential candidate Romney, House Budget Committee Chairman Paul Ryan, and other Congressional leaders have openly opposed higher taxes on investment returns and in some cases even supported reducing or eliminating taxes on investment income. In contrast, both the Bowles-Simpson commission and the Domenici-Rivlin task force proposed taxing capital gains and dividends at the same rates as ordinary income. Provisions in this group are:
   - special rates that apply to capital gains (and dividends, under Current Policy and Current Policy with Reduced Rates)
   - deductibility or exclusion of contributions to retirement accounts
   - exclusion of investment income accrued in retirement accounts
   - exclusion of interest on tax-exempt bonds.

3. Child, Work-Related, and Social Security Benefits. This group consists of provisions that primarily help low-income households, families with children, and low- to moderate-income Social Security beneficiaries. Reducing these tax preferences would not offset the benefit of rate cuts, which primarily benefit high-income taxpayers, and would make the income tax significantly less progressive. Provisions in this group are:
   - Child Tax Credit
   - Earned Income Tax Credit
   - Child and Dependent Care Tax Credit
   - partial exclusion of Social Security benefits.

4. Other Preferences. The last group includes various exclusions from taxable income. Many people are not even aware of these exclusions and would be surprised to learn that tax policy analysts consider some of these items, such as the increase in the value of life insurance policies as people age, as income that escapes tax. Further, some of these provisions would be difficult to administer if they were brought into the income tax base. Most base broadening proposals have ignored these provisions, but the proposals from the Bowles-Simpson commission and the Domenici-Rivlin task force included many of them. This group includes:
   - exclusion of capital gains at death and on most home sales
   - exclusion of imputed rent on owner-occupied housing
   - exclusion of cash benefits for low-income families
   - exclusion of combat pay and veterans' benefits
   - exclusion of inside buildup on life insurance.

**Revenues under the Three Tax Laws**

Revenues under the three tax laws vary substantially, primarily due to differences in income tax rates, but also because of differences in some other provisions. Current Law, under which the 2001-10 tax cuts expire at the end of 2012, has the highest tax rates and includes other provisions (such as a smaller Child Tax Credit and a lower standard deduction and narrower tax brackets for married filers) that raise more revenue than the other two laws. Current Law is projected to raise

$3.3 trillion in 2015, of which $1.8 trillion (53 percent) would come from individual income taxes (top panel of Table 1).[8]

**Table 1. Revenues and Tax Expenditures under Alternative Tax Laws in 2015**
(billions of dollars)

| | Current Law | Current Policy | Current Policy with Reduced Rates |
|---|---|---|---|
| *Revenue* | | | |
| **Total** | 3,289 | 2,876 | 2,556 |
| Individual income tax | 1,757 | 1,378 | 1,058 |
| Other taxes[1] | 1,532 | 1,498 | 1,498 |
| *Tax Expenditures*[2] | | | |
| **Total** | 1,366 | 1,305 | 1,077 |
| 1. Deductions, fringe benefits, small credits | 590 | 525 | 446 |
| 2. Investment and retirement income | 439 | 429 | 327 |
| 3. Child, work-related, Social Security benefits | 88 | 128 | 122 |
| 4. Other preferences | 249 | 224 | 182 |

Source: Tax Policy Center Microsimulation Model.

[1] Estate tax, corporate income tax and payroll taxes.

[2] Amounts are for individual income tax expenditures only, and include outlay effects.

Under Current Policy—basically the tax law in effect for 2012—revenues in 2015 will total a projected $2.9 trillion, with $1.4 trillion (48 percent) coming from individual income taxes. Nearly all of the $0.4 trillion reduction relative to Current Law results from lower rates and other differences in the individual income tax. Compared with Current Law, Current Policy has lower top rates on ordinary income (rates up to 35 percent instead of up to 39.6 percent) and on capital gains (rates up to 15 percent instead of 20 percent) and taxes dividends at the capital gains rate rather than at ordinary rates (a top rate of 15 percent versus 39.6 percent). Current Policy does not impose the limitation on itemized deductions ("Pease") and the personal exemption phase-out (PEP) provisions that increase revenues from higher-income taxpayers under Current Law. In addition, compared with Current Law, Current Policy has a much higher AMT exemption level that is indexed for inflation, a larger Child Tax Credit ($1,000 instead of $500), a higher EITC for families with 3 or more children, and several marriage penalty relief provisions. Current Policy also has a higher estate tax exemption and a lower top estate tax rate than Current Law.

Presidential candidate Mitt Romney has included among his tax proposals a 20 percent across the board reduction in the Current Policy tax rates on ordinary income and repeal of the AMT.[9] This

[8] Each tax law includes only the federal taxes that the Tax Policy Center measures in its distributional analyses: the individual and corporate income taxes, payroll taxes, and estate and gift taxes.

study incorporates those rate cuts and AMT repeal into Current Policy with Reduced Rates. Under this proposal, the top tax rate on ordinary income would be 28 percent. The 15 percent top rate on capital gains and dividends and most other provisions of Current Policy would be retained. Current Policy with Reduced Rates would raise an estimated $2.6 trillion in 2015, with $1.1 trillion (41 percent) coming from individual income taxes. The $0.7 trillion reduction relative to Current Law would come primarily from lower income taxes.

## Tax Expenditures under Each Tax Law

Tax expenditures under the three tax laws vary substantially, from an estimated $1.4 trillion under Current Law to $1.3 trillion under Current Policy and $1.1 trillion under Current Policy with Reduced Rates (bottom panel of Table 1). As with revenues, much of the difference comes from rate differentials, but other provisions are also important. In addition, the order in which tax expenditures are estimated does not affect the total cost of all tax expenditures when the proposals are estimated sequentially, as in this analysis, but it does affect how the total is divided among the different groups.[10]

Group 1 comprises mostly deductions (itemized and above-the-line) and exclusions for employer-provided fringe benefits (other than retirement contributions). The revenue loss from deductions and exclusions depends primarily on the rate structure. Lower rates reduce the amount of revenue lost from a given deduction or exclusion. That effect is reflected in significant differences in the Group 1 tax expenditures: $590 billion under Current Law, $525 billion under Current Policy, and $446 billion[11] under Current Policy with Reduced Rates (Chart 1). Because the revenue gains from curtailing these provisions fall when tax rates are lowered, they would need to be curtailed more to reach any given revenue target when combined with lower tax rates.

The Group 2 tax expenditures result either from special rates (on capital gains for Current Law and on capital gains and dividends for both Current Policy and Current Policy with Reduced Rates) or from exclusions (retirement savings contributions and earnings and tax-exempt bond interest). The revenue loss from special tax rates depends on the difference between the special rate and the ordinary rate that would otherwise apply. For capital gains, the difference in the top bracket is 19.6 percentage points (39.6 percent – 20 percent) under Current Law, 20 percentage points (35 percent – 15 percent) under Current Policy, and 13 percentage points (28 percent – 15 percent) under Current Policy with Reduced Rates. Therefore, the tax expenditure for capital gains is quite similar under Current Law and Current Policy (which have nearly the same

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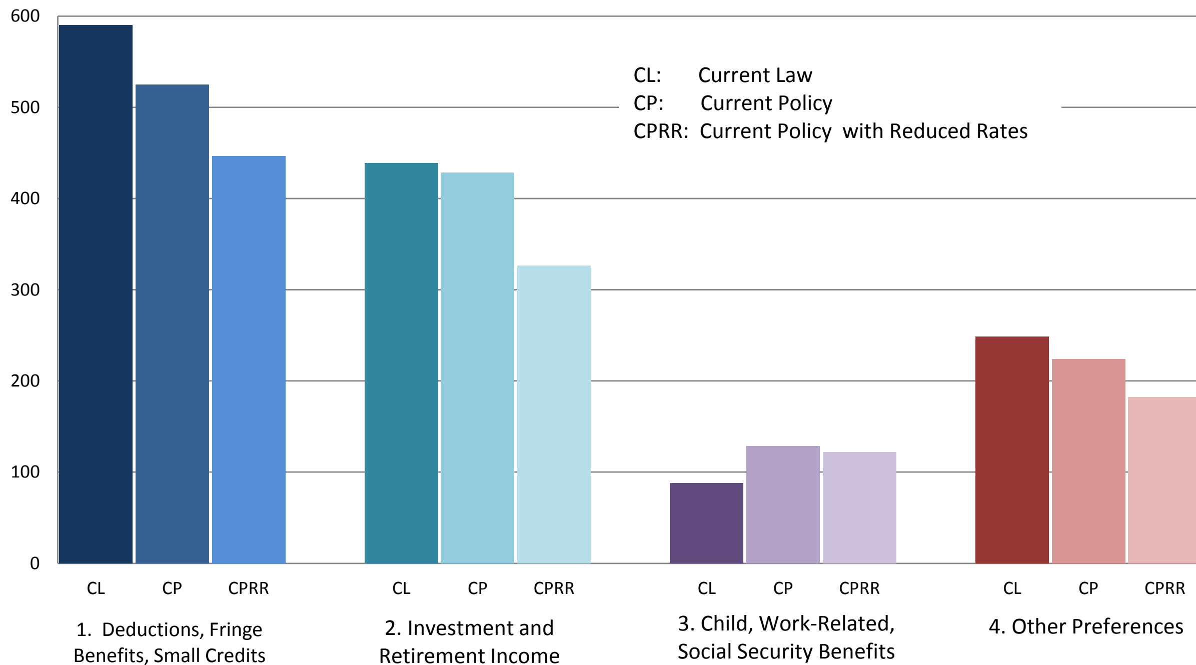
[9] Romney also proposes to extend all provisions of the 2001-03 tax cuts (but not the 2009 tax cuts), provide an exemption from tax on capital gains and dividends received by taxpayers with incomes below $250,000, repeal the estate tax, reduce the corporate income tax rate, and make the corporate tax territorial. He has also promised to repeal or curtail tax preferences to recoup lost revenue and make the proposal revenue neutral, but has not specified these provisions. As a result, Current Policy with Reduced Rates represents only a portion of Romney's tax plan.

[10] The official estimates of tax expenditures prepared by the Treasury's Office of Tax Analysis and the Congressional Joint Committee on Taxation do not group the provisions at all; those estimates examine each provision separately, assuming all other tax expenditure provisions remain in effect. As a result, they ignore any interactions among different provisions.

[11] This amount is not a full 20 percent less than the $525 billion under Current Policy primarily because the AMT reduces the value of certain itemized deductions (particularly the deduction for state and local taxes) under Current Policy.




differential), but much lower under Current Policy with Reduced Rates, where the differential is much smaller. Dividends are taxed under ordinary rates under Current Law, so there is no tax expenditure. In contrast, dividends are taxed at capital gains rates under the other two tax laws, so the same differences in rates determine the tax expenditure for both capital gains and dividends. The revenue losses for exclusions depend directly on the otherwise applicable tax rate, and so are largest under Current Law and smallest under Current Policy with Reduced Rates.

The revenue loss from the Group 2 tax expenditures in 2015 differs little for Current Law and Current Policy ($439 billion compared with $429 billion),[12] but is much less for Current Policy with Reduced Rates ($327 billion) because of both lower ordinary tax rates and the smaller difference between ordinary rates and those applied to capital gains and dividends.

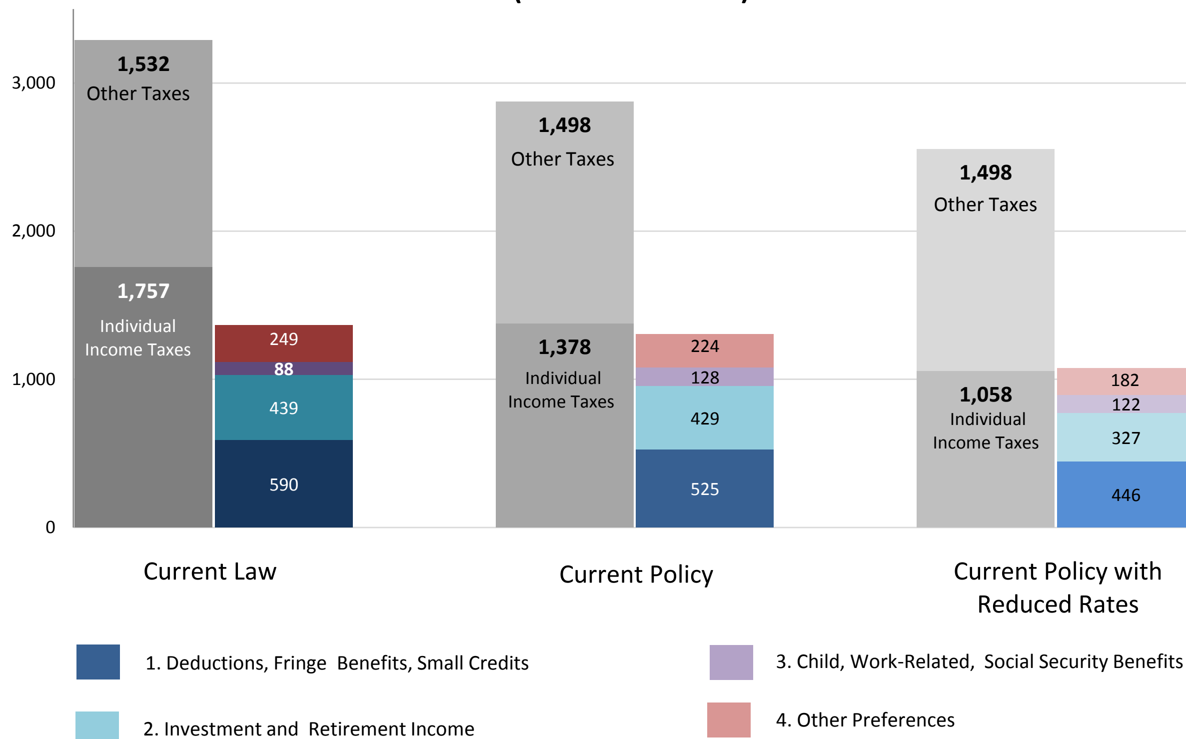
Group 3 tax expenditures are primarily child and work-related credits. The Child Tax Credit is twice as large ($1,000 compared with $500) under Current Policy and Current Policy with Reduced Rates as under Current Law, and the EITC is also larger under Current Policy than under Current Law. In addition, the AMT limits the value of these (and other) credits under Current Law, which reduces their revenue loss. In contrast, the exclusion of some Social Security benefits loses more revenue under Current Law than Current Policy because tax rates are higher.

[12] The amounts are similar due to offsetting effects: there is no tax expenditure for dividends under Current Law as there is under Current Policy, but the higher rates under Current Law make the tax expenditures on exclusions for retirement and tax-exempt bonds larger than they are under Current Policy. The tax expenditure for capital gains is similar under these two tax laws.

The total revenue cost of the Group 3 tax expenditures is lowest under Current Law ($88 billion) and roughly the same under Current Policy and Current Policy with Reduced Rates ($128 billion and $121 billion, respectively).

Group 4 tax expenditures are virtually all exclusions, so their revenue cost varies with tax rates. Their estimated revenue losses in 2015 range from $249 billion under Current Law to $224 billion under Current Policy and $182 billion under Current Law with Reduced Rates.

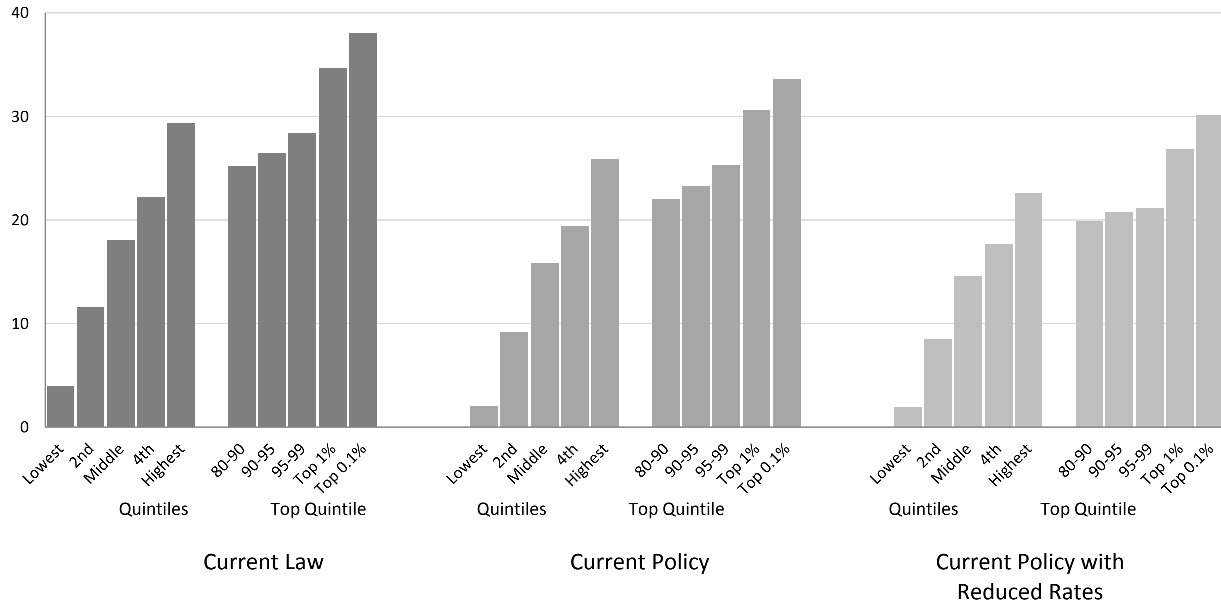
Non-business individual income tax expenditures under all three laws are between 42 percent and 45 percent of total revenues (Chart 2). Tax expenditures are larger relative to individual income tax revenues for the laws with lower tax revenues, however, because differences in income tax revenues are larger than differences in tax expenditures. Tax expenditures are 77 percent of individual income tax revenues under Current Law, 94 percent under Current Policy and 102 percent under Current Policy with Reduced Rates.




## Distribution of Revenues and Tax Expenditures

The tax system is quite progressive under all three tax laws, with effective tax rates (ETRs) rising as income increases across the entire income distribution (Chart 3).[13] Under Current Law,

[13] This analysis includes four federal taxes in its estimates of ETRs: individual and corporate income taxes, payroll taxes, and the estate tax. ETR equals liability from the four taxes as a percentage of cash income.

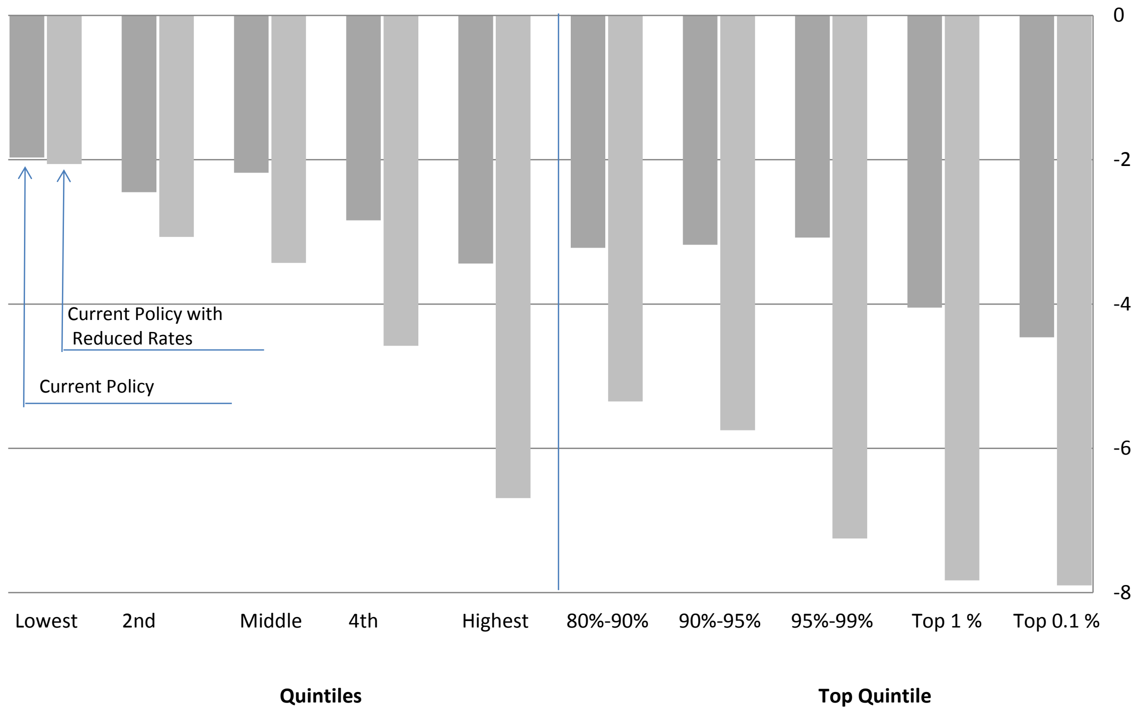



for example, ETRs rise steadily from 4 percent for the lowest quintile to 29.3 percent for the top quintile. Taxes are also progressive within the top quintile, climbing from 25.3 percent for the 80th to 90th percentiles to 38 percent for the top 0.1 percent. Similar patterns hold for the other two tax laws but at lower effective tax rates. The middle quintile, for example, faces an ETR of 18.1 percent under the Current Law, 15.9 percent under Current Policy, and just 14.6 percent under Current Policy with Reduced Rates.

The difference between effective tax rates under Current Law and under Current Policy and Current Policy with Reduced Rates generally increases as income rises (Chart 4). For example, the difference in ETRs for the lowest quintile under Current Law and Current Policy is 2 percentage points, while the difference for the highest quintile is 3.4 percentage points and that for the top 0.1 percent is 4.5 percentage points. That increasing reduction in effective tax rates across income categories indicates that the tax system becomes increasingly less progressive across the three tax laws. Note that the differences between ETRs for Current Law and Current Policy with Reduced Rates generally grow faster across income categories than do the differences between Current Law and Current Policy.

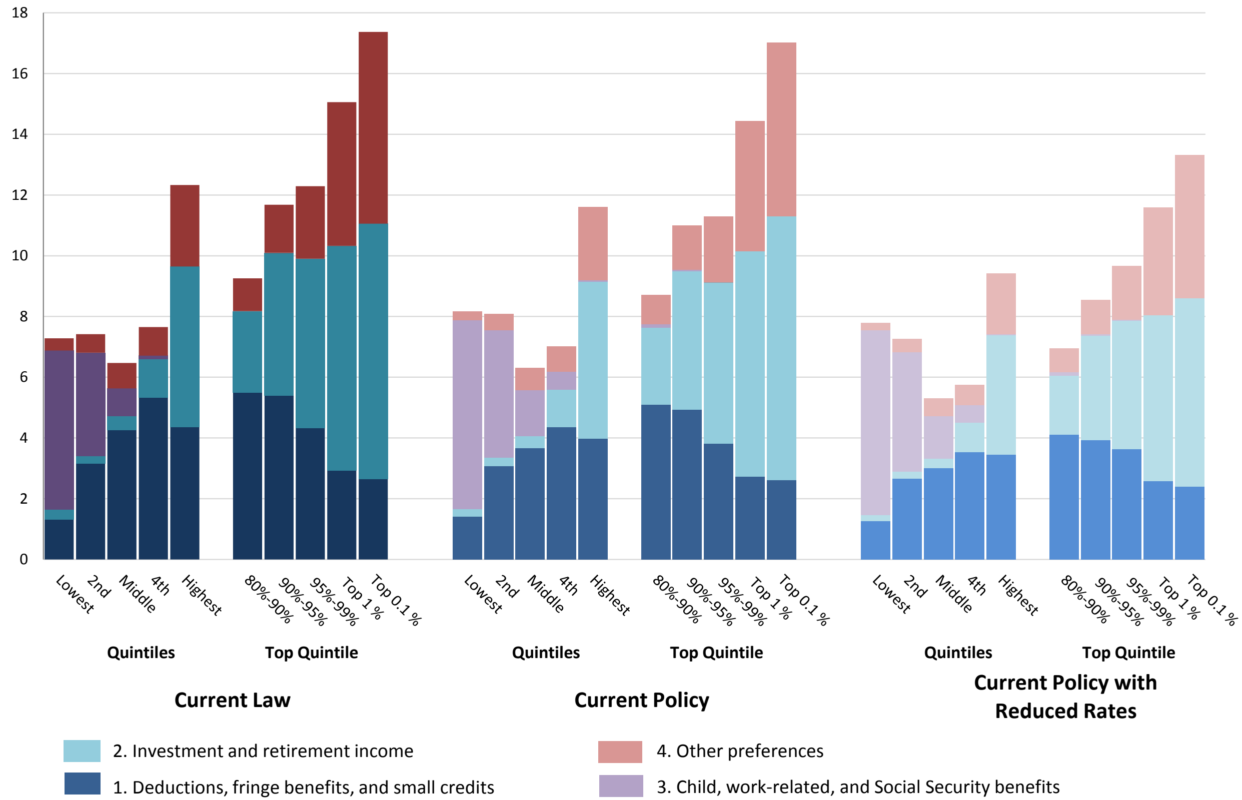
Relative to cash income, total tax expenditures are smallest for the middle quintile and largest for the top quintile under each of the three tax laws (Chart 5). Under all three, total tax expenditures equal between 7 and 8 percent of income in the first two quintiles but are somewhat lower for the third quintile—just over 6 percent for Current Law and Current Policy and only 5 percent for Current Policy with Reduced Rates. Tax expenditures in the fourth quintile are a larger share of income than in the third quintile for all three tax laws. The top quintile receives far and away the largest benefit from tax expenditures as a share of income under all three tax laws, ranging from more than 12 percent for Current Law to 9.4 percent for Current Law with Reduced Rates. Within the top quintile, effective rates for total tax expenditures rise uniformly with income, with the top 0.1 percent receiving the greatest benefit from tax expenditures—more than 17 percent of

**Chart 4. Differences in Average Effective Tax Rates under Alternative Tax Laws Relative to Current Law, by Income Percentile, 2015 (percentage of cash income)**




income under Current Law and Current Policy, and over 13 percent for Current Policy with Reduced Rates.

The distribution of tax expenditures by group varies much more than the total amounts under all three tax laws (Chart 5). The provisions in Group 1 (itemized and above-the-line deductions, fringe benefits other than retirement, and small credits) provide the most benefit for the fourth quintile and the 80$^{th}$ through 95$^{th}$ percentiles—roughly 5 percent of income under Current Law and Current Policy, and somewhat less under Current Policy with Reduced Rates. The value of those tax expenditures drops off moving further down or up the income categories. The Group 2 tax expenditures (investment and retirement income preferences) have little value in the first three quintiles, rise somewhat in the fourth quintile, and then increase significantly throughout the fifth quintile, peaking at above 8 percent of income for the top 0.1 percent under Current Law and Current Policy. The child and work-related credits and the exclusion of a portion of Social Security benefits (Group 3) shrink steadily as income increases. They are by far the most important component of tax expenditures in the first quintile, are lower but a still significant share of tax expenditures in the second and third quintiles, are small in the fourth quintile, and barely affect the top quintile. Finally, the various exclusions in Group 4 (such as taxing unrealized capital gains at death) that appear least feasible to curtail grow slowly in importance across the first four quintiles and faster in the top quintile, becoming quite large for those with the highest incomes.




## Illustrative Base Broadening Revenue Targets

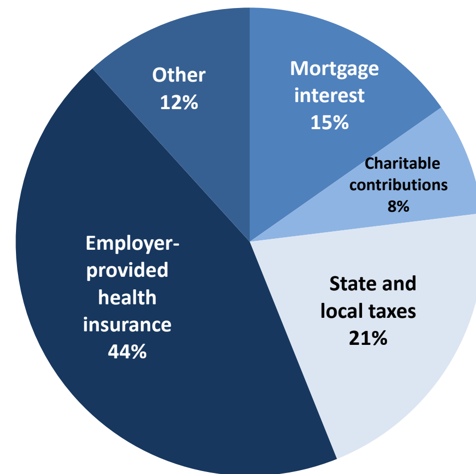
Two revenue targets illustrate how much base broadening would be needed to offset the revenue effect of lower rates. The first target—matching projected individual income tax revenues under Current Policy in 2015—applies only for Current Policy with Reduced Rates. The second target—matching projected individual income tax revenues under Current Law in 2015—is relevant to both Current Policy and Current Policy with Reduced Rates.

Individual income tax revenues in 2015 under Current Policy (the first target) are projected to be $1,378 billion—$320 billion higher than the $1,058 billion raised under Current Policy with Reduced Rates. Group 1 tax expenditures (deductions, fringe benefits, small credits) under Current Policy with Reduced Rates are projected to be $446 billion in 2015, so those tax expenditures would have to be cut 72 percent (= 320/446) to raise the needed $320 billion. Thus, reducing every tax expenditure provision included in Group 1 by 72 percent would restore Current Policy revenues, assuming no behavioral responses.[14]

[14] Reducing all Group 1 tax expenditures by 72 percent would require a "haircut:" taxpayers would need to calculate their tax benefits under the tax rates in Current Policy with Reduced Rates and then claim only 28 percent of those benefits. Requiring taxpayers to do such calculations would make tax filing significantly more complex. Reducing Group 1 tax expenditures in ways that would be easier to implement, such as capping deductions, could result in a quite different distribution of tax increases across income groups.

Alternatively, this reduction could be achieved through any combination of reductions in Group 1 tax expenditure provisions, as long as the overall reduction was 72 percent of the total. However, because the exclusion of employer-provided health insurance premiums accounts for 44 percent of total Group 1 tax expenditures (Chart 6), that exclusion would have to be pared back to meet the revenue goal. Further, taking one of the other major items in Group 1, such as mortgage interest, "off the table" would mean that all the remaining items would have to be cut back even more severely than the 72 percent cut under an across-the-board reduction.

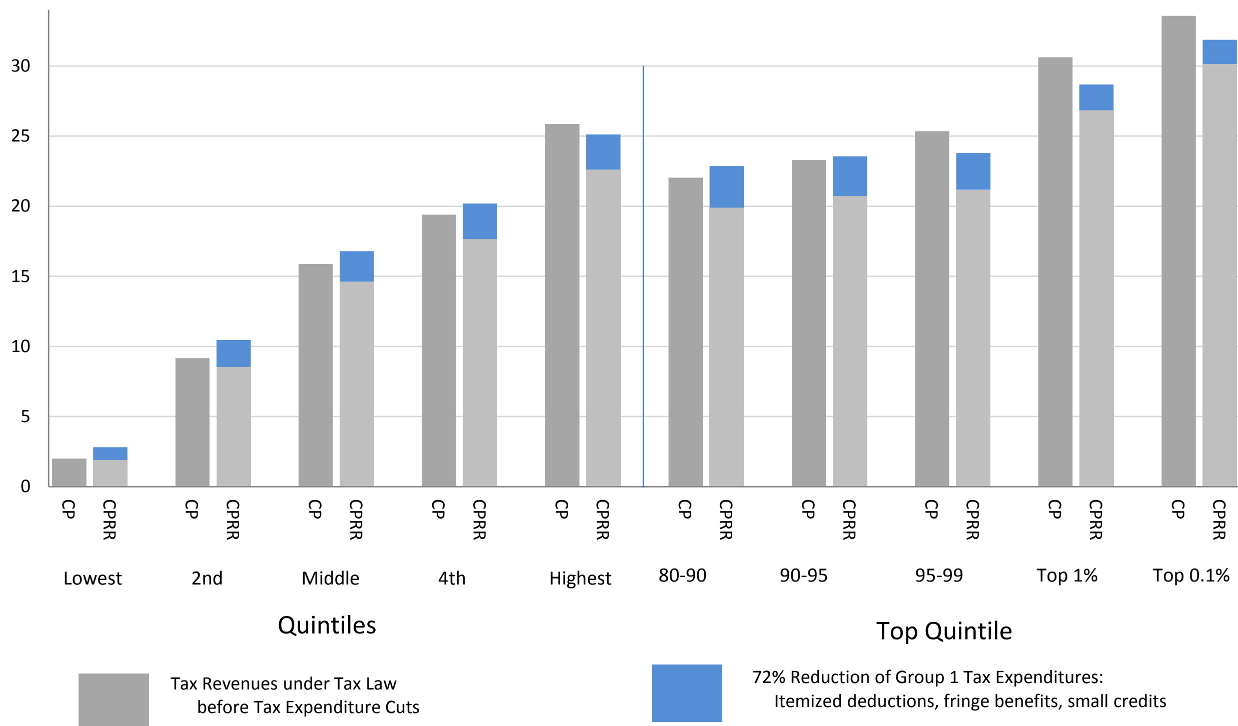
**Chart 6. Group 1 Tax Expenditures under Current Policy with Reduced Rates**




Note: Interactions among provisions have been prorated across the individual provisions.

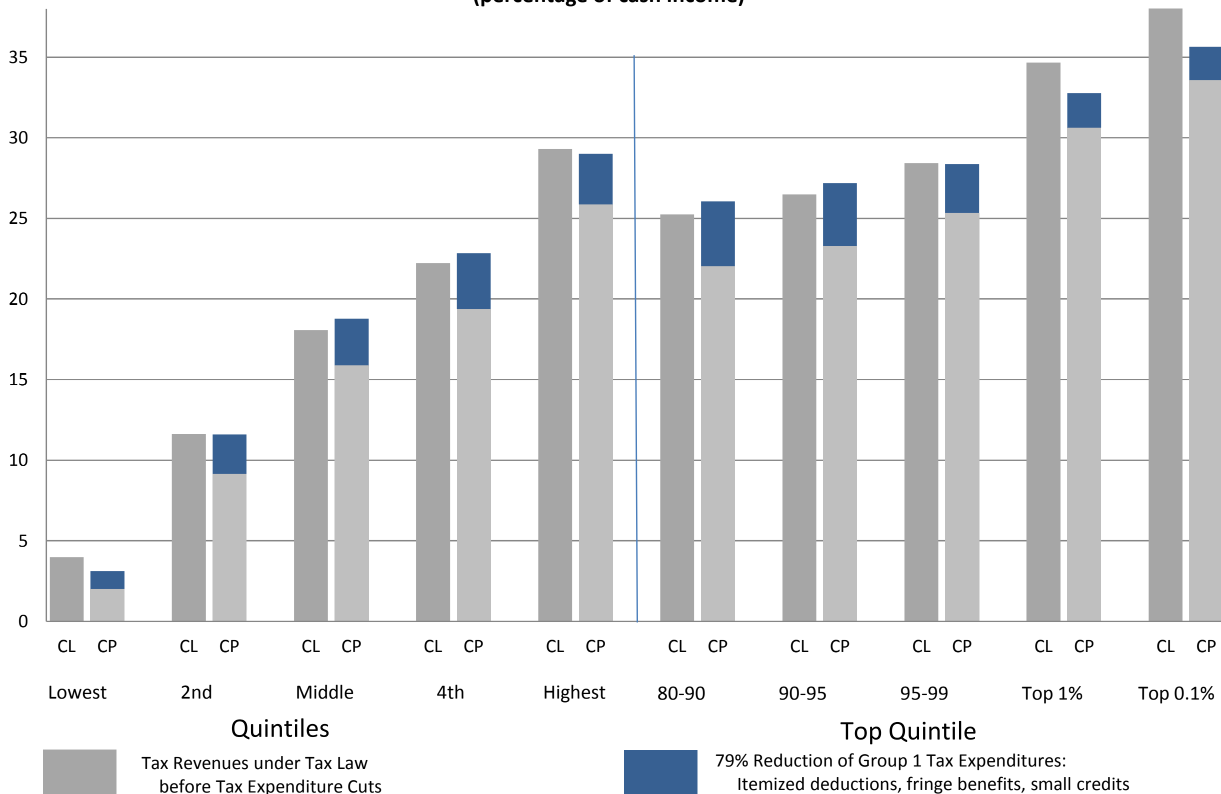
Cutting all Group 1 tax expenditures by 72 percent to meet the Current Policy revenue target under Current Policy with Reduced Rates would result in a different distribution of the tax burden than under Current Policy (Chart 7). The combination of base broadening, a 20-percent across-the-board cut in ordinary income tax

**Chart 7. Effective Tax Rates under Current Policy (CP) and under Current Policy with Reduced Rates (CPRR) plus Reduced Group 1 Tax Expenditures by Income Percentile, 2015 (percentage of cash income)**



rates, and elimination of the individual AMT would increase tax burdens for the first four quintiles, but cut taxes for the top quintile. Within the top quintile, tax burdens would rise for all groups below the 95th percentile and decline for the top 5 percent, with the top 1 percent getting the largest reduction in their effective tax rate. Although a different mix of reductions in Group 1 tax expenditures might alter this distributional result some, the top 5 percent would likely receive a net tax cut relative to Current Policy.

The second target—Current Law individual income tax revenues in 2015—is projected to be $1,757 billion. Meeting that goal requires an additional $379 billion of revenue under Current Policy and $699 billion of revenue under Current Policy with Reduced rates. Cutting all Group 1 tax expenditures by 79 percent would close the $379 billion gap under Current Policy. Although that reduction in tax expenditures is comparable to that required to reach the first target under Current Policy with Reduced Rates, shifting from Current Law to Current Policy with reduced tax expenditures would have sharply different distributional effects (Chart 8). Relative to Current Law, the lowest quintile would receive a tax cut, the second quintile and taxpayers in the 95th to 99th percentiles would see essentially no change in their effective tax rates. Those in the 40th through 95th percentiles would experience tax increases. As in the example with the first revenue target, the largest tax cuts would go to the top 1 percent.



Closing the $699 billion gap under Current Policy with Reduced Rates would be much harder. Eliminating all of the Group 1 tax expenditures would raise $446 billion, leaving a gap of $253 billion. That shortfall might be met by cutting Group 2 tax expenditures (investment and retirement income) by more than 75 percent. But that option would be contrary to the stated policy goals of presidential candidate Mitt Romney and of many members of Congress. An alternative approach would be to reduce tax expenditures from both Group 2 and Group 3 (child, work-related, and Social Security benefits). But cutting Group 3 tax expenditures would violate the policy goals of President Obama and of many members of Congress. Yet another approach might spread the required reductions over Groups 1, 2 and 3, or perhaps even to consider some of the Group 4 provisions. Each approach would have quite different effects on the distribution of the tax burden. Because there is no clear base broadening approach for closing the $699 billion gap under Current Policy with Reduced Rates, we do not evaluate that situation.[15]

**Some Concluding Observations**

As these illustrative examples demonstrate, broadening the tax base to offset the revenue lost to lower rates would require curtailing broadly used and popular tax expenditure provisions, and might well mean curtailing provisions that would require major policy concessions from the leadership of both political parties. Further, the underlying presumption in the examples, that there is an agreed-upon target for revenues, presumes a much higher level of political agreement than appears likely at present. Coming to agreement on an actual set of base broadening provisions and income tax rates, however, might be the most difficult hurdle of all. Our focus here has been on the distributional consequences across income groups of base broadening under alternative rates, but in reaching political consensus the focus of attention will also be on precisely who is made better or worse off *within* income classes; the "winners and losers" from tax reform. And besides questions of revenue and fairness, any major tax reform must also carefully weigh effects on economic efficiency and the administrative burdens placed on taxpayers.

In conclusion, it is possible to maintain revenues in the face of large marginal tax rate cuts by paring back tax expenditures, but it would be very difficult. And the task becomes much harder if another objective is to maintain the progressivity of the federal income tax.

[15] Appendix Table A-2 provides effective tax rates by quintile for revenues and each group of tax expenditures for each tax law. Readers can use those values to construct alternative distributions based on proportional reductions in the tax expenditure groups designed to close the $699 billion gap.

## Table A-1: Detailed List of the Tax Expenditures by Group

**(Numbering and descriptions from the *Fiscal Year 2013 Budget*)**

### Group 1 (Itemized and Above-the-Line Deductions, Most Employer Fringe Benefits, Small Credits)

| | | | |
|---|---|---|---|
| 2 | Exclusion of income earned abroad by U.S. citizens | 116 | Work opportunity tax credit |
| 20 | Exclusion of utility conservation subsidies | 120 | Assistance for adopted foster children |
| 29 | Credit for energy efficiency improvements to existing homes | 121 | Adoption credit and exclusion |
| 30 | Credit for energy efficient appliances | 122 | Exclusion of employee meals and lodging (other than military) |
| 31 | Credit for residential energy efficient property | 126 | Deductibility of charitable contributions, other than education and health |
| 48 | Income averaging for farmers | 132 | Exclusion of employer contributions for medical insurance premiums and medical care |
| 59 | Deductibility of mortgage interest on owner-occupied homes | 133 | Self-employed medical insurance premiums |
| 60 | Deductibility of State and local property tax on owner-occupied homes | 135 | Deductibility of medical expenses |
| 68 | Credit for homebuyer | 139 | Deductibility of charitable contributions (health) |
| 85 | Exclusion of reimbursed employee parking expenses | 142 | Tax credit for health insurance purchased by certain displaced and retired individuals |
| 86 | Exclusion for employer-provided transit passes | 143 | Distributions from retirement plans for premiums for health and long-term care insurance |
| 98 | Exclusion of scholarship and fellowship income (normal tax method) | 154 | Premiums on group term life insurance |
| 99 | HOPE tax credit | 155 | Premiums on accident and disability insurance |
| 100 | Lifetime Learning tax credit | 156 | Income of trusts to finance supplementary unemployment benefits |
| 101 | American Opportunity Tax Credit | 157 | Special ESOP rules |
| 103 | Deductibility of student-loan interest | 158 | Additional deduction for the blind |
| 104 | Deduction for higher education expenses | 159 | Additional deduction for the elderly |
| 110 | Parental personal exemption for students age 19 or over | 160 | Tax credit for the elderly and disabled |
| 111 | Deductibility of charitable contributions (education) | 161 | Deductibility of casualty losses |
| 113 | Special deduction for teacher expenses | 172 | Deductibility of nonbusiness State and local taxes other than on owner-occupied homes |

## Group 2 (Investment and Retirement Income)

13 Capital gains treatment of royalties on coal
14 Exclusion of interest on energy facility bonds
21 Credit for holding clean renewable energy bonds
32 Qualified energy conservation bonds
37 Exclusion of interest on bonds for water, sewage, and hazardous waste facilities
38 Capital gains treatment of certain timber income
41 Exclusion of gain or loss on sale or exchange of certain brownfield sites
47 Capital gains treatment of certain income
57 Exclusion of interest on owner-occupied mortgage subsidy bonds
58 Exclusion of interest on rental housing bonds
61 Deferral of income from installment sales
64 Exception from passive loss rules for $25,000 of rental loss
67 Discharge of mortgage indebtedness
69 Cancellation of indebtedness
70 Exceptions from imputed interest rules
71 Treatment of qualified dividends
72 Capital gains (except agriculture, timber, iron ore, and coal)
73 Capital gains exclusion of small corporation stock
75 Carryover basis of capital gains on gifts
76 Ordinary income treatment of loss from small business corporation stock sale
81 Exclusion of interest on small issue bonds
88 Exclusion of interest on bonds for Highway Projects and rail-truck transfer facilities
90 Exclusion of interest for airport, dock, and similar bonds
95 Credit to holders of Gulf Tax Credit Bonds.
96 Recovery Zone Bonds 9/
97 Tribal Economic Development Bonds
102 Education Individual Retirement Accounts
105 Qualified tuition programs
106 Exclusion of interest on student-loan bonds
107 Exclusion of interest on bonds for private nonprofit educational facilities
109 Exclusion of interest on savings bonds redeemed to finance educational expenses
114 Discharge of student loan indebtedness
115 Qualified school construction bonds
134 Medical Savings Accounts / Health Savings Accounts
136 Exclusion of interest on hospital construction bonds
149 Employer plans
150 401(k)-type plans
151 Individual Retirement Accounts
152 Low and moderate income savers credit
153 Self-Employed plans
169 Exclusion of interest on veterans housing bonds
170 Exclusion of interest on public purpose State and local bonds
171 Build America Bonds
173 Deferral of interest on U.S. savings bonds

## Group 3 (Child, Work-Related, Social Security Benefits)

| | | | |
|---|---|---|---|
| 123 | Child credit | 162 | Earned income tax credit |
| 124 | Credit for child and dependent care expenses | 163 | Social Security benefits for retired workers |
| 137 | Refundable Premium Assistance Tax Credit | 164 | Social Security benefits for disabled workers |
| 138 | Credit for employee health insurance expenses of small business | 165 | Social Security benefits for spouses, dependents and survivors |
| 144 | Exclusion of railroad retirement system benefits | | |

## Group 4 (Other Preferences)

| | | | |
|---|---|---|---|
| 1 | Exclusion of benefits and allowances to armed forces personnel | 128 | Exclusion of parsonage allowances |
| 3 | Exclusion of certain allowances for Federal employees abroad | 130 | Exclusion for benefits provided to volunteer EMS and firefighters |
| 52 | Exclusion of interest on life insurance savings | 145 | Exclusion of workers' compensation benefits |
| 56 | Exclusion of interest spread of financial institutions | 146 | Exclusion of public assistance benefits (normal tax method) |
| 62 | Capital gains exclusion on home sales | 147 | Exclusion of special benefits for disabled coal miners |
| 63 | Exclusion of net imputed rental income | 148 | Exclusion of military disability pensions |
| 74 | Step-up basis of capital gains at death | 166 | Exclusion of veterans death benefits and disability compensation |
| 112 | Exclusion of employer-provided educational assistance | 167 | Exclusion of veterans pensions |
| 118 | Employer provided child care exclusion | 168 | Exclusion of GI bill benefits |
| 127 | Exclusion of certain foster care payments | | |

## Noncorporate Business Individual Income Tax Expenditures Omitted from Analysis

| | |
|---|---|
| 7 | Expensing of research and experimentation expenditures (normal tax method) |
| 8 | Credit for increasing research activities |
| 9 | Expensing of exploration and development costs, fuels |
| 10 | Excess of percentage over cost depletion, fuels |
| 11 | Alternative fuel production credit |
| 12 | Exception from passive loss limitation for working interests in oil and gas properties |
| 15 | Energy production credit |
| 16 | Energy investment credit |
| 17 | Alcohol fuel credits |
| 18 | Bio-Diesel and small agri-biodiesel producer tax credits |
| 19 | Tax credit and deduction for clean-fuel burning vehicles |
| 23 | Credit for investment in clean coal facilities |
| 24 | Temporary 50% expensing for equipment used in the refining of liquid fuels |
| 25 | Natural gas distribution pipelines treated as 15-year property |
| 26 | Amortize all geological and geophysical expenditures over 2 years |
| 27 | Allowance of deduction for certain energy efficient commercial building property |
| 28 | Credit for construction of new energy efficient homes |
| 33 | Advanced Energy Property Credit |
| 34 | Advanced nuclear power production credit |
| 35 | Expensing of exploration and development costs, nonfuel minerals |
| 36 | Excess of percentage over cost depletion, nonfuel minerals |
| 39 | Expensing of multiperiod timber growing costs |
| 40 | Tax incentives for preservation of historic structures |
| 42 | Industrial CO2 capture and sequestration tax credit |
| 43 | Deduction for endangered species recovery expenditures |
| 44 | Expensing of certain capital outlays |
| 45 | Expensing of certain multiperiod production costs |
| 46 | Treatment of loans forgiven for solvent farmers |
| 50 | Expensing of reforestation expenditures |
| 65 | Credit for low-income housing investments |
| 66 | Accelerated depreciation on rental housing (normal tax method) |
| 77 | Accelerated depreciation of buildings other than rental housing (normal tax method) |
| 78 | Accelerated depreciation of machinery and equipment (normal tax method) |
| 79 | Expensing of certain small investments (normal tax method) |
| 82 | Deduction for US production activities |
| 83 | Special rules for certain film and TV production |
| 87 | Tax credit for certain expenditures for maintaining railroad tracks |
| 89 | Investment credit for rehabilitation of structures (other than historic) |
| 92 | Empowerment zones, the DC enterprise zone, and renewal communities |
| 93 | New markets tax credit |
| 94 | Expensing of environmental remediation costs |
| 125 | Credit for disabled access expenditures |
| 129 | Employee retention credit for employers in certain federal disaster areas |

**Table A-2. Effective Tax Rates by Percentile under Alternative Tax Laws in 2015[1]**
**(percentage of cash income)**

| | Quintiles | | | | | Top Quintile | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | **Lowest** | **2nd** | **Middle** | **4th** | **Highest** | **80%-90%** | **90%-95%** | **95%-99%** | **Top 1%** | **Top 0.1%** |
| Current Law | | | | | | | | | | |
| Tax Revenue | 4.0 | 11.6 | 18.1 | 22.2 | 29.3 | 25.3 | 26.5 | 28.4 | 34.7 | 38.0 |
| Tax Expenditures, Total | 7.3 | 7.4 | 6.5 | 7.7 | 12.3 | 9.3 | 11.7 | 12.3 | 15.1 | 17.4 |
| 1. Deductions, fringe benefits, small credits | 1.3 | 3.2 | 4.3 | 5.3 | 4.4 | 5.5 | 5.4 | 4.3 | 2.9 | 2.6 |
| 2. Investment and retirement income | 0.3 | 0.3 | 0.5 | 1.3 | 5.3 | 2.7 | 4.7 | 5.6 | 7.4 | 8.4 |
| 3. Child, work-related, Social Security benefits | 5.2 | 3.4 | 0.9 | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| 4. Other preferences | 0.4 | 0.6 | 0.8 | 0.9 | 2.7 | 1.1 | 1.6 | 2.4 | 4.7 | 6.3 |
| Current Policy | | | | | | | | | | |
| Tax Revenue | 2.0 | 9.2 | 15.9 | 19.4 | 25.9 | 22.0 | 23.3 | 25.4 | 30.6 | 33.6 |
| Tax Expenditures, Total | 8.2 | 8.1 | 6.3 | 7.0 | 11.6 | 8.7 | 11.0 | 11.3 | 14.4 | 17.0 |
| 1. Deductions, fringe benefits, small credits | 1.4 | 3.1 | 3.7 | 4.4 | 4.0 | 5.1 | 4.9 | 3.8 | 2.7 | 2.6 |
| 2. Investment and retirement income | 0.3 | 0.3 | 0.4 | 1.2 | 5.2 | 2.5 | 4.6 | 5.3 | 7.4 | 8.7 |
| 3. Child, work-related, Social Security benefits | 6.2 | 4.2 | 1.5 | 0.6 | 0.0 | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 |
| 4. Other preferences | 0.3 | 0.5 | 0.7 | 0.8 | 2.4 | 1.0 | 1.5 | 2.2 | 4.3 | 5.7 |
| Current Policy with Reduced Rates | | | | | | | | | | |
| Tax Revenue | 1.9 | 8.5 | 14.6 | 17.7 | 22.6 | 19.9 | 20.7 | 21.2 | 26.8 | 30.1 |
| Tax Expenditures, Total | 7.8 | 7.3 | 5.3 | 5.7 | 9.4 | 7.0 | 8.5 | 9.7 | 11.6 | 13.3 |
| 1. Deductions, fringe benefits, small credits | 1.3 | 2.7 | 3.0 | 3.5 | 3.5 | 4.1 | 3.9 | 3.6 | 2.6 | 2.4 |
| 2. Investment and retirement income | 0.2 | 0.2 | 0.3 | 1.0 | 3.9 | 1.9 | 3.4 | 4.2 | 5.5 | 6.2 |
| 3. Child, work-related, Social Security benefits | 6.1 | 3.9 | 1.4 | 0.6 | 0.0 | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 |
| 4. Other preferences | 0.2 | 0.4 | 0.6 | 0.7 | 2.0 | 0.8 | 1.1 | 1.8 | 3.5 | 4.7 |

Source: Tax Policy Center Microsimulation Model.

[1] Effective tax rates are taxes (individual income, corporate income, payroll, and estate and gift) as a percent of cash income.