Committee for a Responsible Federal Budget

Tax Working Paper

Raising Revenue from Higher Earners through Base Broadening
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As lawmakers consider various approaches to reforming the tax code and dealing with expiring tax cuts at year's end, there has been much debate over the tax treatment of high-income earners. Republicans have called for extending virtually all of the 2001/2003/2010 income and estate tax cuts, while Democrats have called for allowing these cuts to expire on individual income above $200,000 and family income above $250,000.

Ideally, policymakers would abandon the debate over whether or not to extend the tax cuts and instead enact a comprehensive re-write of the tax code that reduces tax preferences to not only cut the deficit but also lower rates and improve simplicity and fairness. Unfortunately, such a re-write of the tax code is not possible in the six weeks between now and the end of the year, when the 2001/2003/2010 tax cuts expire. At the same time, simply extending all the tax cuts with a promise of future tax reform, without offsetting any of the costs, would not be seen as credible to financial markets nor the negotiating parties.

Fortunately, there may be a middle-ground in which Democrats can raise revenues from higher earners and Republicans can avoid rate increases. There are some relatively simple tax changes that could be enacted for tax year 2013 to raise the same amount of revenue as letting the upper-income tax cuts expire, from only households earning above $250,000, and without increasing current tax rates.

In this paper, CRFB discuss three models to achieve this goal:

- Placing a dollar cap on itemized deductions for higher earners
- Limiting the combined value of various deductions, credits, and exclusions for higher earners
- Implementing a rate-value limitation on some deductions and exclusions and phasing this limitation down and out at higher-income levels

Ultimately, policymakers should pursue comprehensive tax reform that makes decisions on how to reform or repeal specific tax preferences and uses the revenue to both lower rates and reduce deficits. In the interim, however, the limitations described in this paper can help to move tax reform in the right direction.

What Are the "Upper Income Tax Cuts" and How Much Do They Cost?

When the President and others refer to the upper-income tax cuts, they are generally talking about the changes made to the tax code enacted in 2001 and 2003 and extended in 2010 that apply to individual income above $200,000 per year and household income above $250,000 per year. Both political parties have supported at least temporarily extending the tax cuts that apply to income below $200,000/$250,000 per year, including those that would also benefit higher earners. (As an example, both parties support retaining the bottom rate of 10 percent, as opposed to allowing it to increase to 15 percent, even though taxpayers at higher brackets would still benefit from it.)

Together, extending these policies would cost between $695 and $950 billion (depending on the details) compared to current law, meaning that allowing them to expire would raise a similar amount relative to a current policy baseline that extended all the 2001/2003/2010 tax cuts.

Earlier this year, Senate Democrats proposed a one year-extension of most provisions in the 2001/2003/2010 income tax cuts while allowing the following provisions to change from current policy for those making above $200,000/$250,000 per year:

- An increase in the top two rates of 33 and 35 percent to 36 and 39.6 percent
- An increase in the capital gains rate from 15 to 20 percent above $200,000/$250,000
- An increase in the dividends rate from 15 to 20 percent above $200,000/$250,000
- The reinstatement of the personal exemption phase-out (PEP) for higher earners
- The reinstatement of the Pease provision, which indirectly reduces the value of itemized deductions, for taxpayers with incomes above $200,000/$250,000.

Taken together, these policies would be worth about **$50 billion** for a single year. Over ten years, these policies would be worth roughly **$695 billion**[1].

In addition to these policies, a number of Democrats support reverting the estate tax to 2009 levels – a 45 percent top rate with a $3.5 million exemption as opposed to today's 35 percent top rate on a $5.1 million exemption. That addition to a one-year extension would be worth a total of roughly **$60 billion**. The Administration has also called for taxing dividends for higher earners as ordinary income (a top rate of 39.6 percent) as called for under current law, as opposed to the 20 percent called for by Senate Democrats, which would likely be worth roughly

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[1] This number, along with Figure 1, has been corrected from an earlier version that was based on estimates that "stacked" the provision to tax dividends as ordinary income before the provision to increase rates, therefore counting the interaction within the rate changes. This correction does not affect the overall savings, and actual savings from allowing only some of the upper-income tax cuts to expire may differ from the sum in the figures above due to various interactions.

[2] Estimates are generally based off of tables from the Tax Policy Center and the Feldstein-Feenberg-MacGuineas proposal. The former relies on cash income and the latter on adjusted gross income (AGI). Phase-ins are not modeled but rather imputed roughly. Throughout this paper, revenue-source estimates come from multiplying total revenue

$70 billion. Over ten years, enacting all of these policies together would be worth roughly **$950 billion**.

Fig. 1: Revenue from Allowing the Upper-Income Tax Cuts to Expire (Billions)

	2013 Only	2013-2022
Allow Top Two Rates to Increase from 33% and 35% to 36% and 39.6%	$29	$440
Reinstate Pease for income above $200K/$250K	$7	$110
Reinstate PEP for income above $200K/$250K	$3	$40
Allow Capital Gains Rate to Rise to 20% for People Above $250K	$7	$60
Tax Dividends at 20% for People Above $250K	$3	$45
Subtotal, Senate Proposal	**~$50**	**$695**
Allow Dividends to Be Taxed as Ordinary Income Above $250K*	$9	$120
Extend 2009 Estate Tax Parameters	$9	$135
Subtotal, Administration Additions	**~$20**	**$255**
Total Savings	**~$70**	**$950**

Sources: Tax Policy Center, Congressional Budget Office, Office of Management and Budget.
Note: Figures exclude interactions with the Alternative Minimum Tax.
*Savings above taxing dividends at 20 percent.

The Case for Replacing the Upper-Income Tax Cuts

The revenue generated from allowing the upper-income tax cuts would certainly help to improve our debt situation, particularly in concert with other revenues, spending cuts, and entitlement reforms. However, there are probably better ways to generate the same revenue.

Most economists agree that for a given revenue target, economic growth is better served by a lower tax rate than a higher one. It is for that reason that the mantra of lowering the rates and broadening the base is so popular. Yet, a large portion of the revenue raised from letting the upper-income tax cuts expire would be raised through higher marginal rates that could have some negative effects on people's incentive to work or invest.

Those who support generating revenue from increasing the top rates tend to do so for distributional reasons, based on a belief that the top two percent of Americans – those making above $200,000/$250,000 per year – should pay more to help reduce the deficit. However, what is important for distributional outcomes is not the *marginal tax rate* taxpayers face, but rather the *average tax rates*. And it is possible to raise average tax rates without raising (and even by lowering) marginal rates.

According to the Tax Policy Center, more than 40 percent of tax expenditures – deductions, credits, exclusions, and special rates – accrue to those with incomes above $200,000 per year. Plans like those proposed by the Simpson-Bowles Fiscal Commission and the Domenici-Rivlin Debt Reduction Task Force have shown it is possible to reform the tax code in a way that repeals or reforms many of these tax expenditures while lowering rates, reducing the deficit, and still asking higher earners to contribute the most (see Box 1).

Such comprehensive tax reform cannot be written in the six weeks remaining before the new year. However, policymakers could fairly easily design a limitation on tax expenditures for higher earners and keep rates where they currently are. They could then use the next year to pursue and hopefully enact comprehensive reform.

Options to Replace the Upper-Income Tax Cuts with Base Broadening

The intricacies of tax reform make it impossible to work out all the complexities and transition rules for a detailed and comprehensive tax reform legislation in just a six-week period. Yet, the expiration of the 2001/2003/2010 tax cuts necessitates quick decision-making. Given this timeline, policymakers might consider a broad-based limit on tax expenditures to replace the revenue from allowing the upper-income tax cuts to expire.

A limit could take any of a number of forms, and could either be designed to be very progressive with the vast majority of the revenue coming from the highest earners, or could be even more progressive by applying exclusively to people earning more than $200,000/$250,000.

Below, we walk through three models for broadly limiting tax expenditures with the limitation applying exclusively to higher earners. From these examples, we show how it is possible to achieve the equivalent revenues from letting the upper-income tax cuts expire without raising taxes on those making below $200,000/$250,000 and without increasing marginal rates.

In each case we focus on the revenue raised from the policy over a single-year. Ideally, policymakers would use that year to legislate comprehensive tax reform that addresses specific tax expenditures and provisions of the tax code and uses the revenue to reduce rates, improve simplicity, and further reduce the deficit.

Just as the costs of the upper income tax cuts would grow over time, so too would the revenue raised from any of the options we present if they were made permanent.

Importantly, revenue estimates are very rough but all policies can be dialed and modified if savings prove to be either too low or too high.[2]

Model I: Limit the Amount of Itemized Deductions to $25,000 for Higher Earners

[2] Estimates are generally based off of tables from the Tax Policy Center and the Feldstein-Feenberg-MacGuineas proposal. The former relies on cash income and the latter on adjusted gross income (AGI). Phase-ins are not modeled but rather imputed roughly. Throughout this paper, revenue-source estimates come from multiplying total revenue estimates by share of total federal tax change for each income group. Models I and III are estimated off of Tax Policy Center distribution tables, which are static and therefore might not represent precise distribution after behavior. For purposes of measuring distribution, however, most economists agree that static estimates are a more useful reflection of change in economic welfare.

One way to generate substantial revenue from higher earners is to limit the amount they can take in itemized deductions each year. Currently, taxpayers are allowed to deduct the amount they pay in state and local taxes, mortgage interest, charitable giving, and certain other expenses and therefore count those expenses against their income.

Capping these deductions at a dollar amount, for example $25,000, would in itself be progressive given that two thirds of itemizers don't rely on itemized deductions and only 11 percent have deductions as high as $25,000. According to the Tax Policy Center, such a cap would generate nearly three quarters of the revenue from tax units with income above $200,000 per year.

To make this policy more progressive, the option presented below would limit the total itemized deductions to $25,000 per year for higher earners only. Those making above $200,000/$250,000 would be able to fully deduct their first $25,000 of deductible expenses and partially deduct the remaining expenses, with that partial deduction phasing out completely for those with income at $400,000/$500,000.

Based on estimates from the Tax Policy Center, applying this to all taxpayers in tax year 2013 would raise roughly $94 billion. We estimate roughly that phasing it in for higher earners would raise nearly **$60 billion** – the equivalent to the revenue raised by the Senate tax bill assuming 2009 parameters for the estate tax.

Fig. 2: Revenue from Limiting Itemized Deductions to $25,000 in 2013

2013 Cash Income	Limit Itemized Deductions to $25,000	Phase in Limit Between $250k and $500k
$0 to $200k	$26 billion	$0 billion
$200k to $500k	$17 billion	$7 billion
$500k-$1000k	$8 billion	$7 billion
>$1000k	$43 billion	$43 billion
TOTAL REVENUE	**$94 billion**	**$57 billion**

Source: Authors' estimates based on data from the Tax Policy Center.

If necessary, additional revenue could be raised by incorporating additional tax expenditures such as various above-the-line deductions, exclusions, or even the standard deduction and personal exemptions. The limit amount could also be changed.

Model II: Cap the After-Tax *Value* of Certain Tax Expenditures for Higher Earners

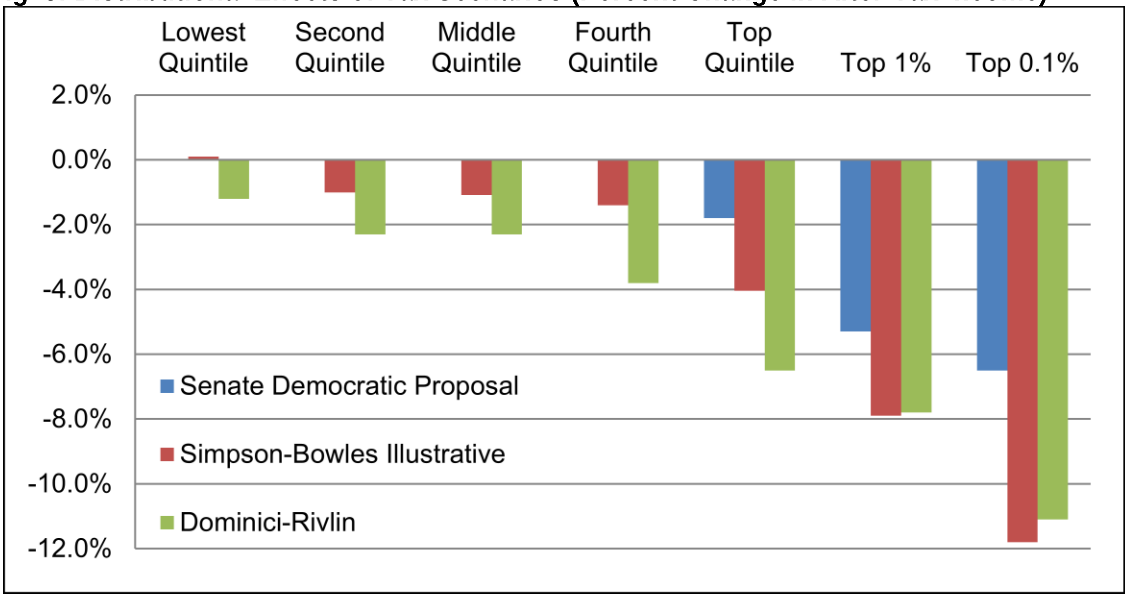
Rather than capping the amount individuals can deduct, an alternative would be to cap the value of tax expenditures – including not only deductions but also tax exclusions and credits. A version of this cap was put forward in a paper by Martin Feldstein, Daniel Feenberg, and CRFB President Maya MacGuineas – and is often referred to as the Feldstein-Feenberg-MacGuineas (FFM) cap.

Box 1: Improving or Maintaining Progressivity of the Tax Code through Base Broadening

While this analysis focuses on ways to improve progressivity through various tax expenditure limits, it is also possible to enact comprehensive tax reform that increases progressivity while substantially reducing rates. Both the Simpson-Bowles illustrative tax plan and the Dominici-Rivlin Debt Reduction Task Force tax plans, in fact, were able to improve progressivity with a top rate of 28 percent.

According to analysis from the Tax Policy Center, both plans would result in a far larger change in after-tax income for the top one percent and 0.1 percent than allowing the upper-income tax cuts to expire – although, unlike allowing the upper-income tax cuts to expire, they *do* require some new revenue on middle-income earners. They would also generate more total revenue.

Fig. 3: Distributional Effects of Tax Scenarios (Percent Change in After-Tax Income)



Source: Tax Policy Center.
Note: Plans are measured in different years and from baselines that are similar, but not strictly comparable. Senate Democrat proposal includes AMT patch and estate tax at 2009 parameters.

How is it possible that these plans are so progressive with a top rate that is so low? Both plans target highly regressive tax expenditures. Both plans would tax capital gains as ordinary income (at 28 percent) and get rid of the tax preference that allows capital gains to avoid any taxes if they are passed down after death. Both plans also eliminate the highly regressive state and local tax deduction as well as a number of other tax preferences that accrue to the highest earners – many of which cannot be easily addressed by an across-the-board-approach. Both plans also replace regressive deductions like those for mortgage interest and charitable giving with progressive credits available to everyone. And after all that, both plans reduce tax rates across-the-board – including at lower incomes.

The results show that comprehensive tax reform, not just a limitation for higher earners, can result in a progressive tax code.

To understand the difference between this cap and the previous model, it's worth recalling that the value of a deduction is equal to the amount deducted times the marginal rate. As an example, the value of deductions for individual deducting $100,000 and paying at the 35 percent rate would be $35,000, while the value under the 25 percent tax rate the would be $25,000.

One advantage of the FFM cap is that it makes it easy to combine different types of tax expenditures – including credits, deductions, and exclusions – into a single limitation. Their specific proposal would include all itemized deductions, the child tax credit, and the exclusion for employer-provided health insurance – though others could be added.

The original FMM proposal would cap these tax expenditures at 2 percent of adjusted gross income (AGI), with the paper also suggesting the possibility of an additional dollar limit at $10,000. That policy could be made more progressive by phasing it in for families earning between $250,000 and $500,000.

Fig. 4: Revenue from Instituting a Feldstein-Feenberg-MacGuineas Style Cap in 2013

2013 AGI	Original FFM w/ $10,000 cap	*Applied Above $200k/$250k*	Include Additional TEs*
$0 to $200k	$213 billion	$0 billion	$0 billion
$200k to $300k	$21 billion	$10 billion	$15 billion
$300k-$500k	$16 billion	$10 billion	$15 billion
>$500k	$66 billion	$66 billion	$80 billion
TOTAL REVENUE	**$317 billion**	**$86 billion**	**$110 billion**

Source: Authors' estimates based on Feldstein-Feenberg-MacGuineas data.
*Exclusion of interest on State & Local Bonds costs $25 billion, about $21 billion from higher earners (JCT and TPC); Foreign-Earned Income Exclusion costs $7 billion, about $1 billion from higher earners (JCT and IRS); credits total about $1 billion for higher earners (IRS); Above-the-Line deductions cost about $9 billion, including $2 billion from higher earners (TPC).

Based on estimates from Feldstein, Feenberg, and MacGuineas – updated to reflect 2013 – the original FMM proposal with a 2 percent of AGI and $10,000 cap would have raised nearly $320 billion in 2013. We estimate roughly that applying this proposal only to higher earners would raise about **$85 billion**. If one were to incorporate additional tax expenditures such as the exclusion of interest for State & Local bonds that number might increase to roughly **$110 billion** – which is far more than what would be raised from letting the upper-income tax cuts expire.

Model III: Limit the Value of Certain Tax Expenditures to the 28 Percent Bracket and then Phase out the Value for Millionaires

A third model for tax expenditure reform would be to combine a limit on the tax preference value of each dollar deducted and phase down that value as income grows.

The first part of this proposal comes from the President, who in his FY2013 budget proposed to limit the value of all itemized deductions, most above-the-line deductions, and exclusions for health care, interest on bonds, and foreign-earned income to the 28 percent bracket. This prevents tax expenditures from growing in value (as a percent of the deduction) for those making above $200,000/250,000 as they move into the 33 and 35 percent tax brackets.

By itself, that proposal would likely raise less than $25 billion in 2013 with a top rate of 35 percent, and only $15 billion if applied more narrowly to itemized deductions only. However, one could phase down this limitation as income grows. The option below would reduce the limitation by 1 percent for every $25,000 of income beyond $300,000 so it would fall to 26 percent at $350,000, 20 percent at $500,000, and 0 percent above $1 million per year.

Fig. 5: Revenue from Capping and Phasing Out the Deduction-Value of Tax Expenditures

2013 Cash Income	Limit Itemized Deductions to 28%	Phase Down to 0% Above $1m	Include Additional TEs*
$0 to $200k	$0 billion	$0 billion	$0 billion
$200k to $500k	$2 billion	$8 billion	$13 billion
$500k-$1000k	$3 billion	$6 billion	$10 billion
>$1000k	$10 billion	$40 billion	$60 billion
TOTAL REVENUE	**$15 billion**	**$54 billion**	**$83 billion**

Source: Authors' estimates based on data from the Tax Policy Center.
*Includes above-the-line deductions and exclusions for health, interest on bonds, foreign income, and other TEs.

We estimate roughly that applying the limitation to itemized deductions would raise **$55 billion**. Incorporating other tax expenditures as the President does, such as the health exclusion, might increase those savings to above **$80 billion**.

Looking Beyond Broad Tax Expenditure Limitations

The types of policy proposals discussed in this analysis could be used to raise some or all of the revenue necessary to replace the upper-income tax cuts, and in some cases more. If policymakers choose to raise additional revenue on top of these caps from higher earners, they could turn to any of a number of discrete policy changes which would either exclusively or predominantly affect higher earners. Some of these options would simply require allowing some of the 2001/2003/2010 tax cuts to expire while retaining the top rates of 33 and 35 percent. Others would repeal various loopholes or tax preference. Among the options (and estimates for enacting them for a single year, excluding interactions) include:

- Allowing capital gains to rise to 20 percent on income above $200k/$250k **($7 billion)**
- Allowing dividends to be taxed as ordinary income above $200k/$250K **($8 billion)**
- Allowing the restoration of PEP above $200k/$250k **($3 billion)**
- Taxing carried interest as ordinary income **($2 billion)**
- Reducing limits on retirement account contributions by 10 percent **($2 billion)**
- Reverting the estate tax exemption to $5 million as in 2011 **($1 billion)**
- Eliminating the mortgage interest deduction for second homes **($1 billion)**
- Repealing the interest tax exemption for private activity bonds **($1 billion)**

Some of these policies would only make sense if enacted on a long-term basis (as opposed to a single-year basis), but would generate far more revenue over time than in the first year. Even accounting for only the effects from the first tax year, however, they would raise a combined $28 billion – a significant portion of the $50 to $70 billion required to offset an extension of the upper-income tax cuts.

Conclusion

As policymakers work to replace the fiscal cliff with a more gradual and intelligent deficit reduction plan, both individual and corporate tax reform can play an important role. Pursuing such reform would allow policymakers to generate revenue in a more efficient way while promoting growth and fairness and making the debt deal politically easier to negotiate.

Making the reforms necessary to reduce both tax rates and deficits will take substantial time and attention. Policymakers must go line by line through the tax code to figure out which tax expenditure to repeal, which to reform, which to retain, what structural changes to make to the tax code, and how to structure transition rules and phase-ins for whatever changes are made.

Though tax reform is certainly needed, policymakers should not wait for it to be developed to begin generating revenue as part of a comprehensive deficit reduction plan that also includes spending cuts and entitlement reforms. At the same time, it is preferable that policymakers make changes that move in the direction of tax reform – by reducing tax expenditures rather than increasing rates.

The models presented in this paper could all raise substantial revenue beginning in 2013 to give time to design tax reform, and could all do so without raising tax rates or increasing tax burdens on individuals making below $200,000 per year and families making below $250,000.

To achieve this, the models all phase in tax expenditure limits as incomes grow. An alternative approach would be to apply to restrictions on everyone but then reduce rates, increase credits, or expand the personal exemption in order to offset the losses for those making below $200,000/$250,000.

Importantly, as lawmakers do pursue comprehensive tax reform, there will inevitably be winners and losers. Even if those making below $200,000/$250,000 were held harmless on average, improving the efficiency of the code will require that some of them pay more and others less.

In advance of such reform, however, it is certainly possible to raise significant revenue from only higher earners and to do so without increasing ordinary tax rates.

Note: The Committee for a Responsible Federal Budget (CRFB) seeks to raise awareness of issues that have significant fiscal policy impact, and its analysis reflects the views of CRFB alone and not those of its partners or sponsors of affiliated projects, including the Campaign to Fix the Debt.