Wasted Opportunity?

Shoring up Social Security may well be necessary again, although the scope of the program's long-term shortfall is not especially daunting. Indeed, that's the point made by Kevin Drum, a blogger for *Mother Jones* magazine, in a post discussing the Begich plan. Social Security is not in deep financial trouble, Drum wrote. Relatively small adjustments in the existing cap (enough, say, to bring 90 percent of total income under the cap) would solve most of the problem. Lifting the cap entirely, on the other hand, would be overkill — a politically explosive tax increase dedicated to a relatively small problem. He offers some math to make the point:

> If you're a high earner — let's say $500,000 per year — you currently pay 12.4 percent of $110,100 in payroll taxes. That's $13,652, or 2.7 percent of your income. Under Begich's proposal, you'd pay the full 12.4 percent on all your income.
>
> That's a total tax increase and a marginal tax increase of 9.7 percentage points. That's huge. It's four times the increase we'd get from letting the high-end Bush tax cuts expire and double the marginal increase.[11]

The inevitable fight over such a large tax increase isn't worth the stated goal, Drum said. If liberals are going to have that sort of fight, they should use the spoils of their eventual victory for something more challenging than just shoring up a program that doesn't need much help in the first place. ■

CORRECTION

An article in the November 19 edition of *Tax Notes* about the effectiveness of divided Congresses in formulating tax policy incorrectly implied that Republicans controlled the House from 1917 to 1919. ["Opinion: A Divided Congress Can Be Good for Tax Policy," *Tax Notes*, Nov. 19, 2012, p. 832, *Doc 2012-23580*, or *2012 TNT 223-2*.]

Although Republicans won a plurality of House seats in the 65th Congress, Democrats were able to organize the House after winning support from Progressive lawmakers and Socialist Rep. Meyer London. Democrat Champ Clark continued to serve as speaker of the House.

Tax Analysts regrets the error. ■

[11]Drum, "Mark Begich's Gigantic Tax Increase on the Rich," *Mother Jones*, Nov. 16, 2012.

ECONOMIC ANALYSIS

Deduction Caps Can Raise Marginal Rates, Cut Economic Growth

By Martin A. Sullivan — martysullivan@comcast.net

Long-run job creation through tax cutting is a two-step process. The first step is to lower marginal tax rates. Then those lower marginal rates increase taxpayers' willingness to invest and seek employment. Most of the unending argument about the effect of taxes on job creation centers on step two — that is, the responsiveness of saving and labor supply to changes in marginal tax rates.

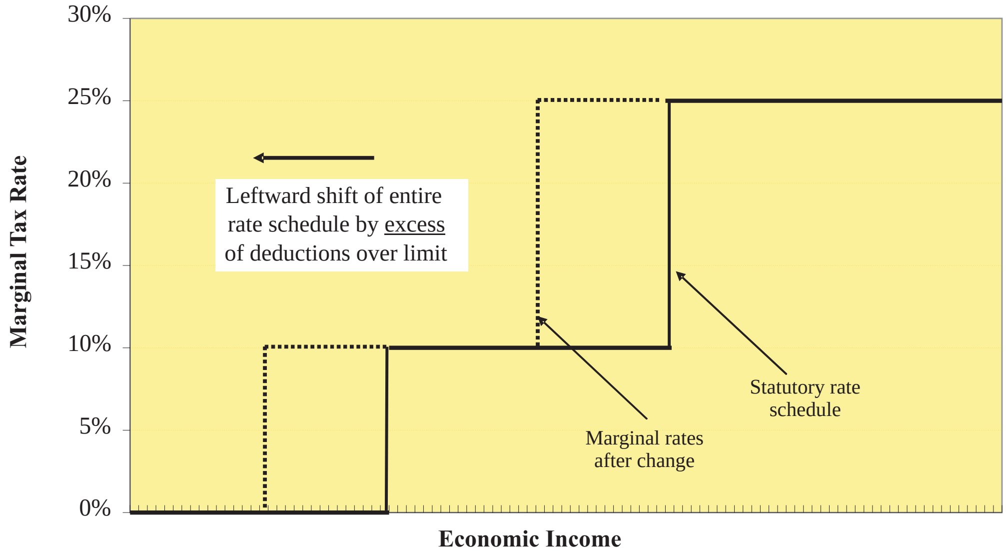
Despite all the effort, there is still enough uncertainty about the empirical research that both pro- and antitax partisans can cite plausible estimates to support their views. This article sidesteps the highly politicized component of the debate about the economic effects of taxes and instead focuses on step one, the oft-neglected arithmetic of the effects of tax reform on marginal rates.

In recent weeks, as our nation's leaders have struggled to find a politically acceptable way to raise taxes, a myth of sorts has developed around the economic power of tax reform. The myth is based on an overoptimistic assessment of the effect of tax reform on marginal rates. On the one hand, yes, it is obviously true that lower statutory rates lower marginal rates. On the other hand, it is also true — but hardly obvious and almost always ignored — that base broadening through limits on deductions and exclusions often increases marginal tax rates for significant parts of the taxpaying public. Therefore, some or all of the benefit of lower statutory rates on labor supply and savings behavior is offset by the effects of higher marginal rates because of base broadening.

> ***It is true — but hardly obvious and almost always ignored — that base broadening through limits on deductions and exclusions often increases marginal tax rates for significant parts of the taxpaying public.***

The negative effects of base broadening on the marginal incentive to work and save exist for a wide variety of proposed tax benefit caps that have been getting a lot of attention. These proposals include: (1) a cap on itemized deductions (and perhaps also exclusions) similar to that proposed by Mitt Romney during the presidential campaign; (2)

Figure 1. Marginal Effective Tax Rates — Fixed Dollar Cap on Deductions (Romney)



a limit on the value of tax benefits equal to 28 percent of the dollar amount of deductions and exclusions, as proposed by President Obama in his fiscal 2013 budget; (3) the phaseout of personal exemptions and the phaseout of itemized deductions (known as Pease phaseouts after the former Ohio representative who originally proposed them in 1990) scheduled to be reinstated with the expiration of the Bush tax cuts on December 31; and (4) the cap on tax benefits (in which benefits are defined by the dollar amount of tax reduction) equal to 2 percent of adjusted gross income, proposed by Harvard economist Martin Feldstein.

The basic intuition regarding why these limitations can raise marginal tax rates is that each one in its own way either shifts the higher rates of the progressive rate structure down the income scale or adds a new, unseen rate to the existing rate structure. To take a simple example, if a married couple with $142,000 of taxable income under current law has their itemized deductions reduced by $5,000 because of any sort of limitation, the couple will be pushed from the 25 percent to the 28 percent bracket, a 12 percent increase in marginal rates.

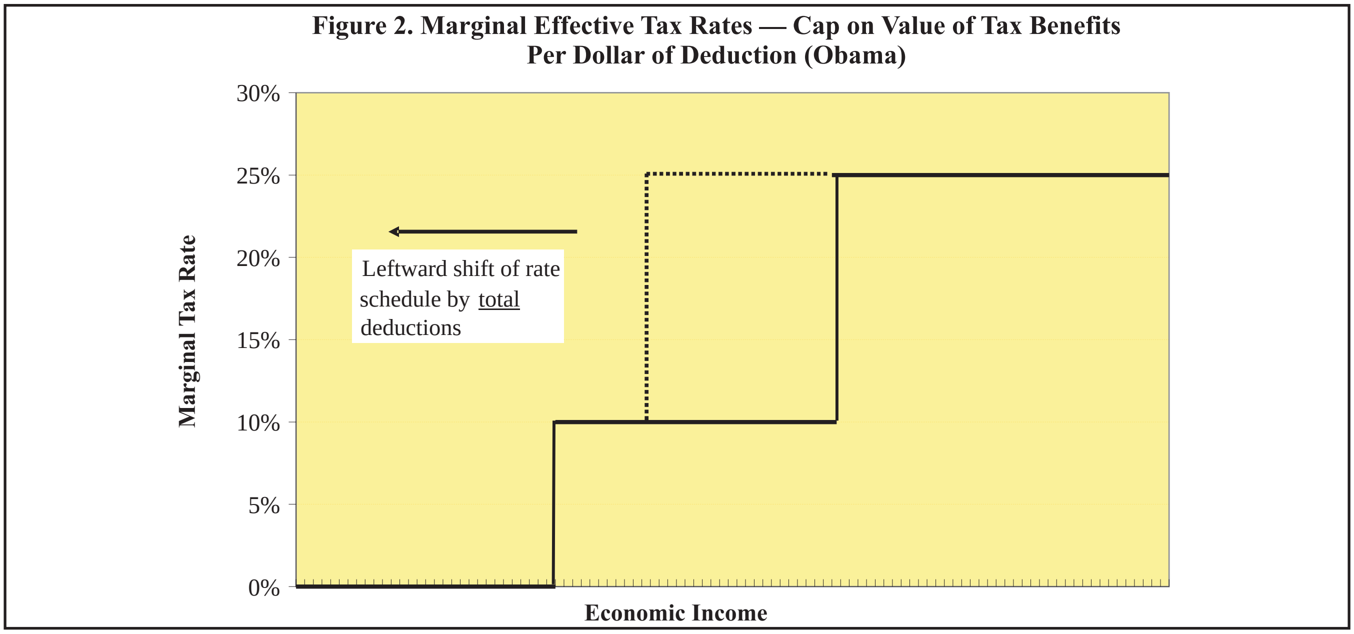
All four of the general approaches described above can have significant effects on marginal tax rates and therefore on economic incentives to work and save. The magnitude of these effects depends on the details of how limitations are specified. They can vary from being insignificant to being so large that they more than offset the benefits of a revenue-neutral rate reduction. So in the best-case scenario, the growth effects of rate cuts in a revenue-neutral reform are muted by limits on deductions. And in the worst-case scenario, we can actually have a revenue-neutral individual income reform that reduces incentives for working and saving.

The message here for Congress is that as it proceeds with revenue-raising tax reform that includes caps on deductions and exclusions, its difficulties will not be limited to resisting immense political pressures from powerful lobbies whose tax benefits are threatened. Congress also must consider the damaging incentive effects of higher marginal rates resulting from the caps. If it cannot minimize marginal rate increases from caps, Congress might want to reconsider using caps and instead adopt straightforward statutory rate increases.

Basics of Each Approach

Each of the four approaches raises effective tax rates for some class of taxpayers. But the size and distribution of those increases in marginal tax rates varies considerably. (Each will also have very different effects on the distribution of the new tax burden. Once Congress puts some real proposals for tax increases on the table, concerns about their divergence from distribution neutrality will be of critical political importance.)

(1) Fixed Dollar Cap on Deduction and Exclusions. When any taxpayer loses the ability to take deductions or exclude income, that taxpayer's taxable income increases. Because the individual income tax has a progressive rate structure, the taxpayer faces higher rates at lower levels of real economic income. With a fixed dollar cap on deductions and exclusions of, for example, $17,000 (the figure initially mentioned by Romney during the campaign),



all taxpayers with deductions and exclusions subject to the cap in excess of $17,000 pay higher taxes. Some of these taxpayers will be pushed into a higher tax bracket and therefore be subject to higher marginal tax rates.

Figure 1 illustrates the effect of such a proposal on a simple hypothetical income tax with a progressive rate structure. The solid line shows marginal rates under a system analogous to current law. The dotted line shows how marginal rates change under the proposal. Taxpayers formerly in the first bracket are pushed into the second bracket as a result of the cap.

(2) Cap on Tax Benefits From Deductions and Exclusions. Under this approach, a taxpayer in a high tax bracket has the benefits of deductions and exclusions cut to be equal to those received by a taxpayer in a lower tax bracket. All non-itemizers in the upper-income brackets are affected, but to what magnitude depends on the amount of their deductions and exclusions. Figure 2 shows the effects. The cap results in a leftward shift in the rate schedule as in Figure 1 but only for the upper brackets — a significantly more progressive change. Taxpayers below the top bracket are effectively pushed into the top bracket and now face higher marginal tax rates, which reduce their incentives to work and save.

(3) Phaseout of Deductions, Exclusions, and Exemptions for Upper-Income Taxpayers. Unlike with the previous two limits, the United States has experience with this type of provision, and its economic effects are more familiar. A phaseout of deductions, exclusions, or exemptions effectively results in a new marginal tax rate at the higher end of the income scale. This new phantom bracket begins at the income level where the phaseout begins. The increase in the marginal rate of tax is equal to the percentage reduction in deductions per dollar of income above the cap times the marginal tax rate. (Under the provision scheduled to take effect on January 1, 2013, the deductions are reduced by $3 for every $100 increase in income above the cap. For taxpayers in the top bracket, the marginal rate increase is 0.03 times 39.6 percent, or 1.12 percent.) The width of this new bracket is the amount of income over the cap needed to eliminate deductions potentially limited by the provision. The effect on marginal tax rates is illustrated in Figure 3.

(4) Cap on Tax Benefits Equal to a Percentage of Income. Of the four proposals considered, this one has the most complicated effect on marginal tax rates. The unique feature of the percentage of income cap is that each additional dollar of income has the salutary effect of increasing deductions for taxpayers subject to the limit. This reduces marginal tax rates for some taxpayers. However, like the other proposals, it also has the effect of subjecting lower-income taxpayers to higher rates by shifting the rate schedule to the left. This is shown in Figure 4.

Caps in a Revenue-Neutral Reform

Is it possible for a base-broadening tax reform that reduces statutory tax rates to increase marginal tax rates? The answer is yes.

A simple example that proves the point. Suppose all taxpayers in the economy had $180,000 of AGI, $25,000 of itemized deductions, and $10,000 of personal exemptions. Assume also that the tax rate

Figure 3. Marginal Effective Tax Rates — Phaseout of Deductions for Upper-Income Taxpayers (Pease)

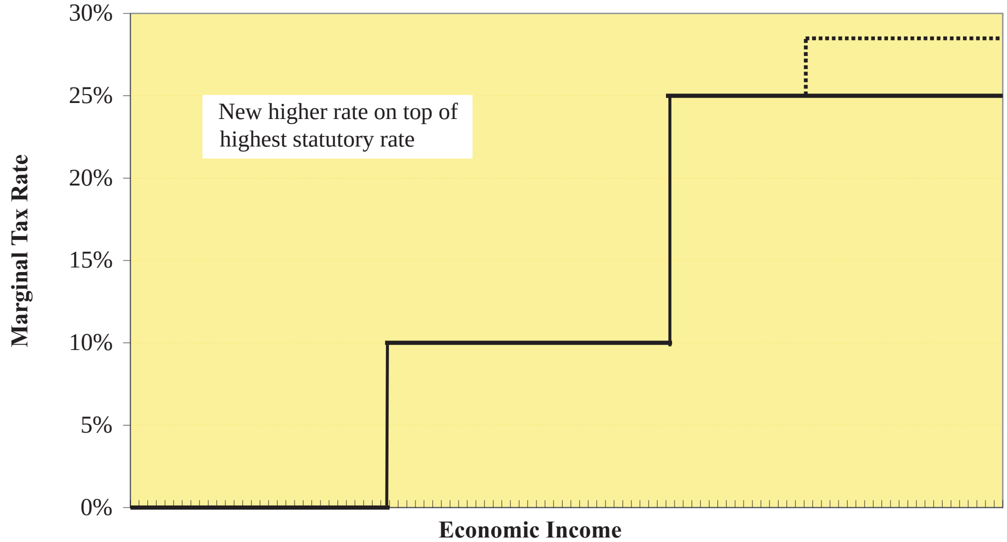
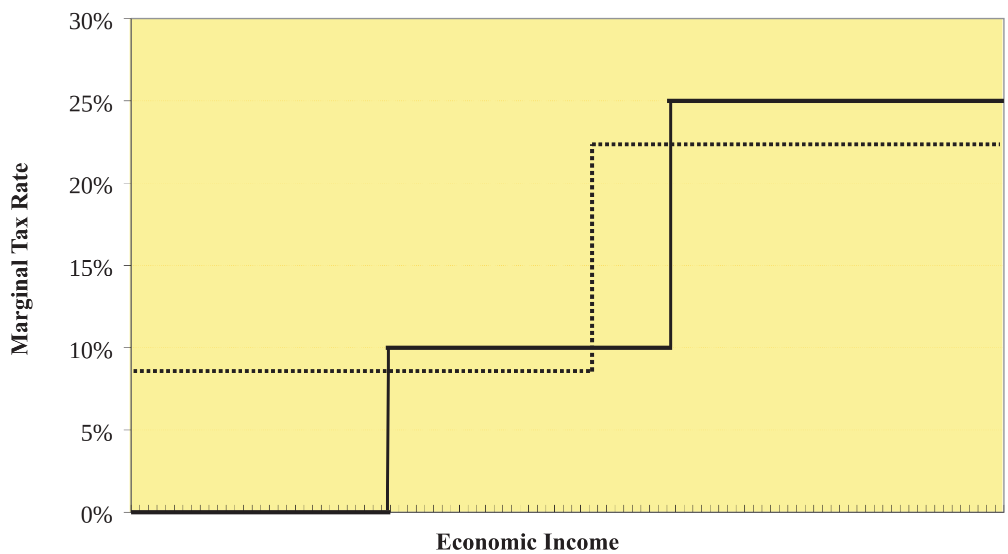


Figure 4. Marginal Effective Tax Rates — Cap on Deductions Equal to a Percentage of Adjusted Gross Income (Feldstein)



is 10 percent on taxable income up to $150,000 and 25 percent on income above $150,000.

Without any limitations on itemized deductions, taxable income is $145,000 and total income tax is $14,500. The marginal tax rate is 10 percent.

Now suppose itemized deductions are capped at $15,000. Each taxpayer's itemized deductions are reduced by $10,000, and taxable income rises to $155,000. Now there is $15,000 of tax collected on taxable income from zero to $150,000 and $1,250 of tax collected on the $5,000 of taxable income in excess of $150,000. Total tax for each taxpayer is $16,250. Now in a new bracket, the taxpayer's marginal tax rate is 25 percent.

The extra revenue generated from reducing deductions can be used to pay for lower rates and leaves net revenue unchanged. What are the new revenue-neutral rates? If rates are reduced by an equal percentage, the new rates are 8.92 percent and 22.31 percent. Although all tax rates are lowered, the effect on marginal rates is obviated by the push into a higher bracket. Marginal rates are more than doubled, from 10 percent to more than 23 percent.

> ***Without careful attention to detail, hoped-for cuts in marginal rates may not materialize and economic benefits from tax reform will be less than anticipated.***

Although this example was chosen to dramatize potentially negative effects of a base-broadening reform, the results clearly show that without careful attention to detail, hoped-for cuts in marginal rates may not materialize and economic benefits from tax reform will be less than anticipated. ■

Could Treasury Broaden the Scope Of *General Utilities* Repeal?

By Amy S. Elliott — aelliott@tax.org

If tax reform preserves the capital gains preference and reduces corporate rates, Treasury should take the opportunity to finally rethink the scope of the repeal of the *General Utilities* (*GU*) doctrine, according to Don Leatherman, a professor at the University of Tennessee College of Law in Knoxville.

The Tax Reform Act of 1986 repealed the *GU* doctrine that enabled corporations to avoid recognizing corporate-level gain on appreciated assets by distributing them to shareholders rather than selling them. It gave Treasury broad authority under section 337(d) to enforce the repeal if taxpayers could reach the same result despite the enactment of sections 311(b) and 336(a).

While Treasury has issued selective guidance under section 337(d), it never systematically defined the scope of *GU* repeal, Leatherman said November 10 at the annual Federal Tax Conference sponsored by the University of Chicago Law School. ''I'd go back to argue for the broader form. I think broader rules are consistent with the purpose of the repeal. I see no reason why corporate gain should ever escape the system,'' he said.

> ***'I think broader rules are consistent with the purpose of the repeal. I see no reason why corporate gain should ever escape the system,' Leatherman said.***

Leatherman said the effect of the *GU* repeal was diminished by simultaneous rate changes. After TRA 1986, the top corporate rate exceeded the top individual rate, and the preferential rate for capital gains ended. ''That was unfortunate because it skewed the interpretation of the *GU* repeal,'' he said.

Stephen D. Rose of Munger, Tolles & Olson LLP questioned Leatherman's assertion that *GU* repeal should apply whenever gain goes outside the corporate system, citing the commonly held view that cash-rich split-offs — which effectively are permanent gain avoidance transactions — are permitted.

Leatherman said, ''I've always been troubled by the cash-rich transaction; I've been troubled by north-south transactions.'' He added that a narrower rule creates winners and losers, benefiting those that are well-advised and trapping those that aren't.