AMERICANS FOR TaxFairness

TAX REFORM REQUIRES RAISING RATES & LIMITING DEDUCTIONS FOR THE RICHEST 2 PERCENT

A major debate is raging in Washington about how to raise revenues in a deficit-reduction deal. President Obama correctly proposes to both raise tax rates on the richest 2 percent of Americans as a first-step during the lame-duck session of Congress and as a second step, to limit the value of deductions the wealthy can take to reduce their taxes. Republican leaders in Congress are opposed to raising tax rates on any income group; they simply want to limit the deductions of wealthier Americans, even as they promise to lower tax rates.

There are major advantages to President Obama's approach: Raising tax rates guarantees that the necessary revenue gets raised, virtually all the revenue would be raised from the richest 2 percent, progressivity of the tax code would increase, and it is much harder for special-interest lobbyists to mount a successful campaign to lower tax rates that are in place.

There are significant problems with the Republican leadership's approach to only limit tax deductions: It will not raise sufficient revenues; it will raise taxes on the middle class; it is a more regressive way to raise revenues, exacerbating inequality; and it is too easy for future Congress's to undo. This is because the deductions that lose the most revenue benefit the rich and the middle class, and there are large well-organized constituencies supporting them. The biggest itemized deductions that taxpayers typically take to reduce their tax bill are for home mortgage interest, state and local taxes on income, sales and real estate, and charitable contributions.

President Obama proposes to raise $1.6 trillion in revenue over 10 years for deficit reduction *both* by letting expire the Bush-era income tax cuts for the richest 2 percent of Americans (taxpayers with incomes over $250,000 for a couple) and by limiting deductions that this same group can take advantage of.

About $1 trillion would be raised by ending the Bush-era tax cuts on the richest 2 percent and by restoring the estate tax to its 2009 parameters, which would affect just 3 out of 1,000 people who die, or the richest 0.3 percent. President Obama would raise nearly $600 billion more by limiting to 28 cents on the dollar deductions that wealthy people can take, rather than the 35 cents they receive under current law.[1]

House Speaker John Boehner has proposed raising $800 billion in new revenue by closing tax loopholes and limiting deductions, although he has not specified how to do it.[2] (He also said he would cut tax rates.) If this sounds familiar, it should. Mitt Romney proposed placing a dollar cap on deductions rather than raise tax rates for the richest 2 percent during his presidential campaign, while also proposing steep income tax rate cuts.

Below is a more detailed explanation of the problems with relying solely on a tax reform plan to limit the deductions of wealthier taxpayers.

Limiting high-income deductions will not raise enough revenue needed for deficit reduction and to meet our nation's needs

There are two methods under discussion for limiting tax deductions. One would cap itemized deductions for families with incomes above $250,000. But to come even close to replacing the $1 trillion lost by extending the top Bush tax cuts, Congress would have to immediately end virtually all itemized deductions for those households, according to a Center on Budget and Policy Priorities analysis.[3] (A separate analysis by the Obama Administration is here.[4]) This is not close to being politically feasible.

Another approach is to cap the value of deductions for everyone. Sen. Bob Corker (R-TN) has proposed setting the cap at $50,000, which would raise about $750 billion according to the Tax Policy Center. But that amount would shrink by about 30 percent – raising just $590 billion – if Congress excludes from the cap the popular deduction for charitable gifts, which it would likely do.[5] Excluding or limiting other popular deductions, such as mortgage interest, would reduce revenues even more.

Limiting deductions will require raising taxes on the middle class

Capping deductions will hurt middle-class taxpayers if Congress wants to come close to raising $800 billion, as Speaker Boehner proposed. A $50,000 cap on deductions would raise $750 billion in new revenue,[6] but some taxpayers who earn $50,000 to $200,000 would pay about $1,000 to $2,900 more a year respectively, on average, compared to current tax law. [7] A tougher $25,000 cap will raise more but hurt taxpayers with more modest incomes, increasing taxes on some people who earn $40,000 to $100,000 a year by about $800 to $1,800 respectively, on average.[8]

President Obama's plan to limit deductions on the richest 2 percent, as a second step after raising rates on the wealthy, would protect the middle class. He would limit the value of itemized deductions and specified exclusions for wealthy people to 28 cents on the dollar, rather than 39.6 cents if the Bush tax cuts expire. Taxpayers with incomes below $100,000 would face no tax increase under this approach, according to the Tax Policy Center.[9]

Limiting deductions is a more regressive way to raise revenues, exacerbating income inequality

Raising revenue by raising tax rates on the wealthy helps keep the tax code progressive. That's harder to do when deductions are capped, particularly when raising huge sums to reduce the deficit. One-third of taxpayers itemize their deductions,[10] and the tighter the cap, the more the people who will be hit. A $50,000 cap will raise taxes on some people who earn $30,000 to

$40,000; a $25,000 cap will raise taxes on some who earn just $10,000 to $20,000, according to the Tax Policy Center.[11]

Moreover, limiting deductions does not fix the problem that some taxes are more regressive than others. Top tax rates on long-term capital gains and dividend income are now 15 percent, while tax rates on wage income top out at 35 percent. That's a 20-point advantage for taxpayers who earn a lot of income from dividends and selling stocks, as the richest 2 percent do. Capping their deductions does nothing to fix this inequity.

When the Bush tax cuts expire the capital gains tax rate will increase to 20 percent and the dividends tax rate will rise to the ordinary income tax rate. President Obama's plan to end the Bush tax cuts for the richest 2 percent will be able to take advantage of these higher rates and result in a more progressive tax system.

With the wealth gap between the rich and the middle class widening, more progressivity is critical. Tax reform needs to tackle the problem of income inequality, as it restores fiscal balance.

Limiting deductions is easy to undo through new tax loopholes

Congress has a tough time limiting tax breaks. There is always pushback, and a broad limit on deductions will create huge pushback. Each deduction has its own beneficiaries who will fight to maintain their tax break and, if it is ended, will fight to reinstate it. Any cap on the mortgage interest deduction will be resisted by builders and realtors, and a cap on the state and local tax deduction will be fought by state and local governments. Charities and the non-profit sector will be up in arms about limiting the charitable gift deduction.

There are good reasons for resisting limits to deductions. The housing market will be hurt by caps on the mortgage interest deduction. Giving to charities will be hurt when wealthy taxpayers limit contributions to fit under the cap. These real problems contribute to the difficulty Congress will have imposing a cap, and protecting a cap once it is law.

The only sure way to raise $1 trillion is to return to the tax rates paid by the richest 2 percent during the Clinton era. Let's lock-in that revenue and those higher rates now and negotiate over what loopholes to close and deductions to limit in 2013.

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[1] Center on Budget and Policy Priorities (CBPP) "Restraining Tax Expenditures Should Complement, Not Replace, Letting High-Income Bush Tax Cuts Expire" (Nov. 29, 2012), p. 3. http://www.cbpp.org/cms/index.cfm?fa=view&id=3867

[2] House Republican leadership letter to President Obama, Dec. 3, 2012. http://www.speaker.gov/sites/speaker.house.gov/files/documents/letter_to_wh_121203.pdf

[3] CBPP, p. 4.

[4] The White House Blog, "Limiting Tax Deductions: The Reality of the Math," (Nov. 29, 2012) http://www.whitehouse.gov/blog/2012/11/29/limiting-tax-deductions-reality-math

[5] CBPP, p. 5

[6] Tax Policy Center (TPC) "Can Congress Raise Taxes on the Rich Without Raising Their Rates? Maybe" (Nov. 15, 2012) http://taxvox.taxpolicycenter.org/2012/11/15/can-congress-raise-taxes-on-the-rich-without-raising-their-rates-maybe/

[7] TPC table T12-0269 on the effects of capping itemized deductions (Oct. 17, 2012) http://taxpolicycenter.org/numbers/displayatab.cfm?Docid=3586&DocTypeID=1

[8] TPC table T12-0263 on the effects of capping itemized deductions (Oct. 17, 2012) http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=3580

[9] TPC table T12-0064 on the effects of the Administration's proposal to limit deductions to 28 percent (March 15, 2012)
http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=3324

[10] TPC, "Itemized deductions" backgrounder.
http://www.taxpolicycenter.org/taxtopics/encyclopedia/Itemized-Deductions.cfm

[11] TPC, see note 8.