ANALYSIS OF SPECIFIC TAX PROVISIONS IN PRESIDENT OBAMA'S FY2014 BUDGET

Benjamin H. Harris, James Nunns, Kim Rueben,
Eric Toder, and Roberton Williams

Urban-Brookings Tax Policy Center
May 8, 2013

ABSTRACT

This document reviews several notable tax proposals in President Obama's Fiscal Year 2014 Budget. These include a 28 percent limit on certain tax expenditures, a cap on tax preferences for retirement savers with high balances, a minimum tax ("Buffett Rule") on high-income taxpayers, alternative incentives for infrastructure investment, and a new measure of inflation ("chained CPI") for indexing tax parameters.

28 Percent Limit on the Value of Certain Tax Expenditures

Tax expenditures are special deductions, exclusions, or deferrals in the tax code that lower taxes for selected activities or taxpayers. For example, taxpayers not using the standard deduction may claim itemized deductions for state and local taxes, mortgage interest, and charitable contributions, and workers compensated with employer-provided health insurance do not pay taxes on the value of the premiums. Because exclusions and deductions reduce taxable income, their effect on tax liability depends on the taxpayer's tax bracket. For example, exclusions or deductions totaling $10,000 reduce taxes for a person in the 15 percent bracket by $1,500 (15 percent of $10,000) but cut taxes by $3,960 for a person in the 39.6 percent bracket (39.6 percent of $10,000).

The rationale for tax expenditures varies by provision. Some household expenses—such as those for extraordinary medical costs or employee business expenses—arguably reduce a taxpayer's ability to pay and should therefore be deducted in computing taxable income. Other deductions and exclusions subsidize behaviors, such as charitable giving and home purchases, which many believe generate wider social benefits. Similarly, the exclusion of interest on state and municipal bonds reduces borrowing costs for states and localities, the exclusion for employer-paid health insurance premiums encourages employers to provide health benefits to their workers, and the deduction for contributions to qualified retirement saving plans encourages workers to save for retirement.

Economists often question the justifications for tax expenditures. For example, retirement security provisions may not boost overall saving much because people can contribute by shifting wealth from other accounts. The exclusion for employer health insurance may encourage excessively generous benefits and raise health care costs. Moreover, even when tax subsidies encourage desirable behavior there is rarely a good reason for providing a larger subsidy per dollar of the favored activity to higher-income than to lower-income taxpayers.

The president proposes limiting the tax benefit of itemized deductions and specified exclusions and deferrals to no more than 28 percent of the amount of the exclusion or deduction, starting in 2014.[1] The limitation would increase taxes for taxpayers whose marginal tax rate exceeds 28 percent and reduce the incentives that these tax preferences provide them. The administration estimates that the proposal would increase revenues by $529 billion between fiscal years 2014 and 2023.[2]

---

[1] In addition to itemized deductions, the limitation would apply to exclusions of state and local bond interest and employer-sponsored insurance purchased with pre-tax dollars and deductions for health insurance costs of self-employed individuals, employee contributions to defined contribution retirement plans and individual retirement accounts, income attributable to domestic production activities, certain trade or business expenses of employees, moving expenses, contributions to health saving accounts and Archer MSAs, interest on education loans and certain higher education expenses.

[2] The 28 percent limitation would apply to itemized deductions that remain after the current law limitation on itemized deductions (Pease). Under Pease, taxpayers with AGI above $250,000 ($200,000 for single returns) lose 3 cents of itemized deductions for every additional dollar of AGI above these income thresholds. This effectively amounts to an increase in marginal tax rates for high-income taxpayers who itemize, but for most of these taxpayers

In contrast to a similar proposal in last year's budget, the current 28 percent limit applies to all taxpayers—instead of only those with adjusted gross income of more than $250,000 for couples and $200,000 for single filers. This change would simplify the application of the limit for taxpayers. Almost of all the increased taxes from the proposal would continue to be paid by taxpayers with incomes above those threshold amounts.

The 28 percent limit would reduce, but not eliminate, incentives for high-bracket taxpayers to engage in certain behaviors, such as giving to charity or taking out a bigger mortgage. Retirement saving incentives would remain, but taxpayers close to retirement could face a penalty if their marginal tax rate in retirement is higher than 28 percent. High-bracket taxpayers will pay a modest federal income tax (up to 11.6 percent) on their state and local bond income, but the value of municipal bonds may experience little or no decline if the marginal bond purchaser is in the 28 percent bracket or below.

Some tax reform plans have proposed even more stringent limitations on tax expenditures. The 2005 President's Advisory Panel on Federal Tax Reform proposed replacing some itemized deductions (including home mortgage interest) with a 15 percent non-refundable credit. The 2010 debt reduction plans of the President's Fiscal Commission (Bowles-Simpson) and the Bipartisan Policy Center (BPC) proposed similar limits. Bowles-Simpson proposed a 12 percent non-refundable credit for mortgage interest and charitable contributions and BPC proposed a 15 percent refundable credit. All three panels proposed to eliminate the deduction for state and local income and property taxes.

---

the limit does not reduce the tax benefit from an additional dollar of a deduction. Pease can reduce itemized deductions by as much as 80 percent for high-income taxpayers, but few taxpayers reach that limit. For taxpayers at the 80 percent limit and in the 39.6 percent bracket, the current benefit of a deduction is 7.9 percent. The combination of the Pease limitation and the new 28 percent cap could further limit the tax savings from itemized deductions to as little as 5.6 percent. (Here, the benefit of each deduction is 28 percent of 20 percent, or 5.6 percent.)

Cap Retirement Saving Tax Benefits for Individuals with High Balances

Under current law, tax benefits for defined-benefit pensions are capped by limiting the maximum benefit paid each year. In 2013, the maximum benefit a pensioner can receive is $205,000; this limit is annually indexed to the cost of living. This limit applies only to related plans; pensioners with multiple plans can receive up to $205,000 per plan. There is no maximum distribution for defined-contribution plans like IRAs and 401(k)s; tax preferences for these plans are instead limited by annual contribution limits. In tax year 2013, a worker and his employer can contribute up to $51,000 each year to a workplace retirement account (a worker can contribute up to $17,500 on their own) and a worker without a retirement plan can generally contribute $5,500 annually to an IRA. Contributions limits are higher for workers over age 50, and contributions can be made regardless of an account's balance.

The president proposes to limit contributions to defined-contribution plans for workers with high balances. The proposed limit is the amount of assets needed to purchase an annuity that would provide the maximum benefit for defined-benefit plans—$205,000 in 2013—at age 62. The cap for workers aged younger than age 62 would be the amount needed to purchase an annuity paying $205,000 when the worker reaches 62. Because this amount is dependent on both worker age and prevailing interest rates, the maximum limit will be lower for younger workers and will decrease if interest rates rise. In 2013, the limit for a 62 year old would be $3.4 million, while the limit for a 40 year-old would be $1.0 million. The limit applies to the combined sum of all tax-preferred retirement assets, including defined-benefit pensions and Roth accounts, in addition to IRAs and 401(k)-type accounts.

The proposal limits only new contributions and would not change the tax treatment of accumulated account balances or future accumulations from prior years' contributions. If a worker's balances are above the cap in one year, she will not be able to make contributions in the following year, but may still be allowed to contribute in future years if interest rates fall, cost-of-living increases, or the balance in her account declines. The rationale for the change is to limit tax benefits for investments in qualified retirement plans to amounts that provide a "reasonable" level of retirement income. The president points out that the new limit would reduce tax expenditures and reduce the extent to benefit of retirement saving incentives is tilted towards the highest income taxpayers, while preserving subsidies for most retirement saving. Opponents of the proposal argue that it will weaken incentives for firms to establish and contribute to retirement saving plans, unfairly punish high savers, and add unnecessary complexity to the tax code.

The proposal is unlikely to have much of an impact on either the deficit or retirement saving. Treasury estimates it will raise just $9.3 billion over 10 years and it would affect only a very small proportion of account holders. For example, recent analysis by the Employee Benefits Research Institute found that just 0.1 percent of workers over 60 would be limited by this threshold. (The president's proposed 28 percent cap on tax expenditures will have a much stronger impact on retirement saving incentives than would this limitation.) The proposal is likely very progressive, limiting tax benefits for the wealthiest taxpayers able to shield a large amount of wealth from income tax, but will also add a substantial compliance burden for plan administrators and taxpayers.

Implement a New Minimum Tax (the "Fair Share Tax") on High-Income Taxpayers

The basic structure of the income tax exempts from tax a subsistence level of income, measured by the standard deduction and personal exemption amounts, and imposes tax on income above those levels at graduated rates. These provisions cause average tax rates to rise with income, so the basic structure of the income tax is progressive. But the tax law also includes special deductions, exclusions, credits, and preferential rates of tax that reduce effective tax rates and make the tax system less progressive than it would be if all income were taxable at ordinary rates. These provisions also undermine the principle of equal treatment of equals (horizontal equity) by making the effective tax rate facing taxpayers with favored forms of income or categories of expenses lower than the effective tax rates of others with the same total income.

The income tax contains several provisions that partially address the effects on progressivity and horizontal equity of special deductions, exclusions, credits, and rates of tax. The limitation on itemized deductions ("Pease") reduces the benefit of itemized deductions for higher-income taxpayers. The alternative minimum tax (AMT) also limits the value of certain itemized deductions (primarily the deductions for state and local taxes) and other tax preferences. The president's budget proposes to further limit all itemized deductions and some exclusions and other deductions by capping their tax value at 28 percent.

The president's budget proposes a new minimum tax called the "Fair Share Tax" (FST) as a further measure to limit tax preferences. The FST (also known as the "Buffett Rule") affects special deductions, credits and rates, but not exclusions. Under the proposal, taxpayers with incomes above $2 million would pay an additional tax (the FST) equal to the excess of 30 percent of AGI over the sum of income and employee payroll taxes, less a credit for 28 percent of charitable contributions (as reduced by Pease). Income tax for this purpose is defined as the sum of regular income tax (reduced by all special credits), AMT, and the 3.8 percent surtax on investment income. The FST would phase in pro rata between $1 million and $2 million of AGI. So, for example, a taxpayer with income of $1.5 million would pay an FST equal to 50 percent of the difference between 30 percent of AGI and income plus payroll taxes (less the charitable credit) and a taxpayer with income of $1.2 million would pay an FST of 20 percent of that amount. Income limits would be half these amounts for married couples filing separately. All income limits would be indexed for inflation.

The FST would mostly affect high income taxpayers with substantial amounts of capital gains and qualified dividends. The special rates applied to these sources of income are worth the most per dollar of preferred income to taxpayers facing the highest ordinary income rates. And on average the highest income taxpayers receive a much larger share of their income in the form of capital gains and dividends than other taxpayers. The FST would substantially increase the marginal tax rate high income taxpayers pay on additional gains and dividends, especially for those with incomes in the $1 million to $2 million phase in range. The FST would not affect taxpayers who benefit from exclusions, such as those for municipal bond interest income, accruals within retirement saving plans, and employer-paid health insurance benefits, because these forms of income are not counted in AGI. But these exclusions would be limited by the president's 28 percent limitation on the value of tax preferences.

Incentives for Investment in Infrastructure

The president's budget includes eleven tax proposals to expand public and private investment in infrastructure. The major new proposal is the introduction of America Fast Forward Bonds (AFFBs), taxable bonds that offer a direct refundable tax credit to issuers and would be an optional alternative to traditional tax-exempt bonds. AFFBs are modeled after the Build America Bonds (BABs) that were available to state and local governments in 2009 and 2010 as part of the American Recovery and Reinvestment Act of 2009 (ARRA). Other proposals would loosen regulations for some existing private activity bond programs by repealing limits on the use of specific types of debt, removing volume caps for some activities, and broadening program eligibility.

State and local governments undertake most of U.S. spending on infrastructure. Bonds that state and local governments issue to finance these projects are mostly either guaranteed by state or local general revenues (general obligation bonds) or by revenue from specific projects (revenue bonds). The interest on debt issued for public purposes (schools, roads etc.) is excluded from federal taxable income, reducing the cost of borrowing because investors are willing to accept a lower interest rate in exchange for federal tax exemption. However, because this subsidy varies with the tax rate of the bond-holder, it provides a windfall benefit to taxpayers in the highest bracket, whose benefit per dollar of lending from tax-exemption exceeds the reduced borrowing costs to states and localities. A fixed-percentage tax credit for interest costs (like AFFBs or BABs) could provide the same borrowing subsidy at a lower fiscal cost.

The administration considers BABs to have been a successful program, helping to shore up a struggling municipal debt market in the aftermath of the financial crisis. About $185 billion in BABs were issued from April 2009 through December 2010 when the program ended. This money financed new public infrastructure.

There are differences between AFFBs and BABs. AFFBs generally will provide a smaller subsidy than BABs. For standard AFFBs, the tax credit will equal 28 percent of interest in contrast to the 35 percent credit offered on BABs, but the subsidy for school construction projects would equal 50 percent of interest. In addition, AFFBs will allow a broader category of projects to be eligible. AFFBs and other taxable bonds can attract new sources of capital, since non-traditional buyers such as foreigners and pension funds that do not benefit from tax-exemption would benefit from the subsidized interest rates.

The 28 percent credit for interest is equal to the president's proposed limit on tax preferences and would be approximately revenue neutral (if outlay costs are included), assuming the overall limitation on tax preferences is enacted, but move costs from the tax to the expenditure side of the budget by replacing the revenue loss from tax-exempt debt with direct outlays. In contrast, the increased Federal subsidy rate for school construction bonds is expected to cost on net about $10 billion from 2014 through 2023. In total, AFFBs raise receipts by $79 billion, while increasing outlays by $90 billion. The entire set of infrastructure proposals will increase the federal deficit by $17.4 billion between 2014 and 2023.

While the president's budget stresses the benefits of the BABs program, there is some skepticism on the part of some state and especially local governments about the attractiveness of the direct interest subsidies. Local governments express some doubts about the ability of small borrowers to access these bonds, and worry this is a first step to eliminating the standard tax exemption for municipal bond interest. They also worry about whether the promised subsidies will be provided, and cite the fact that BAB payments are subject to the sequestration cuts, leaving borrowers with higher net interest costs than expected.

Replace the Consumer Price Index (CPI) with the Chained CPI for Purposes of Indexing Tax Provisions for Inflation

Many parameters in the federal tax system are indexed for inflation to prevent rising prices from raising tax burdens. Those parameters include the standard deduction, personal exemptions, thresholds for individual income tax brackets, and phaseout ranges for various tax preferences. Indexation is typically based on changes in the Consumer Price Index for All Urban Consumers (CPI-U).

The CPI-U generally overstates the effect of inflation on living costs because it does not fully account for changes in consumption that households make in response to changing prices. In particular, the index measures the change in cost of a fixed basket of goods and services and allows substitution only among very similar items. It does not account for shifts between different items, such as consuming less beef and more chicken when the relative price of beef rises.

In contrast, the chained CPI (C-CPI) takes account of actual changes in consumption by using contemporaneous expenditures to weight price changes. It therefore provides a more accurate measure of actual changes in living costs. If people buy more chicken and less beef in response to rising beef prices, the weight given to chicken prices increases relative to that for beef. That alternative method means that the C-CPI will generally, but not always, change less than the CPI-U.

The president proposes to use the C-CPI in place of the CPI-U to index tax parameters. The change would apply to tax years starting after 2014, but the budget does not explain the transition between the two indices. In addition, a separate proposal would further modify indexation to make sure that a fall in prices would not lead to a reduction in tax parameters.

Because the C-CPI grows more slowly than the CPI-U, using it instead of the CPI-U to index tax parameters would reduce the growth rate of standard deductions and personal exemptions, bracket widths for determining higher tax rates, and income levels at which provisions phase in and phase out. All of those factors would raise tax revenue.

Because the effect of using a slower growing price index compounds over time, differences between tax parameters indexed by the alternative measures and revenue gains from the proposal, while initially very small, would grow rapidly. The administration estimates that shifting to the C-CPI would increase revenue by $1 billion in fiscal year 2015, by $28 billion between 2015 and 2019, and by $100 billion over the 2014–2023 period.

One concern about using the C-CPI involves the substantial delay until final values are available. Because estimating the chained index requires consumption data, the Bureau of Labor Statistics (BLS) issues estimates in three installments: initial values the month after the month in question, interim values in February of the following year, and final values in February of the second subsequent year. As a result, final values appear between 14 months and 25 months later. Although this delay means that a single year's adjustment could be too high or too low, such errors would not cumulate because the BLS corrects errors in earlier years over time (see note below).

BLS first produced the C-CPI for 2000, so there is little history on which to judge the relationship between the chained index and the CPI-U. The CPI-U has exceeded the C-CPI by an average of 0.3 percentage points over the 2000-2011 period, but the difference has ranged from 0.8 points higher to 0.1 point lower (Table 1). Furthermore, the difference has declined in recent years, averaging less than 0.2 percentage points since 2006 and just 0.1 point since 2008.

Regardless of revenue savings, however, the C-CPI does provide a better—though still imperfect—measure of the change in living costs over time.

Table 1. December-December percentage changes, CPI-U and C-CPI, 2000–2011

Year	CPI-U	C-CPI	Difference
2000	3.4	2.6	0.8
2001	1.6	1.3	0.3
2002	2.4	2.0	0.4
2003	1.9	1.7	0.2
2004	3.3	3.2	0.1
2005	3.4	2.9	0.5
2006	2.5	2.3	0.2
2007	4.1	3.7	0.4
2008	0.1	0.2	-0.1
2009	2.7	2.5	0.2
2010	1.5	1.3	0.2
2011	3.0	2.9	0.1

Source: U.S. Bureau of Labor Statistics.

Note: Judging by the short history of the C-CPI, it's clear that the version of the C-CPI used could often result in different indexing of tax parameters. In the first few years after BLS initiated the chained index, price changes measured by the three versions—initial, interim, and final—differed little (Table A). Through 2007, the difference between the largest and smallest measures for each year never exceeded 0.2 percentage points. More recently, however, the values have diverged further, averaging 0.9 percentage points (in absolute value) for 2008–2010. In 2009, in fact, the initial and final values both showed a drop in prices while the interim value showed an increase.

Table A. Initial, Interim, and Final Values of Chained CPI, 2000-2012

	Values			Change from Previous Year		
	Initial	Interim	Final	Initial	Interim	Final
2000	---	---	102.00	---	---	---
2001	---	104.13	104.30	---	---	2.3
2002	105.40	105.62	105.60	---	1.4	1.2
2003	107.55	107.66	107.80	2.0	1.9	2.1
2004	110.04	110.24	110.50	2.3	2.4	2.5
2005	113.32	113.61	113.70	3.0	3.1	2.9
2006	116.88	116.90	117.00	3.1	2.9	2.9
2007	119.82	119.95	119.96	2.5	2.6	2.5
2008	123.91	123.88	124.43	3.4	3.3	3.7
2009	123.23	124.35	123.85	-0.5	0.4	-0.5
2010	126.30	125.66	125.62	2.5	1.1	1.4
2011	129.39	129.14	---	2.4	2.8	---
2012	131.56	---	---	1.7	---	---

Source: Bureau of Labor Statistics and Tax Policy Center calculations.