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MAINTAINING CURRENT VALUE OF ITEMIZED DEDUCTIONS FOR HIGH-INCOME TAXPAYERS COULD HELP PAY FOR HEALTH CARE REFORM

Move Would Save $68 Billion Over Ten Years

by Chuck Marr

If Congress rejects the President's proposal to help pay for health care reform by limiting the value of itemized deductions for high-income filers, it should at least prevent those subsidies from expanding in 2011, as they would under current law.

Simply keeping the value of itemized deductions for filers in the top two brackets at their current levels of 33 and 35 percent, rather than allowing it to expand when those tax rates rise to 36 and 39.6 percent respectively, would raise $68 billion over ten years, according to the Urban-Brookings Tax Policy Center.[1] It could help to finance health care reform, while addressing the criticisms that have been leveled against the Administration proposal — and maintaining current incentives to donate to charity or buy a home.

Current Deduction Structure Is Inequitable and Inefficient

The tax code provides incentives for certain activities that are considered socially beneficial, such as home ownership and charitable giving. Generally, however, these incentives take the form of deductions rather than credits, which means they provide the largest subsidies to people in the highest tax brackets.[2] Tax policy experts have argued that the current deduction structure is inefficient.[3]

Consider, for example, a teacher in the 15 percent bracket and a banker in the 35 percent bracket, each of whom donates $100 to charity. The donation costs the teacher $85, with the government subsidizing the remaining $15 through the itemized deduction the teacher takes. But the donation costs the banker only $65, with the government subsidizing the other $35.

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[1] "Alternatives to the Administration's 28-Percent Limitation on Itemized Deductions," Tax Policy Center, June 4, 2009, http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=2401&DocTypeID=5.

[2] The value of a deduction is the deductible dollar amount times the marginal tax rate.

[3] "Efficiency and Tax Incentives: The Case for Refundable Tax Credits," Lily Batchelder, Fred Goldberg Jr., and Peter Orszag, Stanford Law Review, Volume 59, Issue 1, 2006, http://lsr.nellco.org/cgi/viewcontent.cgi?article=1081&context=nyu/lewp.

Or consider the situation in which the teacher and the banker both seek to purchase a home and take out a mortgage. Through itemized deductions, the government will defray 15 percent of the teacher's mortgage interest costs — and 35 percent of the banker's. Yet the size of the deduction is, if anything, more likely to affect the teacher's than the banker's ability to buy a home. This is why many tax policy experts from across the political spectrum believe the current deduction structure is economically inefficient. Indeed, President George W. Bush's Tax Reform Panel proposed turning the mortgage interest deduction into a uniform 15 percent tax credit.[4]

President's Proposal Has Merit But Faces Political Obstacles

Earlier this year, President Obama proposed to limit the value of itemized deductions to 28 percent for households in the top two tax brackets, the same limit that applied during the latter Reagan years when the top tax rate was 28 percent. This proposal would affect only the highest-income 1.4 percent of taxpayers, according to the Tax Policy Center, and would raise substantial sums to help pay for health care reform.

Under this proposal, the banker in the example cited above would still receive a higher subsidy rate on his or her home purchase and charitable donations than the teacher, but the advantage would shrink from 20 cents on the dollar (35 minus 15) to 13 cents on the dollar (28 minus 15). The tax treatment of itemized deductions would still be inequitable and inefficient, but less so.

Despite its merit, the proposal has generated considerable political opposition, in part because of overblown claims about its impact on charitable giving. Research about the effects of tax incentives on donations suggests that the proposal would reduce total charitable giving by a little less than 2 percent.[5]

Congress Can Help Finance Health Reform By, At a Minimum, Keeping These Tax Subsidies at Current Levels

If Congress declines to adopt the Administration's proposal, a modest alternative can be considered that addresses the criticisms made about that proposal — Congress could adopt a "status quo" approach for itemized deductions and simply maintain the current tax subsidies for deductible expenses incurred by high-income households.

Under current law, the 33 percent and 35 percent tax brackets will return to the levels that prevailed during the 1990s — 36 percent and 39.6 percent, respectively — in 2011, when the 2001 tax cuts are scheduled to expire. This means that if Congress does not act, the value of itemized deductions for filers in the top two brackets will rise correspondingly, exacerbating the inequities and inefficiencies in the current deduction structure.

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[4] "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System," Report of the President's Advisory Panel on Tax Reform, November 2005, http://govinfo.library.unt.edu/taxreformpanel/final-report/TaxPanel_1_11-1.pdf.

[5] "Limiting the Tax Exclusion for Employer-Sponsored Insurance Can Help Pay for Health Reform," Paul N. Van de Water, revised June 4, 2009, http://www.cbpp.org/cms/index.cfm?fa=view&id=2832.

At a minimum, Congress should keep the value of itemized deductions at today's 33 and 35 percent levels. This would simply maintain the incentives for charitable giving — and other deductible costs — where they are today. And it would help finance health care reform by saving $68 billion over ten years, according to the Tax Policy Center.