TAX EXPENDITURES

14.471 - Fall 2012

Base-Broadening Strategies for Tax Reform:

- Eliminate Existing Deductions
- Retain but Scale Back Existing Deductions
  o Income-Related Clawbacks
  o Cap on Rate for Deductions
- Expand Definition of AGI & Taxable Income
  o Imputed Rent on Homes
  o Employer Provided Health Insurance

Itemized Deductions with Largest Revenue Cost, FY2010 ($Billion)

Employer-Provided Health Insurance	$159.9
Pension Contributions & Earnings	142.0
Mortgage Interest Deduction	92.2
State/Local Income Taxes	33.9
Charitable Giving	44.2
State/Local Property Taxes	18.9

Source: OMB, 2011Budget.

Key Questions:

* How Responsive are Taxpayer Choices to Variation in After-Tax Price of Activity (Health Insurance, Housing, Charity)?
* What are the Efficiency Costs of Allowing Tax Deductions and Exclusions?

General Problem of Tax Rate Endogeneity:

Illutration Using Charitable Giving. Assume Underlying Demand Model is Log-linear:

$$\ln G_i = \alpha + \beta * \ln Y_i + \gamma * \ln (1-\tau_i) + \delta * X_i + \varepsilon_i$$

Marginal Tax Rate $\tau_i = T_i'(Y_i - G_i)$ where T(.) is the tax function that depends on gross income minus deduction for charitable gifts. Problem is that ε_i is correlated with G_i, which in turn is correlated with τ_i. Larger values of error term translate into larger deductions, hence (if tax schedule is progressive) <u>lower</u> marginal tax rate, hence larger value of $(1-\tau_i)$. Thus there is a spurious positive correlation between G_i and $(1-\tau_i)$ leading to an upward bias in the estimates of γ. Since this parameter is the price elasticity of demand for charitable giving it is expected to be negative; the positive bias will therefore lead to an underestimate of the price elasticity.

How do we solve this? Use "<u>first dollar marginal tax rate</u>" for instrument. Simple example (can be improved upon): calculate $\tau_i^* = T_i'(Y_i)$ for all taxpayers. Note τ_i^* is correlated with τ_i but it is NOT affected by the spurious correlation channel noted above. Some studies estimate reduced form regressions replacing τ_i with τ_i^* in the regression equation; better strategy uses IV.

Illustration: Elasticity of Charitable Giving with respect to "Tax Price" $(1-\tau)$: W. Randolph, "Dynamic Income, Progressive Taxes, and the Timing of Charitable Contributions," JPE 1995 709-738.

Estimates Almost Ideal Demand System with current and future income, current and future tax price variables. Dependent variable is <u>share</u> of income devoted to charitable gifts. Let Y_{it} = "modified after-tax income" (correcting for inframarginal charitable donations at higher MTR).

$$(1-\tau_{it})*G_{it}/Y_{it} = \delta_{0t} + \delta_{0i} + X_{it}\beta + \delta_1*\ln[(1-\tau_{it})/(1-\tau_i*)]$$
$$+ \delta_2*\ln(1-\tau_i*) + \delta_3*\ln[Y_{it}/Y_i*] + \delta_4*\ln Y_i*$$
$$+ \delta_5*\ln[(1-\tau_{it})/(1-\tau_i*)]^2$$
$$+ \delta_6*\ln(1-\tau_i*)*\ln(1-\tau_{it}) + \varepsilon_{it} n$$

One important measurement issue: how to include gifts of appreciated assets in tax rate calculation (problem: if part of the charitable donation is made up of appreciated stock, the tax benefit is even larger than for a cash gift). Set

$(1-\tau_{it})$ = 1 - MTR$_{it}$ - (gift share of appreciated assets)*(effective tax rate on long-term capital gains)

Sample of 12000 taxpayers, six years of panel data (1979, 80, 83, 84, 85, 88). Spans significant change in marginal

tax rates (TRA86) so there is "transitory" tax rate variation. Few demographic variables on tax returns (married, number of exemptions, age (sometimes age > 65 dummy variable). Estimation sample: 51,146 returns.

"Permanent price elasticity": both τ_{it} and τ_i^* change by the same amounts. In this case

$$dG_{it}/d\ln(1- \tau_i^*) = [\delta_2 + 2*\delta_6*\ln(1-\tau_i^*)]*Y_{it}/(1-\tau_{it}) - G_{it}$$

when we divide through by G_{it} to obtain $d\ln G_{it}/d\ln(1- \tau_i^*)$ this yields the elasticity of charitable giving with respect to a "permanent" tax change of:

$$d\ln G_{it}/d\ln(1- \tau_i^*) = \{\delta_2 + 2*\delta_6*\ln(1-\tau_i^*)\}/\omega_{it} - 1$$

where $\omega_{it} = (1-\tau_{it})*G_{it}/Y_{it})$.

Key Findings:

Elasticity Measure	Income	Tax Price
"Current" (no transitory/perm distinction)	0.82 (0.01)	-1.21 (0.07)
Transitory	0.58 (0.01)	-1.55 (0.06)
Permanent	1.14 (0.01)	-0.51 (0.06)

Capital Gains Taxation:

Long-standing question of whether capital income should be taxed at the same rate ("income tax") or lower rate ("consumption tax") than other income.

Three key questions about capital gains taxation:

i) does a lower tax rate on capital gains stimulate venture capital and encourage risk-taking?

ii) should capital gains rate be lower than ordinary income rate to avoid taxation of inflationary gains?

iii) would lowering the tax rate on realized gains raise or lower revenues? Short run vs. long run issue. Realized gains are among the most elastic elements of the tax base.

Important institutional features:
* gains are taxed at realization not on accrual (note that this COULD be done, but difficult to explain)
* long-term (> 12 months today) vs. short term gains distinction (short term gains taxed as ordinary income)
* loss offset limitations ($3K of losses used against ordinary income, then loss-carryforward with no interest)
* "step up in basis at death" (can reduce effective tax burden substantially)

Empirical literature on capital gains realizations: has advanced from aggregate time series data to household level data with controls for time, person effects), distinguishing permanent vs. transitory tax rate effects

Open underlying question: why do taxpayers realize gains? for consumption? to rebalance their portfolio?

Burman & Randolph AER 1994: careful distinction of permanent vs. transitory

Identification from state-level tax rates and from changes in federal tax law

Elasticity of realizations with respect to "Permanent" changes in tax rate: -0.18 (0.48)

Elasticity of realizations with respect to "Transitory" changes in tax rate: -6.42 (0.34)

Very large differences - suggests that long-run reductions in capital gains tax rates would reduce revenues, while there can be large short-run gyrations in realizations when tax rates change.

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