Statement before the Senate Committee on Finance Hearing on Individual Tax Reform

The Opportunities for Individual Income Tax Reform

ALEX M. BRILL
Resident Fellow

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Chairman Hatch, Ranking Member Wyden, and other Members of the Committee,

Thank you for the opportunity to testify this morning. My name is Alex Brill, and I am a resident fellow at the American Enterprise Institute, a public policy think tank here in Washington, DC. I commend the Committee for holding this important and timely hearing. The views and opinions I offer today are mine alone and do not represent those of my employer or necessarily those of my colleagues at AEI.

The opportunity for fundamental and comprehensive tax reform is before this Committee for the first time in many decades. As every Member of this Committee well knows, the tax code has frequently and sometimes significantly changed over the last 30 years, but not since 1986 has it been truly reformed in a manner that sought to broaden the base – that is, eliminate special deductions, credits, and exclusions – while lowering statutory tax rates. As Senators Hatch, Wyden, Roberts, and Grassley know firsthand, that legislative process was arduous and sometimes controversial, but the 1986 Tax Reform Act did result in a simpler income tax code with a broader tax base and significantly lower statutory tax rates.

The last 30 years have seen tax complexity increase dramatically with the introduction of more and more tax expenditures. In many regards, the tax code today imposes undue and unnecessary burdens on taxpayers. Complexity and compliance costs are significant. High effective marginal tax rates impede investment,[1] discourage savings,[2] and encourage taxpayers to reduce their reported taxable income.[3] Moreover, the myriad of tax expenditures in the tax code today yields wide disparities in tax burdens among taxpayers with similar amounts of income.

Reversing the trend of the last three decades and pursuing an individual income tax reform that relies on a broader and fairer tax base will facilitate a move toward lower statutory rates and a more efficient and simpler tax code. A more neutral tax code will facilitate a more productive allocation of resources and can contribute to a pro-growth economic environment.

In my testimony today, I would like to discuss 5 points:

1. The current individual income tax system is complex, burdensome, and riddled with deductions, exclusions, and credits. Broadening the tax base can be a meaningful tax simplification.
2. The current individual income tax system treats taxpayers with similar amounts of income very differently. Broadening the tax base is an effective means for correcting this disparity and reducing horizontal inequity in the tax code.
3. In addition to contributing to complexity and horizontal inequity, itemized deductions are generally regressive tax policies. The deduction for state and local taxes is an excellent example of this and is a policy that, ironically, incentivizes states to pursue more progressive (but inefficient) tax policies.

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[1] See, for example, Kevin A. Hassett and R. Glenn Hubbard, "Tax Policy and Business Investment," in *Handbook of Public Economics, Volume 3*, ed. Alan J. Auerbach and Martin Feldstein (Amsterdam: North Holland Publishing Co., 2002), 1,293–1,343.

[2] See, for example, Alan D. Viard, "Capital Income Taxation: Reframing the Debate," AEI *Economic Perspectives*, July 2013, available at www.aei.org/wp-content/uploads/2013/07/-capital-income-taxation-reframing-the-debate_172019152543.pdf.

[3] See, for example, Emmanuel Saez, Joel Slemrod, and Seth H. Giertz, "The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review," *Journal of Economic Literature* 50, no. 1 (2012): 3–50, available at https://eml.berkeley.edu/~saez/saez-slemrod-giertzJEL12.pdf; and Sarah Burns and James Ziliak, "Identifying the Elasticity of Taxable Income," *The Economic Journal* 127, no. 600 (March 2017): 297–329.

4. Broadening the tax base, particularly with regard to limiting itemized deductions, is an opportunity to move toward a more neutral tax code and a more level playing field economically.
5. The transitionary path from the tax code we have today to a fairer, simpler, and more pro-growth tax system is itself a complex challenge that will require lawmakers to strike a careful balance. Inadequate or insufficient transition relief may cause some taxpayers to face steep, unanticipated tax burdens judged unfair by policymakers. Conversely, overly extended transition relief (for example, repeal of an ineffective tax credit beginning ten years hence) may severely limit the potential economic gains from tax reform.

1. Complexity in the Tax Code Abounds

Members of this Committee know well the complexity of the current tax code. The IRS Taxpayer Advocate estimates that nearly 2 billion hours are spent preparing Form 1040 every year. Various Form 1098s, 1099s, and 5498s, which relate to reporting mortgage interest expense, dividends and interest income, and distribution of pensions, among other activities, total over 700 million additional hours annually. Collectively, this 2.7 billion hours is equivalent to over 1.3 million full-time workers.[4] Taxpayers employ a variety of strategies to comply with tax-filing obligations. Based on data from *IRS Compliance Data Warehouse*, about 40 percent of individual taxpayers use software to help them prepare their returns. These services can offer valuable convenience and save time but may cost taxpayers $3 billion annually.[5]

This complexity is not related to the statutory rate (or number of rates) at which the government taxes incomes but rather is primarily related to the elements of the tax code that alter taxpayer's tax liabilities, whether by permitting a deduction, an exclusion, or a credit. The Joint Committee on Taxation (JCT) identifies more than 250 such tax expenditures in the Internal Revenue Code,[6] though there is no definitive methodology for constructing this list and many of these provisions do not relate directly to individuals. Moreover, surtaxes such as the Alternative Minimum Tax are another clear source of complexity.

One indicator of the complexity of the tax code can be observed by analyzing the number of taxpayers who itemize their deductions as opposed to claiming the standard deduction. According to recently released statistics from the IRS Statistics of Income (SOI), 150.6 million individual income tax returns were filed in tax year 2015, the most recent year for which these statistics are available. Of these, 44.5 million returns claimed a total of $1.2 trillion in itemized deductions. Mortgage interest deductions were claimed by 32.7 million taxpayers and totaled $279 billion. Charitable deductions were claimed on 36.6

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[4] See Figure 2.1.2 from the National Taxpayer Advocate's 2016 Annual Report to Congress, available at www.taxpayeradvocate.irs.gov/reports/2016-annual-report-to-congress/full-report. Total estimated preparation time for all forms is 6 billion hours annually. Because this hearing focuses on individual income tax, compliance costs related to business tax (corporate, partnership, and S corp), estate and gift tax, excise tax, and taxation of foreign persons' US source income are excluded.
[5] According to the National Taxpayer Advocate's 2016 Annual Report to Congress, the average cost of tax prep software is about $50. With 40 percent of the approximately 150 million individual returns completed using software (or 60 million tax returns), the estimated cost is $3 billion.
[6] Joint Committee on Taxation (JCT), "Estimates of Federal Tax Expenditures for Fiscal Years 2016–2020," JCX-3-17, January 30, 2017.

million returns and totaled $201 billion. State and local income tax deductions (including the general sales tax deduction) were claimed on 42.6 million returns and totaled $338 billion.

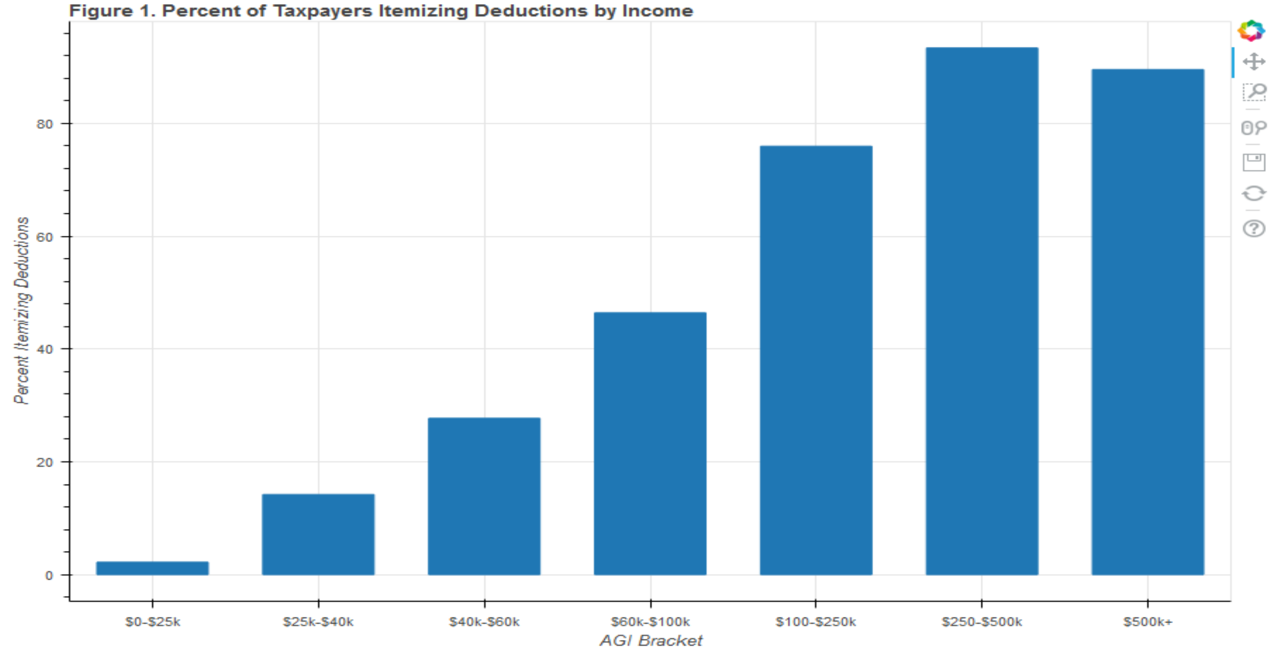
More than one-fourth of all itemized deductions are claimed by fewer than 3 percent of taxpayers – those with adjusted gross incomes (AGIs) greater than $250,000. However, because these higher-income taxpayers face higher marginal tax rates, the tax savings they receive from these deductions is far greater than half of the total tax savings associated with these policies. Table 1 summarizes the distribution of itemized deductions as reported by the IRS for tax year 2015, while Figure 1 illustrates this distribution visually using data and modeling made available by the Open Source Policy Center (OSPC) Tax-Calculator.[7] In brief, one-fifth of taxpayers earning near the median income are burdened with the complexity of itemized deductions. Over three-fourths of taxpayers with AGIs between $100,000 and $200,000 are itemizers, and nearly all taxpayers with AGIs greater than $200,000 itemize their deductions.

Table 1. Itemized Deductions by Adjusted Gross Income in Tax Year 2015

	Total	Under $15,000	$15,000 to $29,999	$30,000 to $49,999	$50,000 to $99,999	$100,000 to $199,999	$200,000 or more
Number of returns	150,565,918	35,584,745	30,103,270	26,564,740	32,892,457	18,634,133	6,786,573
Itemized deductions	44,477,185	1,323,310	2,785,803	5,485,481	14,438,234	14,101,283	6,343,076
Share itemizing	29.5%	3.7%	9.3%	20.6%	43.9%	75.7%	93.5%

Source: IRS SOI Bulletin.

Figure 1. Percent of Taxpayers Itemizing Deductions by Income

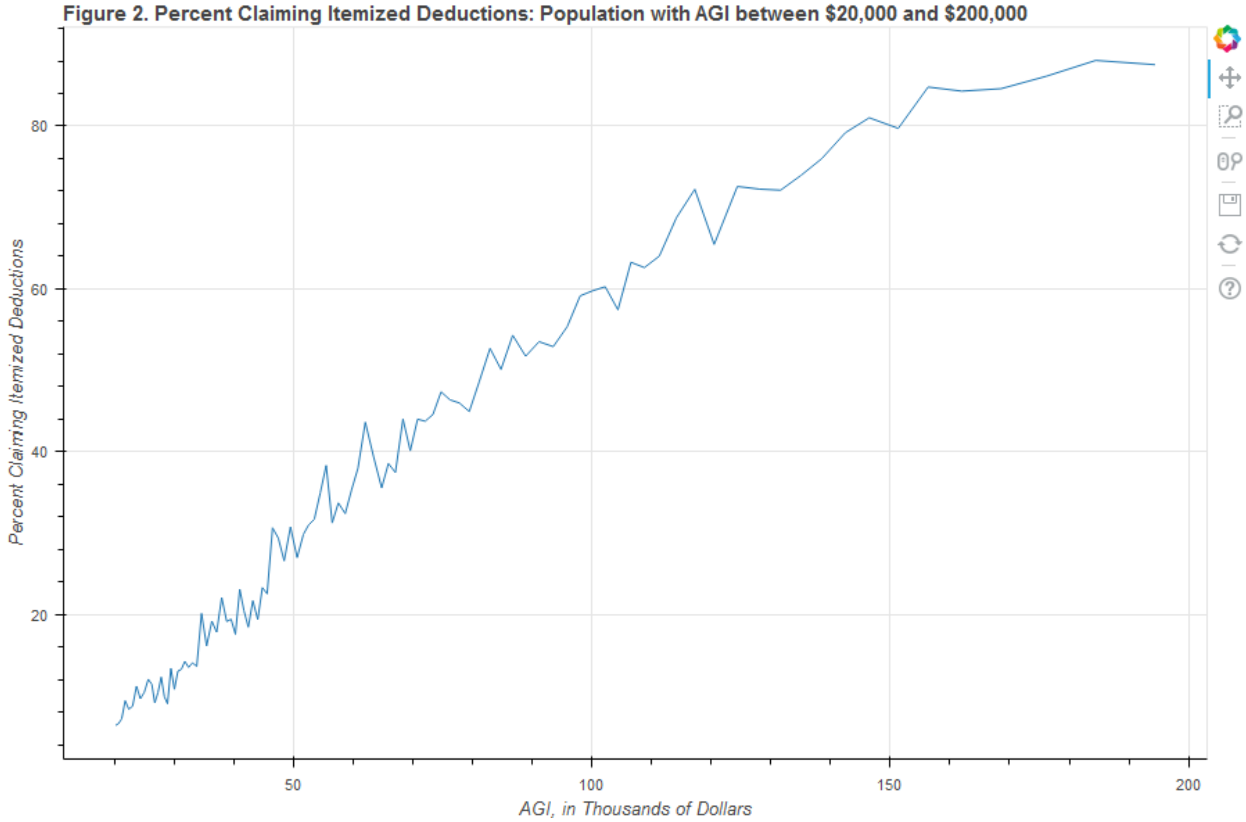


[7] The Tax-Calculator is part of the Open Source Policy Center's (OSPC) TaxBrain modeling suite. More information about TaxBrain and the OSPC generally can be found at www.ospc.org. The entire suite of models, including source code, is publicly available.

Source: Open Source Policy Center (OSPC).

Figure 2 narrows in on those taxpayers with AGIs between $20,000 and $200,000 and looks across this income spectrum in a more granular manner, making evident a clear and dramatic trend: as incomes rise, so does the tax code's complexity.

Figure 2. Percent Claiming Itemized Deductions: Population with AGI between $20,000 and $200,000



Source: OSPC.

Other factors in addition to itemized deductions also contribute to the complexity of the tax code for individuals. In tax year 2015, 49.4 million taxpayers claimed one or more tax credits, including 22.6 million who claimed the child tax credit, 9.7 million who claimed an education tax credit, 2.7 million who claimed a residential energy credit, and 28.4 million who claimed the earned income tax credit (EITC).

These credits and deductions reduce tax liabilities for targeted populations and can incentivize or reward particular behaviors or offer tax relief for taxpayers in certain circumstances. The merits and efficiency of various credits and deductions can be debated, but they generally add to the complexity of the tax code. Further complicating the tax code and leading to higher effective marginal tax rates is the phase out of various credits. For example, the JCT reports that 3.5 million households are subject to the phase out of the child tax credit. As a result, these taxpayers face marginal tax rates 5 percentage points higher.[8]

2. The Individual Income Tax Breeds Horizontal Inequity

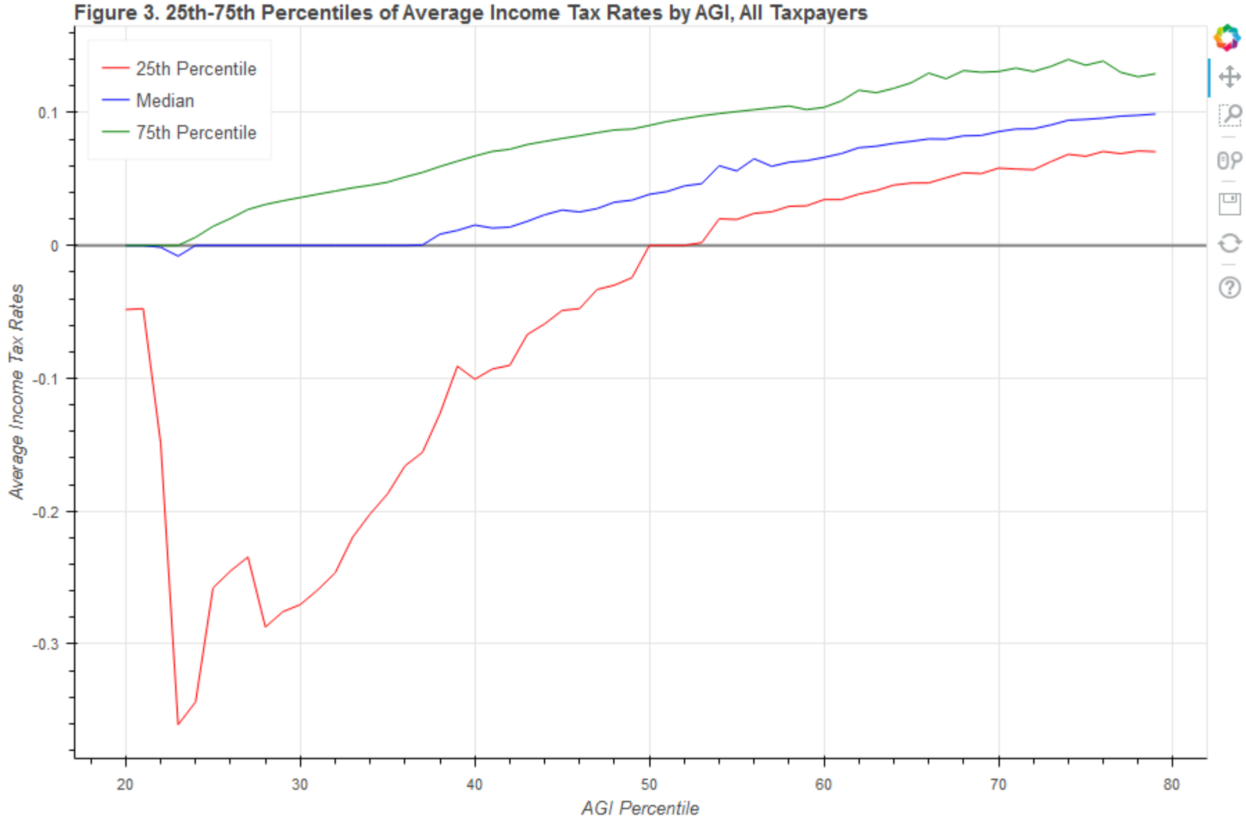
[8] JCT, "The Taxation of Individuals and Families," JCX-41-17, September 12, 2017.

In addition to adding to the complexity of the tax code, a second consequence of the myriad of tax expenditures available to individual taxpayers is an increase in *horizontal inequity* – that is, similarly situated taxpayers paying dissimilar amounts of federal income tax. In the most general terms, similar taxpayers may be considered two taxpayers with similar amounts of income. An alternative approach would be to consider both income and household size, recognizing the established principle in the U.S. tax code that, all else equal, larger households should pay less tax.

Consider, for example, two neighbors. Neighbor A owns her home, and Neighbor B rents. Neighbor A donates a significant amount of her income to charity. Neighbor B donates a significant amount of his time to a local charity. Neighbor A lives in Bristol, VA, and Neighbor B lives down the street in Bristol, TN. Even if these two taxpayers had identical incomes of $100,000, their federal tax liabilities would differ considerably. Neighbor B would likely claim the standard deduction, but Neighbor A would likely deduct her mortgage interest costs, her charitable giving, and the income taxes she paid to the Commonwealth of Virginia. Moreover, if Neighbor A has a 17 year child, and Neighbor B has an 18 year old child, their income tax liabilities would be even more disparate.

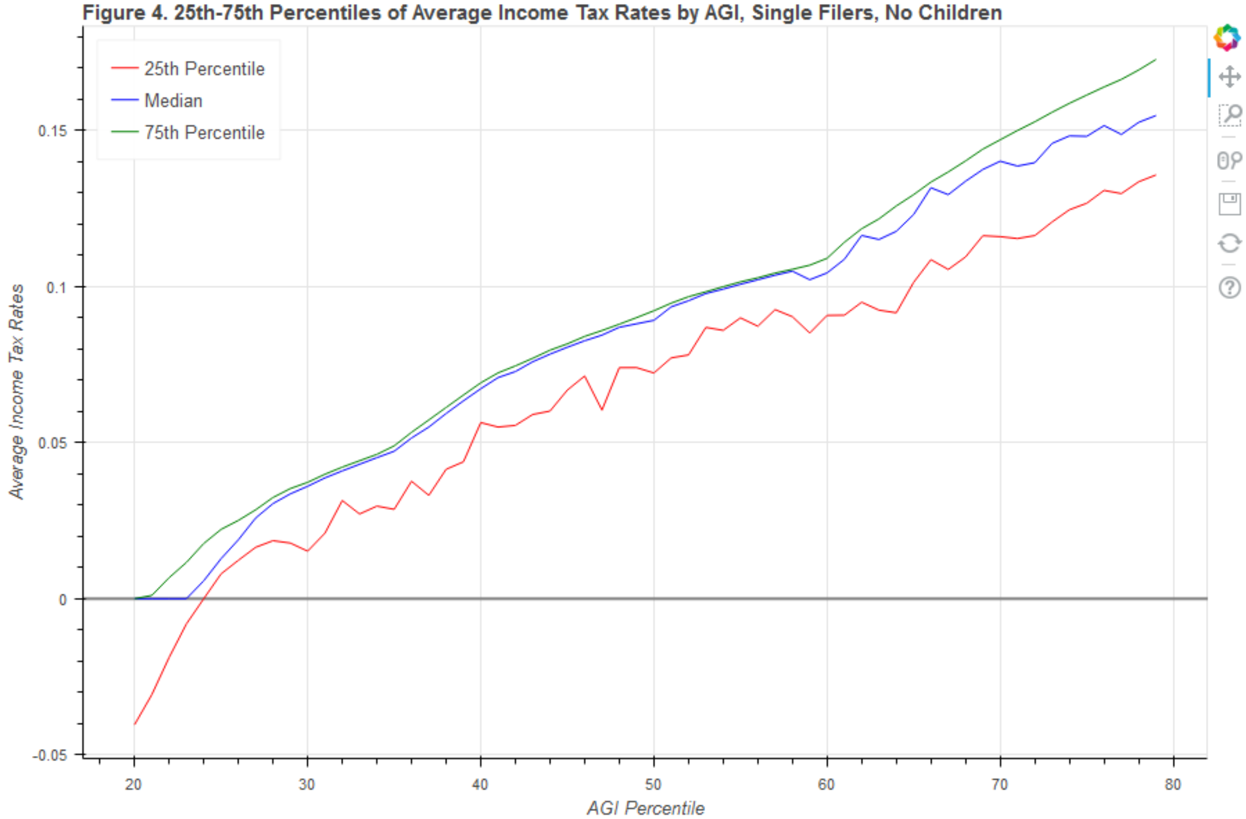
To better understand this variance in tax liability among taxpayers with similar incomes, Figure 3 illustrates the disparity in tax liabilities among taxpayers within the same AGI percentile. For example, at the 70th AGI percentile, the median taxpayer within that group faces an average tax rate of 8 percent, while a quarter of those taxpayers pay 4 percent of their AGI or less and another quarter pay 13 percent or more. Figure 4 repeats this analysis but only for taxpayers with a constant household size, single filers with no children. The disparity within percentiles is much less but still present.

Figure 3. 25th-75th Percentiles of Average Income Tax Rates by AGI, All Taxpayers



Source: OSPC.

Figure 4. 25th-75th Percentiles of Average Income Tax Rates by AGI, Single Filers, No Children



Source: OSPC.

A final perspective on the variance in tax liabilities is illustrated in Table 2, which breaks down the range of tax bills for all taxpayers, single taxpayers with no children, and married taxpayers with two children, with AGIs at both the 50th percentile and the 75th percentile. For example, roughly 40 percent of all median taxpayers have zero or negative tax liabilities, while 15.1 percent owe $2,500 or more in federal income tax.

Table 2. Variance in Tax Liability by Household Size

	Median AGI			75 Percentile of AGI		
Tax Liability	All Tax Units	Single, No Children	Married, 2 Children	All Tax Units	Single, No Children	Married, 2 Children
<$0	37.6%	3.1%	100.0%	1.8%	0.0%	6.4%
$0	2.5	1.5	0.0	0.6	0.7	0.7
$1–$1,500	19.9	12.5	0.0	4.2	0.9	15.1
$1,501–$2,500	24.9	51.7	0.0	6.3	0.8	20.3
$2,501–$5,000	14.8	30.7	0.0	17.9	3.3	54.6
$5,001+	0.3	0.5	0.0	69.2	94.3	2.9

Source: OSPC.

The disparities in federal tax liabilities for similarly situated taxpayers contributes, in my view, to a lack of confidence in the system by many taxpayers. After all, while the overall federal income tax is progressive, nearly 20 percent of taxpayers who report $36,000 in AGI pay a higher average tax rate than 60 percent of taxpayers who earn $50,000. In short, many taxpayers are correct in their suspicion that higher-income earners are paying a lower tax rate, but importantly this is true across the entire income spectrum.

3. Itemized Deductions Are Distortionary and Regressive: The State and Local Tax Deduction Example

Among the many provisions of the individual income tax code that narrow the tax base, itemized deductions are, as a group, the largest. As mentioned above, according to the IRS SOI, itemized deductions totaled $1.2 trillion in tax year 2015. Within this category, the largest itemized deduction was for state and local taxes (SALT). In 2015, $338 billion in SALT deductions were claimed. (Mortgage interest deductions totaled $279 billion and charitable giving deductions $201 billion.)

The revenue loss (calculated as the deduction amount multiplied by the weighted average marginal tax rate for taxpayers claiming the deduction) from reducing the tax base by $338 billion in a single year is quite large. According to my estimation, full repeal of the SALT deduction would raise $1.4 trillion over a decade. Of this, 89 percent– $1.26 trillion – would come from taxpayers with AGIs above $100,000. In other words, the policy itself is highly regressive. It is available only to the minority of taxpayers who itemize their taxes (generally higher-income taxpayers) and is more valuable to taxpayers in higher tax brackets (though for truly high-income earners and taxpayers on the AMT, the benefits are limited).

What is the purpose or rationale for a federal tax deduction for state and local taxes? As the Congressional Budget Office (CBO) explains:

> The deduction for state and local taxes is effectively a federal subsidy to state and local governments; that means the federal government essentially pays a share of people's state and local taxes. Therefore, the deduction indirectly finances spending by those governments when federal revenues could be used to fund the activities of the federal government.[9]

Moreover, this federal subsidy reduces the "tax price" for deductible state and local taxes for those taxpayers who itemize. For example, a $1 state income tax increase paid by a taxpayer in the 33 percent marginal tax bracket would reduce her federal tax liability by $0.33, yielding a net additional cost to the taxpayer of $0.67. This reduced tax price can encourage states to rely on deductible taxes more and to impose more of those taxes on high-income taxpayers. In short, the SALT is, in isolation, a regressive tax policy at the federal level and one that encourages a progressive income tax at the state and local level. As Kirk Stark observed in *Virginia Tax Review*, "All else equal, state and local governments will have an incentive to design their tax systems to take maximum advantage of the SALT subsidy, which suggests a strong price effect in favor of a more progressive tax system. Empirical studies have shown that the federal deduction for state and local taxes exerts a substantial influence on subnational progressivity."[10] In fact, the most recent evidence of this empirical response, David Coyne finds that local governments

[9] Congressional Budget Office (CBO), "Limit the Deduction for State and Local Taxes," *Options for Reducing the Deficit: 2017 to 2026*, December 8, 2016, available at www.cbo.gov/budget-options/2016/52253.
[10] Kirk J. Stark, "The Federal Role in State Tax Reform," *Virginia Tax Review* 30 (2010): 407.

are very sensitive to changes in the tax price with respect to their willingness to rely on deductible taxes.[11] He estimates that a 1 percent increase in the tax price will lead to a 3.5 percent reduction in the use of deductible taxes.

CBO continues:

> An argument in favor of capping the deduction is that the federal government should not provide a tax deduction that subsidizes the spending of state and local governments because revenues from state and local taxes are largely paid in return for services provided to the public. When used to pay for public services, such taxes are analogous to spending on other types of consumption that are nondeductible. . . . Additionally, the unlimited deductibility of taxes could deter states and localities from financing some services with nondeductible fees, which could be more efficient.[12]

Overall, the combination of high marginal tax rates on income earned by taxpayers claiming the largest share of itemized deductions yields a set of regressive and costly tax expenditures. The list is led by a policy that unfairly distorts state tax policy.

4. A Broader Tax Base Can Promote Greater Tax Neutrality

If lawmakers pursue a tax reform agenda with a commitment to broaden the tax base, the benefits can be categorized in two types: First, there are the direct benefits discussed above: the potential for a less complex tax code with lower compliance costs, a fairer tax system with less inequality among similarly situated taxpayers, and a less distortionary system that is also less regressive. (Such a result is not, however, to be assumed for all base-broadening policies, of course. For example, eliminating an exclusion of income, while perhaps desirable, could increase complexity or compliance.)

Second, there is an important indirect benefit: leveling the playing field and promoting economic efficiency by reducing tax-induced distortions in the allocation of resources. As my colleague Alan Viard and I wrote in an AEI *Tax Policy Outlook* in 2011:

> The economy is generally most efficient when the free market determines the allocation of resources between goods, based on production costs and consumer preferences. When different goods are taxed at different rates, efficiency is impeded because the allocation of resources is based partly on tax considerations, rather than costs and preferences. For example, if apples, but not oranges, are tax-deductible, the economy produces too many apples and too few oranges. Switching to a [single] tax on both goods corrects this misallocation, increasing the production of oranges and reducing the production of apples and yielding a set of goods consumers find more attractive. . . . Base broadening is likely to be most useful when it addresses the major distortions of the current tax system.[13]

However, some base broadening should certainly be avoided. The income tax, by its very nature, discourages savings and investment by taxing future consumption more heavily than current

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[11] David Coyne, “Unmasking Local Fiscal Responses to Federal Tax Deductibility,” *National Tax Journal* 70, no. 2 (2017): 223–256.
[12] CBO, “Limit the Deduction for State and Local Taxes.”
[13] Alex M. Brill and Alan D. Viard, “The Benefits and Limitations of Income Tax Reform,” AEI *Tax Policy Outlook*, September 2011, available at www.aei.org/wp-content/uploads/2011/10/TPO-Sept-2011.pdf.

consumption. The current tax code includes a host of policies intended to mitigate or eliminate this distortion. While lower tax rates on dividends and capital gains, tax preferences for defined contribution plans, and other similar policies may appear on lists of tax expenditures, they in fact promote economic efficiency and should be preserved in even expanded.

5. Tax Reform and Transition Policy: Finding the Balance

The final point I would like to address relates to the transition policies necessary to consider in a fundamental tax reform effort that transforms the tax code from the one we have today to one consisting of a broader base (that is, with fewer expenditures) and lower statutory rates. In many respects, the transition rules – the tax policies that will feature prominently in the tax code in the intervening years – may be as important as the final tax policies. As lawmakers ponder the most appropriate strategies for crafting these rules, I would like to offer three observations.

First, if pursuing fundamental and broad-based reform, providing little or no transition relief risks imposing large and unanticipated tax hikes on unsuspecting taxpayers. Beyond the political challenges this may pose, it could yield painful adverse short-term economic effects. Second, the corollary is true, too. Overly generous and slow transition policies that delay needed reforms many years into the future will also delay the potential economic gains associated with tax reform.

And finally, when considering the budgetary impact associated with tax reform, the costs associated with transition policy – for example, that the "payfors" may phase in more slowly than a rate cut – are far less important than the budgetary impact of tax reform beyond the budget window. As I discussed in a recent article, lawmakers in pursuit of revenue-neutral tax reform should focus on the likely revenue impact of tax reform *beyond* the ten-year budget window rather than the impact within the budget window.[14]

In conclusion, the opportunity for fundamental reform of the individual income tax system is an opportunity to simplify the tax code, improve the equity of the system, and reduce distortions. Tax reform that wisely broadens the tax base can achieve these goals. To pursue the additional core objective of a tax reform that promotes economic growth, tax reform should also be careful not to increase the tax penalty on savings and should instead pursue opportunities to reduce the current savings penalty.

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[14] Alex Brill, "Investing in Tax Reform Today Will Yield a Strong Economy Tomorrow," *The Hill*, April 11, 2017, available at www.aei.org/publication/investing-in-tax-reform-today-will-yield-a-strong-economy-tomorrow.