2015

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Limiting Tax Expenditures

DAVID M. SCHIZER* 

I. Introduction

The federal government devotes over a trillion dollars each year to tax provisions that pursue "nontax" goals, such as the deduction for mortgage interest and the exclusion for employer-provided health insurance. Scaling back these "tax expenditures" should be a high priority, as many have urged. Yet too often, the same limit is suggested for a broad range of tax expenditures. In the 2013 budget deal, for instance, Congress revived a single limit on all itemized deductions called the "Pease rule." In 2012, both presidential candidates pro-

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* Dean Emeritus and the Harvey R. Miller Professor of Law and Economics, Columbia Law School. I appreciate comments from Joshua Blank, Tom Brennan, Jake Brooks, Wei Cui, Michael Doran, Victor Fleischer, Brian Galle, Michael Graetz, Glenn Hubbard, David Joulfaian, Alex Raskolnikov, Michael Schler, Dan Shaviro, Joel Slemrod, Richard Squire, Shlomo Yitzhaki, Eric Zolt, and workshop participants at the Tax Club, Columbia Law School, the American Law and Economics Association, and Hebrew University.

1 William McBride, Tax Found., Fiscal Fact No. 391, A Brief History of Tax Expenditures 1, 3 (2013), http://taxfoundation.org/sites/taxfoundation.org/files/docs/ff391.pdf. (explaining that Treasury estimates the tax expenditures budget is $1.2 trillion, and the Joint Committee estimates $1.3 trillion, representing 96% growth since 1991); James R. Hines Jr. & Kyle D. Logue, Understanding the AMT, and Its Unadopted Sibling, the AMxT, 6 J. Legal Analysis 367, 373 n.23 (2014) (describing the tax expenditure budget as "a readily available (if flawed) measure of federal tax preferences").

2 Congress defines tax expenditures as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction, from gross income a special credit, a preferential rate of tax, or a deferral of tax liability." Congressional Budget and Impoundment Control Act of 1974, § 3, 2 U.S.C. § 622(3) (2012). They are "analogous to direct outlay programs, and the two can be considered as alternative means of accomplishing similar budget policy objectives.” Staff of the Joint Comm. on Tax’n, Background Information on Tax Expenditure Analysis and Historical Survey of Tax Expenditure Estimates 2 (2011), available at http://www.jct.gov/publications.html?func=startdown&id=3740. This Article defers to Congress’ definition, instead of entering the traditional debate about which provisions are “special” enough to be tax expenditures. See, e.g., Boris I. Bittker, Accounting for Federal “Tax Subsidies” in the National Budget, 22 Nat’l Tax J. 244, 257-58 (1969). The focus here is not on their conceptual compatibility with a particular tax base, but on the welfare effects of repealing or limiting them.

3 See Section II.B.

posed their own one-size-fits-all limit. In the same year, the United Kingdom imposed a single cap on all personal deductions. Likewise, the Bowles-Simpson Commission, Martin Feldstein, Edward Kleinbard, and other distinguished commentators have each recommended their own version of uniform treatment.

Although one-size-fits-all answers may be good politics, they are not good policy. What makes sense for the earned income tax credit (EITC) is unlikely to work for green energy or charity. After all, each tax expenditure encourages different behavior. In scaling it back, we lose some private benefits and positive externalities. If these "programmatic benefits" are meager, we have good reason to scale back. Even if they are significant, reaping them at lower cost is desirable. This Article canvasses five strategies for doing so: tightening the definition of favored conduct; focusing on claimants who are easiest to motivate; favoring claimants who use the subsidy more effectively; calibrating how much favored activity we subsidize; and changing the government agency that administers the subsidy. The right strategy depends on the relevant externalities, elasticities, and other context-specific factors.

Repeal or a limit also can influence excess burden and distribution, affecting labor and savings decisions, planning, and administrative costs. For example, limits can push claimants into a higher tax bracket. In some cases, a limit moves us closer to the distribution we

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8 See Martin Feldstein, Daniel Feenberg & Maya MacGuineas, Capping Individual Tax Expenditure Benefits, 131 Tax Notes 505, 505-07 (May 2, 2011) (advocating an overall cap on all itemized deductions, as well as some other tax expenditures, so that the tax benefit does not exceed 2% of AGI).
9 Edward Kleinbard, We Are Better Than This: How Government Should Spend Our Money 382 (2014) (proposing to replace all personal itemized deduction with a 15% credit).
10 See Lily L. Batchelder, Fred T. Goldberg Jr. & Peter R. Orszag, Efficiency and Tax Incentives: The Case for Refundable Tax Credits, 59 Stan. L. Rev. 23, 24-25 (2006) (arguing that the most efficient default structure for tax expenditures is a uniform refundable credit, so that low-income and high-income taxpayers receive the same marginal reimbursement rate); Neil Warren, A Politically Viable Strategy for Limiting Personal Income Tax Deductions: The Case for a Global Cap, 29 Austl. Tax F. 357, 359 (2014) (favoring "the UK approach where the focus is on global caps rather than imposing specific caps on a myriad of individual itemized deductions").
want, while in others it takes us farther away. After all, some tax expenditures focus especially on low-income people, while others do not. Indeed, since low- and middle-income taxpayers are taxed at much lower rates than thirty years ago, many tax expenditures offer them a correspondingly reduced tax benefit.\footnote{See Eric M. Zolt, Inequality in America: Challenges for Tax and Spending Policies, 66 Tax L. Rev. 641, 686-88 (2013).} Given the broad swath of relevant issues, then, the analysis is too complex and multi-faceted for one-size-fits-all answers. Instead, this Article offers a three-part framework for limiting tax expenditures, focusing on programmatic benefits, excess burden, and distribution.

This Article also analyzes seven different types of limits. Obviously, each helps the government raise more revenue. In addition, each raises the after-tax cost of favored activity, and also introduces complexity to the tax system. But otherwise, these limits have very different effects. For example, a “cap” eliminates the subsidy for high levels of favored activity. A “fixed-dollar” cap defines this boundary as a specified amount (for example, retirement savings above $18,000 per year\footnote{IRC § 401(k); Notice 2014-70, 2014-48 I.R.B. 905 (Nov. 24).}), while an “income-based” cap defines it as a percentage of income (for example, charitable contributions above 50% of adjusted gross income (AGI)\footnote{IRC § 170(b)(1)(B)(ii) (limiting deduction for individuals).}). In contrast, a “floor” disallows the subsidy for low levels of favored activity. Again, there are fixed-dollar floors (as in proposals to disallow charitable deductions for contributions below $500\footnote{See Deena Ackerman & Gerald Auten, Floors, Ceilings, and Opening the Door for a Non–Itemizer Deduction, 59 Nat’l Tax J. 509 (2006) (discussing proposal to add a fixed dollar floor to the charitable deduction); cf. IRC § 165(h)(1) (disallowing casualty losses of less than $100 per event).}) and income-based floors (as in proposals disallowing charitable contributions below 1% of AGI\footnote{See Ackerman & Auten, note 14, at 509 (discussing proposal to add a 1% floor to the charitable deduction); cf. IRC § 67 (allowing miscellaneous itemized deductions, including charitable contributions only to the “extent that the aggregate of such deductions exceeds 2 percent of AGI).}). Other limits preserve the subsidy for both high and low levels of favored activity, but in weakened form: A “haircut” disallows a fixed percentage of a deduction or exclusion (for example, 50% of travel and entertainment expenses\footnote{IRC § 274(n).}); a “maximum fraction” limits the tax benefit to a fixed percentage (for example, capping the tax benefit from the charitable deduction at 28%, even for those in higher tax brackets);\footnote{Cong. Budget Office, Options for Reducing the Deficit: 2014 to 2023, at 121 (2013), available at https://www.cbo.gov/sites/default/files/cbofiles/attachments/44715-OptionsFor-ReducingDeficit-3.pdf (proposing such a rule).} and a “phase-out” reduces the tax benefit for high-income claimants.
Just as these various limits have diverse effects on programmatic benefits, they also influence excess burden and distribution in different ways. For example, some limits increase the effective marginal tax rate (as do phase-outs and income-based floors), while others decrease it (as do income-based caps). Likewise, some especially reduce the subsidy for high-income claimants (phase-outs, fixed-dollar caps, haircuts, and maximum fractions), while others do not (income-based floors, fixed-dollar floors, and income-based caps). As a result, each limit has a different mix of strengths and weaknesses, making it a better fit in some contexts than others.

Like limits, tax expenditures also vary in systematic ways, and this Article identifies an important distinction among them: For some tax expenditures, marginal benefits vary only with the activity level of all claimants in the aggregate; for others, marginal benefits also vary with the activity level of each claimant. When we subsidize green energy, for instance, the aggregate is our main concern; the goal is to replace as much carbon-based energy as possible, and it matters less who is doing so (as long as they do it well enough). In contrast, when we subsidize health insurance, we care a lot about how much insurance each individual has. The difference between what this Article calls “aggregate” subsidies (like green energy) and “individually-based” subsidies (like health insurance) can influence the type of limit we want.

For example, caps are likely to be a better fit for individually-based subsidies than aggregate ones, since we care more about how much each claimant claims. In deciding whether to impose a cap, we should ask what happens when individual claimants engage in additional favored activity. Do the marginal programmatic benefits decline? If they do, encouraging more activity stops being cost effective at a certain point. For example, what if a basic health insurance policy creates positive externalities, but a more expensive “gold-plated” policy does not add more? If this is the case, we should subsidize only basic policies. Capping the subsidy saves money while preserving programmatic benefits. A further advantage is that, unlike other limits, a cap does not disallow more deductions as claimants earn more. By not increasing a claimant’s effective marginal rate in this way, a cap adds less to excess burden. A cap also can improve distribution, since high-income taxpayers are more likely to buy gold-plated policies. As long as the marginal benefits from health insurance subsidies decline in this way, then, a cap can advance all the goals. In contrast, we do

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19 See Feldstein et al., note 8, at 506.
not get the same "grand slam" in capping a green energy subsidy, since marginal externalities for each claimant do not decline in the same way. After all, installing one solar panel on every roof in a particular neighborhood is no better than two on every other roof. Either way, we replace the same amount of carbon-based energy.

While capping health insurance could advance all our goals, it is more typical for trade-offs to arise. Each limit offers a different mix of trade-offs, which is a better fit for some subsidies than others. For example, income-based floors involve a trade-off between programmatic benefits and excess burden. They avoid subsidizing the first dollar of favored activity, which is helpful if the targeted group would engage in this activity anyway. At the same time, though, they increase the effective marginal tax rate by disallowing more deductions as claimants earn more. A similar trade-off arises with phase-outs. There are programmatic advantages in excluding high-income claimants, since they need less help and are more likely to engage in the favored activity anyway. But phase-outs also increase the effective tax rate. Whether a floor or phase-out makes sense in a particular context depends on the empirical magnitude of these (and other) competing effects. For example, a floor is a poor fit when the goal is to persuade claimants to do what they are not already doing (for example, joining the work force), but a good fit when the goal is to encourage more of what they are already doing (for example, charity).

Empirics feature prominently in this analysis. As a result, since empirical assessments are beyond this Article's scope, only tentative suggestions—not definitive recommendations—are offered about individual tax expenditures. Even so, the importance of empirics and context has four further implications. First, there are advantages in varying the subsidy rate, which this Article calls the "marginal reimbursement rate,"\(^\text{20}\) for different tax expenditures. Instead of using the marginal tax rate, as we do for deductions and exclusions under current law, we should rely on context-specific assessments of externalities and elasticity. Second, we should tailor a separate limit for each tax expenditure. For instance, instead of imposing a $25,000 cap on all itemized deductions, as Mitt Romney proposed,\(^\text{21}\) we should use a separate limit for each. Third, empirical research on these issues has obvious value. Treasury should consider investing more in this research, as well as sharing more data. Fourth, the marginal reimbursement rate often should vary with income, notwithstanding the


contrary recommendation of Lily Batchelder, Fred Goldberg, and Peter Orszag.\textsuperscript{22}

Needless to say, none of this is easy. Two problems loom especially large in reforming tax expenditures. First, many of the relevant empirical questions are quite difficult to resolve. There is only limited evidence about the magnitude of relevant externalities, elasticities, labor and savings distortions, and administrative costs.\textsuperscript{23} Effects on distribution are also contested.\textsuperscript{24} Yet empirical uncertainty is a perennial challenge in tax policy (and, indeed, in life). If we refuse to make policy changes without full information, we (tacitly) commit to the status quo. This is itself a decision based on imperfect information. Instead, we should do what we can with the limited information we have.

Second, the political hurdles are quite daunting, since each tax expenditure draws support from a range of interest groups. Real estate developers, contractors, and mortgage lenders defend the mortgage interest deduction,\textsuperscript{25} while religious organizations, universities, and museums support the charitable deduction,\textsuperscript{26} and so on. Overcoming this opposition is especially difficult in a climate of partisan deadlock. Even so, any effort to reduce the deficit has to disappoint someone. Compared with the alternatives, limits on tax expenditures have a notable political advantage. Because they are complicated, limits are less salient to voters.\textsuperscript{27} For example, we can increase effective marginal rates not only by raising the stated rate, but also by disallowing more deductions as taxpayers earn more. Because the Pease rule uses

\textsuperscript{22} Batchelder et al., note 10, at 24-25.
\textsuperscript{24} See James Poterba & Todd Sinai, Tax Expenditures for Owner-Occupied Housing: Deductions for Property Taxes and Mortgage Interest and the Exclusion of Imputed Rental Income, 98 Am. Econ. Rev. 84, 84 (2008).
\textsuperscript{25} Dennis J. Ventry, Jr., The Accidental Deduction: A History and Critique of the Tax Subsidy for Mortgage Interest, 73 Law Contemp. Probs. 233, 233 (2010).
the latter approach, it is less visible to unsophisticated taxpayers. In any event, political challenges should not keep us from considering how to reform tax expenditures. After all, we need to know where we want to go, even if it is hard to get there.

This Article contributes to an ongoing debate about the effectiveness of subsidies and Pigouvian taxes. For example, Victor Fleischer argues that we should "curb our enthusiasm" for these instruments because the social benefits and costs of the targeted behavior vary for different people; as a result, a uniform tax or subsidy is too generous for some and insufficient for others. To deal with this heterogeneity and uncertainty, Brian Galle favors using different prices for different people. This Article analyzes and classifies challenges associated with heterogeneity, uncertainty, and other context-specific factors, shows how daunting these challenges can be, and offers a range of strategies for dealing with them.

In developing a three-part framework and analyzing different limits, this Article focuses more on institutional design than does the public finance literature on optimal tax and externalities. At the same

28 IRC § 68(b)(1).
31 See, e.g., Helmuth Cremer, Firouz Gahvari & Norbert Ladoux, Externalities and Optimal Taxation, 70 J. Pub. Econ. 343 (1998) (noting that the optimal mix of Pigouvian and income taxes depends on the degree and type of information available, so that Sandmo’s additivity principle may not always apply); Peter Diamond, Optimal Tax Treatment of Private Contributions for Public Goods With and Without Warm Glow Preferences, 90 J. Pub. Econ. 897 (2006) (incorporating tax-favored donations in optimal tax framework); Louis Kaplow, Optimal Control of Externalities in the Presence of Income Taxation, 53 Int'l Econ. Rev. 487 (2012) [hereinafter Optimal Control] (arguing that simple Pigouvian directive to set tax equal to marginal harm should not be modified in light of pre-existing labor distortions or distributional goals); Louis Kaplow, The Optimal Supply of Public Goods and the Distortionary Cost of Taxation, 49 Nat'l Tax J. 513 (1996) [hereinafter Optimal Supply] (noting circumstances in which optimal supply of public goods can be determined with simple cost-benefit calculus, without regard to distortionary costs of taxation); Yew-Kwang Ng, The Optimal Size of Public Spending and the Distortionary Cost of Taxation, 53 Nat'l Tax J. 253 (2000) (arguing that incentive effects of both the public spending and the accompanying tax must be considered, as well as their net distributional effect); Jukka Pirttila & Ronnie Schob, Redistribution and Internalization: The Many-Person Ramsey Tax Rule Revisited, 27 Pub. Fin. Rev. 541, 554 (1999) (developing many-person Ramsey tax rules in model with externalities); Emmanuel Saez, The Optimal Treatment of Tax Expenditures, 88 J. Pub. Econ. 2657 (2004) (arguing that optimal subsidy on “contribution good” that provides both private and public benefits, such as charity, increases with the price elasticity of contributions, the size of the public benefit, and the extent to which public contributions crowd out private contributions); Agnar Sandmo, Optimal Taxation in the Presence of Externalities, 77 Swed. J. Econ. 86 (1975) (incorporating externalities in an optimal tax framework and showing that usual commodity taxes based on elasticity must be coupled with taxes and subsidies targeting externalities); Joel Slemrod & Shlomo
time, this Article offers more general observations and prescriptions than does the vast literature on specific tax expenditures, which includes work on the employer-provided health insurance exclusion, mortgage interest deduction, state and local tax deduction, EITC, charitable deduction, Pease Rule, alternative minimum tax, the Romney cap and the alternative tax proposed by Warren Buffett, as well as economic simulations of various proposals. Some other work also operates at this intermediate level of generality. But this work often comes to different conclusions, and considers only a subset of the issues addressed here, including the effect of limits on marginal


37 See, e.g., Reed Shuldiner & David Shakow, Lessons from the Limitation on Itemized Deductions, 93 Tax Notes 673, 678 (Oct. 29, 2001) (showing that the Pease Rule increases effective marginal rates but does not affect the tax savings from the marginal deduction).

38 See, e.g., Hines & Logue, note 1, at 1-6 (defending the alternative minimum tax, while also proposing an alternative maximum tax). Daniel Shaviro has also invoked the AMT as evidence of congressional ambivalence about tax expenditures. Daniel Shaviro, Perception, Reality and Strategy: The New Alternative Minimum Tax, 66 Taxes 91, 92-93 (1988) (describing enactment of AMT as a move from ambivalence to schizophrenia).


41 For example, James Hines and Kyle Logue focus only on the trade-off between progressivity and the "nontax" policies pursued through tax expenditures, without incorporating excess burden into their analysis. Hines & Logue, note 1, passim. Likewise, in his short piece, Shaviro focuses only on the Romney cap and the Buffett alternative tax and
rates, the macroeconomic impact of tax expenditures, the nontax goals of tax expenditures, fairness, the nontransparent nature of these limits, and the advisability of uniformity.

While tax expenditures are a broad topic, they (and other subsidies) are merely a subset of the policy instruments available to the government. For example, instead of subsidizing favored behavior, the government can penalize disfavored behavior. Since these strategies are mirror images, the analysis here can be relevant to Pigouvian taxes and other penalties, although these connections are not the focus of this Article. Still another alternative—instead of carrots and sticks—is for the government simply to require the behavior it wants or to prohibit what it opposes. Since regulatory mandates are the subject of a robust literature, and involve a somewhat different mix of costs and benefits, they are beyond this Article's scope.

Part II of this Article surveys a spate of proposals that use one-size-fits-all limits. Part III develops the three-part framework and discusses five strategies for preserving programmatic benefits at lower cost. Part IV analyzes seven limits and the trade-offs they involve. Part V identifies two "grand slam" scenarios in which all the goals

do not seek to discuss the costs and benefits of various other limits and the trade-offs they involve. Shaviro, note 39.

42 Elliott Manning and Laurence Andress show how limits on various tax expenditures influence effective marginal rates, but they focus only on excess burden and not programmatic incentives and distribution. Elliot Manning & Laurence M. Andress, The 1996 Marginal Federal Income Tax Rates: The Image and the Reality, 73 Tax Notes 1585 (Dec. 30, 1996). Martin Sullivan discusses different ways that caps influence effective marginal rates, but does not discuss their effects on programmatic incentives and distribution, or the impact of other limits (such as floors or fractions). Martin A. Sullivan, Deduction Caps Can Raise Marginal Rates, Cut Economic Growth, 137 Tax Notes 939 (Nov. 26, 2012).


44 Gregg Polsky proposes to analyze two types of tax expenditures differently in deciding whether to repeal them. For distributional tax expenditures (which promote equity), he focuses on fairness; yet for allocative tax expenditures (which encourage specific behavior), he focuses on what this Article calls "programmatic incentives." In contrast, this Article argues that both of these issues are relevant for all tax expenditures, as is excess burden, which Polsky does not discuss. His brief article also does not evaluate specific types of limits and the trade-offs they involve. Gregg D. Polsky, Rationally Cutting Tax Expenditures, 50 U. Louisville L. Rev. 643 (2012).

45 Id. at 644 (focusing on fairness for what Polsky calls "distributional" tax expenditures).

46 See Galle, note 27, at 61-65; Jacob Goldin & Yair Listokin, Tax Expenditure Salience, 16 Am. L. & Econ. Rev. 144, 144-49 (2014); Schenk, note 27, at 256-60.

47 See Batchelder et al., note 10, at 24-25.


align. It also shows how context-specific tailoring is needed to balance trade-offs, and takes issue with Batchelder, Goldberg, and Orszag’s view\(^\text{50}\) that tax expenditures usually should offer the same reimbursement rate at all income levels. Part VI is the conclusion.

II. REVENUE, POLITICS, AND A PROLIFERATION OF ONE-SIZE-FITS-ALL PROPOSALS

A. A Potentially Significant Source of Revenue

Repealing or limiting tax expenditures can raise a great deal of revenue. The federal government committed $1.2 trillion to tax expenditures in Fiscal Year 2014,\(^\text{51}\) compared with $3.5 trillion of direct spending and $3.02 trillion of taxes collected.\(^\text{52}\) Adjusted for inflation, tax expenditures have nearly doubled since 1991.\(^\text{53}\) The largest tax expenditure, the exclusion for employer-provided health insurance, was estimated at $143 billion in 2014.\(^\text{54}\) This is more than the 2014 federal budget allocated to the Departments of Homeland Security ($39 billion), Education ($71.2 billion), and Justice ($16.3 billion) combined.\(^\text{55}\) Likewise, the three largest tax expenditures supporting home ownership were estimated at $123.8 billion in 2014 ($67.8 billion for home mortgage interest, $31.9 billion for property taxes, and $24.1 billion for profits from the sale of a personal residence).\(^\text{56}\) This rough estimate suggests that health insurance and homeownership together ($267.5 billion) cost more than the interest on the national debt ($231 billion).\(^\text{57}\) Like direct expenditures, tax expenditures support a broad

\(^{50}\) See Batchelder et al., note 10, at 24-25.


\(^{53}\) McBride, note 1, at 1 (representing 96% growth since 1991).

\(^{54}\) Joint Comm. on Tax’n, note 51, at 31.


\(^{56}\) Joint Comm. on Tax’n, note 51, at 25-26.

range of activities, including charity ($46.9 billion),\textsuperscript{58} research and development ($10.2 billion),\textsuperscript{59} green energy ($3.8 billion),\textsuperscript{60} earned income ($69.2 billion),\textsuperscript{61} retirement savings ($132 billion),\textsuperscript{62} and education ($33.6 billion).\textsuperscript{63}

\section*{B. Politics and the Proliferation of One-Size-Fits-All Proposals}

Since so much money is at stake, it is not surprising that nonpartisan commissions, politicians on both sides of the aisle, and leading academics have proposed to scale back tax expenditures in various ways. Yet advancing this agenda is not easy, since tax expenditures have deep political roots. They offer concentrated benefits to organized interest groups, and are subject to less scrutiny than spending programs under congressional rules.\textsuperscript{64} Tax expenditures also allow taxpayers to keep money they already have, drawing strength from a cognitive bias known as the endowment effect.\textsuperscript{65}

Even so, limiting tax expenditures has four political advantages over other ways to cut the deficit. First, for some voters, limits are less salient than rate increases.\textsuperscript{66} Like the alternative minimum tax, their effects can be hard to discern, particularly for less-sophisticated taxpayers.\textsuperscript{67} Second, this is especially true when politicians promise to

\textsuperscript{58} Joint Comm. on Tax’n, note 51, at 29, 31 (showing $46.9 billion in total, with $4.8 billion for health, $6.3 billion for education, and $35.8 billion for other charity).
\textsuperscript{59} See Appendix.
\textsuperscript{60} Id.
\textsuperscript{61} Joint Comm. on Tax’n, note 51, at 32.
\textsuperscript{62} See Appendix.
\textsuperscript{63} Id. The Appendix offers more detail about these and other examples. Of over 200 tax expenditures identified by JCT in 2014, the top five were: exclusion of health insurance, exclusion of pensions, preferential treatment of dividends and capital gains, state and local taxes, and mortgage interest. Joint Comm. on Tax’n, note 51, at 22-33.
\textsuperscript{65} Daniel N. Shaviro, Rethinking Tax Expenditures and Fiscal Language, 57 Tax L. Rev. 187, 220 (2004) ("A deeper cause [of the appeal of tax expenditures] is the heuristic bias that decision researchers call the endowment effect, under which people systematically under-weight opportunity costs relative to equivalent out-of-pocket costs."); David A. Weisbach & Jacob Nussim, The Integration of Tax and Spending Programs, 113 Yale L.J. 955, 970 (2004) ("They may perceive a tax subsidy as merely letting them keep their money, even while they perceive an identical program that taxes them and gives the money back through programs or services to be a subsidy.").
\textsuperscript{66} See Schenk, note 27, at 255 (arguing that in a "political landscape [where] there is a looming fiscal crisis but intense tax aversion and [where] the politics of taxation make raising additional revenue extremely difficult, Congress [should] use low salience provisions that make taxation more palatable.").
\textsuperscript{67} As other examples, Schenk mentions the Pease rule, limits on personal exemptions and, more generally, limits on tax expenditures. Id. at 276-77 ("For example, interaction between various provisions may obscure their effects. For example, the top nominal marginal tax rate is quite salient but often does not apply because other provisions, such as
impose limits, but do not specify which tax expenditures they will target. While they eventually have to fill in specifics, the proposal can gain momentum before then. Third, scaling back tax expenditures can be characterized as either a tax increase or a spending cut. This hybrid quality gives some “cover” to both political parties. Republicans who pledged not to raise taxes can say they kept their promise, as can Democrats who promised not to cut social programs. Fourth, policies that make the overall economic pie grow can attract a political following. Constituents who expect to reap these welfare gains can become political allies. The same is true of interest groups who do not currently benefit from a tax expenditure, and thus would not be adversely affected by a limit. Instead of being indifferent, they will affirmatively support this limit if they expect to bear the cost of an alternative response to the deficit, such as higher marginal rates, spending cuts, or deficit spending.

Yet, although there is growing political interest in scaling back tax expenditures, a common problem is that proposals often treat all (or almost all) tax expenditures the same way. A prominent example is the 2010 Bowles-Simpson Commission that “relies on ‘zero-base budgeting’ by eliminating all income tax expenditures and then using the revenue to lower rates and reduce deficits.” Commenta-

income ceilings, rate-bubbles, and phase-outs, have the effect of increasing the rate.”); see Manning & Andress, note 42, at 1614 (“[T]he overall limitation on itemized deductions [was] probably deliberately designed to obscure their effect on the [rate] structure and particularly their creation of higher brackets at lower amounts of income.”).


Admittedly, this is the opposite of the traditional view about the bipartisan appeal of tax expenditures articulated by Gene Steuerle and others, but the political dynamic seems to be changing. Eugene Steuerle, Tax Policy from 1990 to 2001, in American Economic Policy in the 1990s, at 139, 154 (Jeffrey A. Frankel & Peter R. Orszag eds., 2002) (“‘[C]onservatives’ still hold a belief that tax expenditures are reductions in tax and ways of giving money back to people, even while ‘liberals’ have come to realize that they can achieve certain social objectives more easily if enacted as a tax cut.”); see Eric J. Toder, Tax Cuts or Spending—Does it Make a Difference?, 53 Nat'l Tax J. 361, 361 (“Tax incentives serve the needs of political leaders by enabling them to appear to reduce spending and taxes, while at the same time pursuing an activist policy that promotes popular programs.”).

Cf. Siona Listokin, Yair Listokin & Samson Mesel, Americans' Preferences for Tax Increases and Spending Cuts, 139 Tax Notes 188, 190 (Apr. 8, 2012) (finding that 58% of survey respondents supported repeal of state and local tax deduction, while 53% supported repeal of home mortgage interest deduction; in contrast, 84% supported tax increases on “at least some” (unspecified) Americans, while 66% supported cuts in (unspecified) nondefense spending, and 64% supported cuts in (unspecified) defense programs).

Nat'l Comm'n on Fiscal Responsibility and Reform, note 7, at 29. In addition to this “zero option,” the commission also offers alternative proposals that retain but scale back a
tors and politicians routinely praise the Bowles-Simpson report,\textsuperscript{73} and rarely focus on its reliance on a uniform approach.

Likewise, both presidential candidates in 2012 proposed uniform approaches to scaling back tax expenditures. President Obama sought to limit the value of a broad range of tax expenditures to 28%. His proposal applied to all itemized deductions as well as a number of exclusions.\textsuperscript{74} Meanwhile, Governor Romney suggested an overall cap on itemized deductions. He originally proposed a $17,000 cap and then increased it to $25,000.\textsuperscript{75} This cap applied to a basket of tax expenditures, although the proposal did not specify which were included.\textsuperscript{76}

Similarly, the United Kingdom introduced an overall cap on "tax reliefs" in 2012, limiting them to the greater of £50,000 or 25% of income. The stated rationale was "to help ensure that those with the highest incomes pay a fairer share."\textsuperscript{77} Commentators have urged other jurisdictions to follow this model.\textsuperscript{78}

There are obvious political advantages to proposals that apply uniformly to all tax expenditures. They spread the pain more broadly. Each interest group has less reason to resist if it is footing only a fraction of the bill. Congress also can say that "we are all in this together," casting interest groups that seek special treatment in a less


\textsuperscript{74} U.S. Treasury Dep't, General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals 74 (2012), available at http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf (proposing to limit "exclusions and deductions [for] any tax-exempt state and local bond interest, employer-sponsored health insurance paid for by employers or with before-tax employee dollars, health insurance costs of self-employed individuals, employee contributions to defined contribution retirement plans and individual retirement arrangements, the deduction for income attributable to domestic production activities, certain trade and business deductions of employees, moving expenses, contributions to health savings accounts and Archer MSAs, interest on education loans, and certain higher education expenses. . . . after they have been reduced by the statutory limitation on certain itemized deductions for higher income taxpayers").

\textsuperscript{75} Entin, note 21.

\textsuperscript{76} Id.


\textsuperscript{78} See, e.g., Warren, note 10, at 359.
flattering light. It may also be harder for interest groups—or at least for average voters—to predict a limit’s effects when it applies to a basket of tax expenditures, instead of a single one. Likewise, defenders of a global limit can say (somewhat disingenuously) that they are not targeting any specific tax expenditure, but are merely making sure that taxpayers do not use too many or lower their tax bill too much. Yet in addition to politicians, leading academics also have advocated uniform treatment of tax expenditures. Governor Romney’s cap originally came from Martin Feldstein, although Feldstein’s proposal uses a percentage of income to define the cap (2% of AGI), instead of a dollar amount ($17,000 or $25,000). Also, instead of capping the amount that can be deducted or excluded, as Romney does, Feldstein caps the tax benefit that can be claimed; under Feldstein’s proposal, then, someone in a higher bracket (who derives more tax benefit per dollar) can claim fewer dollars of deductions and exclusions. Feldstein’s basket cap covers a very broad range of tax expenditures. Earlier versions apply to all itemized deductions, the exclusion for employer-provided health insurance, as well as some credits, while later versions exclude the charitable deduction. Likewise, Edward Kleinbard advocates recasting all personal itemized deductions as 15% credits. “The reason to curb all the personal itemized deductions,” he argues, “is that it is impossible to choose among them. Each can be defended as an incentive for one desirable goal or another.” Echoing this theme, Neil Warren advocates “the UK approach where the focus is on global caps rather than imposing specific caps on a myriad of individual itemized deductions.” Similarly, tax expenditures are treated uniformly in a prominent proposal by Lily Batchelder, Fred Goldberg, and Peter Orszag. Their focus is not on how to limit tax expenditures, but how to struc-

79 See Walter J. Blum, Federal Income Tax Reform—Twenty Questions, 41 Taxes 672, 679 (1963) (“[T]he existence of any one special dispensation makes it easier to argue on behalf of others. . . . [A] Spartan attitude toward defending the integrity of the base will aid in creating the impression that the reform plan is intended to improve the system as a whole, with the chips falling as they may, and is not calculated to benefit certain identifiable groups possessing political strength.”); Martin Feldstein, A Simple Route to Major Deficit Reduction, Wall St. J., Feb. 21, 2013, at H15, (“The 2% overall cap on tax expenditures should be politically more acceptable than changes in the treatment of mortgage interest or other specific deductions because it treats all tax expenditures equally.”).
80 See Warren, note 10, at 376 (arguing that global caps “elicit far less strident criticism as they do not target one particular group but all taxpayers whose total deductions increase with increasing income”).
81 See Feldstein et al., note 8, at 505-07.
82 See Feldstein, note 79, at H15 (“The existing charitable deduction in particular deserves to be maintained.”)
83 Kleinbard, note 9, at 382.
84 Warren, note 10, at 359.
85 Batchelder et al., note 10, at 24-25.
They want each tax expenditure to be a refundable credit (so that it is available even to those who would not otherwise owe tax), instead of a deduction or exclusion. This way, all taxpayers receive the same marginal reimbursement rate, whether they have low or high incomes. To be clear, their goal is uniformity among taxpayers, not among tax expenditures (so they are not arguing that all tax expenditures should have the same marginal reimbursement rate). Rather, they offer an efficiency-based argument that uniform treatment of all taxpayers should be the default.

III. THREE-PART FRAMEWORK: PROGRAMMATIC BENEFITS, EXCESS BURDEN, AND DISTRIBUTION

Notwithstanding their political advantages, one-size-fits-all approaches are not good policy. Rather, in deciding whether to scale back a tax expenditure, we should use context-specific cost-benefit analysis. As Joel Slemrod and Shlomo Yitzhaki have shown, we should consider how welfare costs and benefits change at the margin.

A. A Context-Specific Framework

This Section offers a three-part framework for these judgments. I begin with the programmatic benefits we lose if the tax expenditure is scaled back. For example, if the exclusion for employer-provided health insurance is scaled back, will people be less healthy? Likewise, if a tax expenditure has negative effects, repealing or limiting it could reduce these programmatic costs. The balance is different for each tax expenditure. The next Section explores these issues.

Second, how does scaling back a tax expenditure affect excess burden? For tax expenditures that create significant deadweight loss, repeal or a limit is especially appealing. Yet if repeal or the limit itself creates deadweight loss, the case becomes weaker. Again, there is no one-size-fits all answer. Section II.C considers these questions.

A third important factor is distribution. If a tax expenditure particularly benefits low-income taxpayers, scaling it back is less appealing. Likewise, we should be more wary of administrative and programmatic costs that burden these taxpayers. How much we favor low-

86 Id.
87 See Slemrod & Yitzhaki, note 31, at 189.
88 Models in this literature typically use optimal taxation, supplemented by commodity taxes that pursue redistribution or correct for externalities. See, e.g., Pirtila & Schob, note 31, at 554 (“[T]he modified many-person Ramsey tax rule reveals that the influence of commodity taxation on the demand for taxed goods depends on both redistributional and environmental objectives.”); Sandmo, note 31, at 86.
income taxpayers depends on our social welfare function. Whether a limit disproportionately affects low-income taxpayers depends on the context. For example, the EITC and mortgage interest deduction have different distributional impact, so limiting them in the same way would have different welfare effects. Section II.D analyzes these issues.

This framework focuses on what is lost in repealing or limiting a tax expenditure. The offsetting benefit, of course, is that the government saves money. To know how much this savings enhances welfare, we need to know how it will be used. Will we cut taxes? Will we avoid raising them? Will we cut the deficit? Or fund a new initiative? The case for repeal or limits is stronger if we use the savings wisely. But this is a separate issue, which is beyond this Article's scope. Before we determine the best way to use savings, we first need to generate it—ideally, at the lowest possible (welfare) cost.

Although the rest of this Part discusses programmatic benefits, excess burden, and distribution separately, analyzing only one without the others does not yield a conclusive assessment. While examples are offered at various points to clarify the analysis, they are merely illustrative, and are not meant as definitive recommendations. Such a thorough analysis would require fact-specific inquiries that are beyond this Article's scope. Instead, the goal here is to clarify the relevant

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89 As Louis Kaplow has shown, excess burden and distribution need not be considered if the government can tell what benefit each individual derives from a program and charges each taxpayer this amount. This benefits tax involves no redistribution or behavioral distortions, since people are simply paying for value. Kaplow, Optimal Supply, note 31, at 514 (explaining that, when "any reduction in disposable income due to the tax adjustment is balanced by the benefit from the public good," work effort and utility level are unaffected and "the simple cost-benefit formula indicates whether the public good should be supplied"); Kaplow, Optimal Control, note 31, at 487-89 (formalizing this result). But if the program is financed with a tax that involves redistribution and behavioral distortions, as is generally the case, these additional factors must be considered.

90 Indeed, it could be that the same limit is cost-justified if the savings is used one way, but not another. See, e.g., Michael Schuyler, Tax Found., The Effect of Terminating Tax Expenditures and Cutting Individual Tax Rates (Sept. 30, 2013), http://taxfoundation.org/article/effects-terminating-tax-expenditures-and-cutting-individual-income-tax-rates (using Tax Foundation's taxes and growth model to simulate effects of cutting various tax expenditures with and without rate cuts; simulations suggest that rate cuts are needed to counteract potentially significant adverse effects on growth); cf. Slemrod & Yitzhaki, note 31, at 189 (noting that when tax and transfer policy is not set optimally, decision about whether to add a new government program depends on how it will be funded; answer can change if one funding source is used instead of another).

91 Of course, if tax and spending policies were optimal, then this would not be the case. As Slemrod and Yitzhaki have observed, the marginal benefit from all public projects and the marginal cost of public funds would all be the same. Otherwise, we would replace low-benefit projects with higher-benefit ones, and we would replace higher-cost funding sources with lower-cost ones, until all were equal at the margin. Slemrod & Yitzhaki, note 31, at 191-96. Yet only the staunchest optimist would suggest that current tax and spending policies are anything close to optimal.
questions, identify trade-offs and patterns, and develop more general lessons.

**B. What Programmatic Benefits Would Be Lost in Repealing or Limiting a Tax Expenditure?**

This Section considers the programmatic benefits that would be lost when scaling back a tax expenditure. We want to keep as much of the benefit as possible, even as we cut costs. The goal, then, is to extract more programmatic benefits per subsidy dollar—that is, more “bang for the buck.”

1. **Externalities, Private Benefits, and Incidence**

The priority should be to preserve positive externalities (as opposed to private benefits), since otherwise these benefits to third parties would be undersupplied. At the margin, a subsidy usually should equal the marginal positive externalities it creates (net of any marginal negative externalities). By contrast, the market usually provides private benefits without a subsidy. For example, we do not need to subsidize mortgage interest to ensure that wealthy people live in houses they like. However, some private benefits are worth subsidizing for distributional reasons. An important justification for the EITC, for instance, is the private benefits it offers to low-income taxpayers.

In assessing the value of externalities and private benefits, we need to account for economic incidence. For example, if the EITC enables employers to reduce wages, the real beneficiary is the employer instead of the employee. Likewise, a subsidy for health insurance might drive up the cost of care, benefiting health care providers more than policyholders. Obviously, we need to know who is really benefitting in order to determine the value of a subsidy.

2. **Three Possibilities: Repeal, Status Quo, or Tightening Strategies**

A tax expenditure (or, indeed, any government program) that is counterproductive obviously is a promising candidate for repeal. For instance, cigarette companies used to argue that cigarettes—or at least

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92 Louis Kaplow, On the (Ir)Relevance of Distribution and Labor Supply Distortion to Government Policy, J. Econ. Persp., Fall 2004, at 159-64 (advocating the idea that optimal subsidy equates marginal social benefit of activity with marginal social cost). It also can be lower if these externalities correlate with leisure, and higher if they correlate with another (unsubsidized) externality. This is equivalent to offsetting the subsidy with a commodity tax. Kaplow, Optimal Control, note 31, at 497, 501, 505; Kaplow, Optimal Supply, note 31, at 518; Saez, note 31, at 2675-80.
some brands—were good for a smoker’s health. If a subsidy had been enacted to encourage better health through smoking, the right response obviously would be to repeal it.

The same is true of a tax expenditure that offers only meager programmatic benefits. For example, if a tax expenditure enables the government to endorse a particular activity, but fails to induce more of it, the government should look for cheaper ways to make a symbolic statement.

In contrast, it is costly to scale back a tax expenditure that produces substantial positive externalities. For instance, accelerated depreciation and other investment incentives arguably promote economic growth more effectively than marginal rate cuts (and, in fact, would not be classified as “tax expenditures” under a consumption tax baseline). Robust programmatic benefits can supply a powerful reason to keep a tax expenditure, although we also should account for excess burden and distribution.

Yet even if a tax expenditure (or any government program) is worth preserving, we should try to attain all (or most) of its programmatic benefits at lower budgetary cost. The rest of this Part identifies five ways to do so: (1) defining the funded activity more precisely; (2) identifying more responsive claimants; (3) favoring claimants who will make more effective use of the subsidy; (4) calibrating how much activity we should fund, both for each claimant and overall; and (5) housing the program in a part of the government that can implement it most effectively. In choosing a strategy, we have to account for the factual context, as well as excess burden and distribution. What works for one tax expenditure may not work for another.


94 For example, a widely cited study claims that repealing accelerated depreciation and other investment incentives to fund reductions in the corporate tax rate would slow growth. See John W. Diamond, George R. Zodrow, Thomas S. Neubig & Robert J. Carroll, The Dynamic Economic Effects of a U.S. Corporate Income Tax Rate Reduction 17-18 (Oxford Univ. Ctr. for Bus. Tax’n, Working Paper No. 14/05, 2014), available at http://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications/Working_Papers/series-14/WP1405.pdf. Other studies conclude that repealing individual tax expenditures that favor savings and investment would significantly reduce savings and investment; the effect is especially pronounced if repeal is not accompanied by an across-the-board rate cut, but remains even if it is. See, e.g., Schuyler, note 90, at 5.
3. Which Activity Do We Want to Encourage?:
   Definitional Strategies

A familiar way to "tighten up" a tax expenditure is to define the funded activity more precisely. A clearer and more focused signal presumably is more likely to motivate the behavior we want. There is value, then, in explicitly excluding low-value activities. For example, education credits exclude "education involving sports, games, or hobbies" as well as nonacademic fees. The reason presumably is that these expenses add less to human capital than academic tuition, and also are not easy to distinguish from leisure.

Yet precision is helpful only if it actually distinguishes high- and low-value activities, and this is not always the case. For example, detailed rules specify what qualifies as a deductible medical expense, but the answers sometimes seem arbitrary: Removing lead paint is deductible, but covering it with wallpaper is not; breast pumps are deductible, while maternity clothes are not, and so on.

Precise definitions also can be costly to formulate and administer. Sometimes these costs are justified, but sometimes they are not. For example, the charitable deduction arguably should cover for-profit charity, as well as gifts to family and friends, since these activities can generate positive externalities. Yet a key problem with subsidizing them, as Kaplow has observed, is the challenge of distinguishing them from standard commercial arrangements.

In some cases, the government does not have the substantive expertise or political independence to develop precise funding parameters. For these reasons, the research and development credit is imprecise by design. The government is not well positioned to determine which technologies are most promising. Instead, the R&D credit uses expansive criteria, such as requiring projects to be "technological in nature," and "useful in the development of a new or improved business

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95 IRC § 25A(f).
96 See Staff of the Joint Comm. on Tax'n, 113th Cong., Background and Present Law Related to Tax Benefits for Education 7 (Comm. Print 2014), available at https://www.jct.gov/publications.html?func=startdown&id=4621 (noting these expenses are deductible only if undertaken to improve jobs skills).
98 Kaplow, note 36, at 475 ("Of course, any rationale for subsidizing gifts assumes that, as a practical matter, they can be distinguished from payments for goods or services. But the presence of return flows from beneficiaries to donors (which could even include returning the gift itself) would often be difficult to detect, particularly for gifts within the family. This administrative constraint may be more of a problem with respect to private giving than contributions to public charities.")
component." The charitable deduction is similarly broad and vague.

Its nondirective approach promotes experimentation, enabling the government to fund causes that would not (yet) be supported by the median voter. As a result, the civil rights movement, environmentalism, and the women’s rights movement all were launched with deductible charitable contributions. At the same time, a nondirective approach also creates the risk that undeserving activities will be funded. The optimal balance between promoting experimentation and reducing waste will vary for each tax expenditure, and excess burden and distribution must also be considered. Again, there is no one-size-fits-all answer.

4. Which Claimants Are Easiest to Motivate?: Elasticity Strategies

Once the favored conduct has been defined, a key question is how much the government must pay to induce more of it. Obviously, less is better. Another familiar strategy, then, is to favor claimants who are relatively open to the favored conduct, and thus respond to a leaner subsidy. “By targeting the subsidy to those whose tastes for the favored commodity are relatively intense,” Alan Blinder and Harvey Rosen have observed, a subsidy “does not ‘waste’ money on those whose consumption is not stimulated very much.”

The amount needed to change behavior will vary with the person, as well as the tax expenditure. Sometimes tastes and philosophical commitments are relevant. For instance, it probably is easier to persuade a committed environmentalist to buy solar panels.

Typically, high-income taxpayers are easier to influence, since they have more capacity in their budgets. For example, if we want some-

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99 IRC § 41(d).
100 See IRC § 170(c).
101 Schizer, note 36, at 244.
102 See Batchelder, et al., note 10, at 46; Kaplow, Optimal Supply, note 31, at 518; Saez, note 31, at 2659 (“First and obviously, the size of the subsidy is closely related to the size of the external effect. . . . Second, the optimal subsidy is positively related to the price elasticity of the contribution good.”); Sandmo, note 31, at 93, 97 (“[E]ven in a world of distortions where the allocative functions of the price system cannot be separated from its effects on distribution, there is scope for taxing externality-generating commodities according to the Pigouvian principle” and “the optimal tax rate for the externality-creating commodity is a weighted average of the inverse elasticity and the marginal social damage”). In general, this Article focuses on uncompensated elasticity, so I do not assume that income is adjusted to eliminate any income effects.
103 Alan S. Blinder & Harvey S. Rosen, Notches, 75 Am. Econ. Rev. 736, 741-42 (1985) (analyzing “notch” strategies that vary subsidy with consumption levels, including floor on charitable deduction; arguing that “reasonable notch schemes make smaller demands on the treasury . . . but often have larger excess burdens” and that this trade-off can be worthwhile because “real world tax finance creates its own efficiency costs.”).
one to commit $25,000 to solar panels or a fuel-efficient car, a potential claimant earning $2.5 million is easier to persuade than one earning $50,000. In response, we can structure the subsidy so it declines with income, or we can set it at the (leaner) level that is appropriate for high-income claimants. Likewise, limiting the subsidy to itemizers tends to channel it to high-income claimants. Of course, distribution or excess burden sometimes counsels against this approach, and should be weighted in the balance.

Although claimants should be responsive, they should not be too responsive. We should not pay for what taxpayers would do anyway. For example, subsidizing the first dollar of charity is wasteful if everyone would give this amount without a subsidy. In response, we can disallow charitable contributions below a floor. In other work, I have suggested a charitable credit that becomes more generous as taxpayers give a higher percentage of their income to charity. Likewise, President Bush's 2005 tax reform panel proposed to subsidize charity only above 1% of income. Yet a familiar challenge is that preferences vary. For example, although many Americans give at least 1% of their income to charity—and some receive no subsidy, since they claim the standard deduction—a 1% floor would still be too high for some and too low for others. Some will stop giving, some

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104 Stanley S. Surrey, Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures, 83 Harv. L. Rev. 705, 719 (1970) ("It is generally argued that tax incentives are wasteful because some of the tax benefits go to taxpayers for activities which they would have performed without the benefits."); Edward A. Zelinsky, Efficiency and Income Taxes: The Rehabilitation of Tax Incentives, 64 Tex. L. Rev. 973, 992 (1986) ("To the extent a tax incentive rewards a producer for production in which he would have engaged anyway, or reimburses a consumer for consumption he would have undertaken in any event, the government has acted inefficiently by giving up revenue without inducing more activity.").

105 See Ackerman & Auten, note 14, at 523; Joel Slemrod, Buenas Notches: Lines and Notches in Tax System Design 18 (2010), available at http://webuser.bus.umich.edu/jslemrod/pdf/Buenas%20Notches%20090210.pdf ("[C]ompared to a constant per-unit subsidy that applies to all charitable donations, a notch grant that kicks in only for those whose consumption exceeds a certain amount limits the amount of subsidy for inframarginal giving. In principle, when revenue is costly to raise, the ideal subsidy scheme would provide a subsidy only at the margin of favored consumption but, in the absence of personalized incentive schemes or other non-linear consumption taxes or subsidies, a notch may increase welfare.").

106 Schizer, note 36, at 268.


108 A 1% floor may be too high at the top. According to Ackerman and Auten, the median itemizer (in 2003) gave 2.3% of economic income, those earning between $500,000
will receive an inframarginal subsidy, and some will reduce their contribution to offset the subsidy they lost through the floor. These competing effects should all be considered in deciding whether, and where, to set a floor (along with excess burden and distribution).

5. Which Claimants Will Make Most Effective Use of the Subsidy?: Comparative-Advantage Strategies

A third approach is to favor claimants who make the most effective use of a subsidy. In some circumstances, claimants are fungible. For instance, assume we want to subsidize carpooling to reduce negative externalities from traffic, such as delays, noise, and accidents. We are unlikely to care which commuters claim this subsidy, as long as enough do.

In contrast, factors such as expertise, infrastructure, geography, or even weather sometimes give claimants a comparative advantage. For example, if our goal is to encourage technological innovation, engineers have an edge over literary critics and musicians. Similarly, some charitable donors make wiser philanthropic decisions than others. Alternatively, assume our goal is to reduce fuel consumption as a way to enhance national security (by reducing imports from unstable or hostile countries). If we subsidize mass transit, residents of Manhattan (which has extensive mass transit) can use the subsidy more effectively than residents of rural Kansas (which does not). Likewise, subsidizing weather stripping to conserve fuel in heating homes is more effective in frigid Chicago than in mild Los Angeles.

For some tax expenditures, financial need is a source of comparative advantage. Private benefits to low-income claimants add more to welfare, given diminishing marginal utility. In addition to distribution, there also is an externalities-based reason. If a community is committed to supporting anyone who is not self-sufficient, the community saves money when people become self-sufficient. Someone who enters the workforce no longer relies on the community for support.

and $1 million gave 1.4%, and those earning over $1 million gave 1.1%. Ackerman & Auten, note 14, at 515 tbl.1. Panel Study of Income Dynamics (PSID) data for nonitemizers shows a 1.36% median for nonitemizers. Id. at 516 tbl.2. Fifty-eight percent of families that made charitable contributions gave more than 1%. Id. at 517.

109 For example, assume that someone subject to a 50% rate has been giving 3% of her income to charity; if we add a 1% floor, she can preserve the same after-tax cost by reducing her giving to 2%. Without the floor, a 3% contribution costs 1.5% (that is, 50% of 3%). With a 1% floor, a 2% contribution also costs 1.5% (that is, 1% plus 50% of 1%). See id. at 513 (discussing net altruism); Martin Feldstein & Lawrence Lindsey, Simulating Nonlinear Tax Rules and Nonstandard Behavior: An Application to the Tax Treatment of Charitable Contributions, in Behavioral Simulation Methods in Tax Policy Analysis 139, 151-52 (Martin Feldstein ed., 1983) (same).
The same is true when he funds his own health care, housing, and retirement savings. By inducing people to take these steps, a subsidy can generate what this Article calls positive "self-sufficiency externalities." Low-income claimants are especially likely to generate these externalities, since they are at greater risk of depending on the community.\(^{110}\)

In promoting self-sufficiency externalities, we target those who (by definition) would not otherwise engage in the favored conduct (for example, working or saving for retirement). If we are successful, the good news is that we are less likely to pay for what claimants would do anyway. The other side of this coin, though, is that these claimants are (by definition) resistant, rather than responsive. As a result, they are harder (and more expensive) to motivate. For these subsidies, greater welfare gains come at greater cost.

But fortunately, this trade-off between comparative advantage and elasticity does not always arise. In other contexts, taxpayers who make the most effective use of a subsidy are also the most responsive. For example, the same reason Chicagoans use weather stripping more effectively than Angelinos—the cold weather—also makes them want it more. As a result, Chicagoans require less persuasion to buy it. The same is true of mass transit subsidies. Since Manhattan residents actually can use this subsidy, they will be more responsive. Likewise, it will be easier to persuade an engineer than a literary critic to engage in R&D. Since claimants would have to invest time and resources, they are more likely to do so if they expect a return.

Thus, while we have a uniform goal with each subsidy—to favor claimants who generate the most welfare per subsidy dollar—we should pursue this goal differently for each tax expenditure. If a claimant’s comparative advantage derives from financial need, an income-based test may be the right mechanism. Yet if comparative advantage is rooted instead in a claimant’s effectiveness in engaging in the favored conduct—given their preferences, location, expertise, and the like—other approaches will be preferable. In some cases, we should sort claimants with a competitive process, as when developers apply to state housing agencies for the low-income housing credit. In

\(^{110}\) Another option is simply to require the relevant behavior, or to penalize those who do not engage in it. Yet even if we otherwise would be tempted to take this approach, there are particular challenges with low-income citizens. Can we really require them to spend money they do not have? Instead, we are likely to subsidize them. For instance, although the Affordable Care Act penalizes those who do not buy health insurance, it also subsidizes policies for low-income people. Patient Protection and Affordable Care Act, Pub. L. No. 111-148, tit. I-II, 124 Stat. 119, 130-353 (2010) (creating the penalty at IRC § 1501, providing tax subsidies in Title I, and expanding Medicaid in Title II). Thus, the analysis of subsidies here remains relevant.
other cases, substantive conditions could be introduced, for instance, so weather-stripping is subsidized only in cold climates. We also can winnow with price. By keeping the subsidy low, the government allocates it to taxpayers who are most willing to put up their own money, such as researchers who are especially confident about R&D or philanthropists who are particularly committed to a cause. The right strategy varies with the factual context and, of course, must also account for excess burden and distribution.

6. How Much Favored Activity Do We Want?
Activity-Level Strategies

In addition to defining the favored activity carefully and identifying the right claimants, we also need to calibrate the amount of activity we want to subsidize. Another tightening strategy, then, is to focus on how much funded activity we want overall and, in some cases, how much we want per claimant.

For any tax expenditure, there are likely to be diminishing returns when we encourage more favored activity in the aggregate. Once we have funded all the high-value projects (for example, solar panels in sunny locations), the remaining low-value projects (cloudy locations) offer less bang for the buck. In response, Congress can cap its overall annual spending on a tax expenditure. Although common for direct expenditures, a fixed appropriation is rare for tax expenditures. Congress does use one, though, for the low-income housing credit.\textsuperscript{111}

\textbf{a. Individually Based Tax Expenditures Versus Aggregate Tax Expenditures}

Marginal returns can vary not only with the overall activity level, but also with the activity level of each claimant. These variations are crucial for some tax expenditures, and minor for others. Distinguishing these two types of tax expenditure is a contribution of this Article. This difference affects the type of limit we should use.

Sometimes the activity level of each claimant is quite important. For instance, assume our goal in subsidizing retirement savings is to keep retirees from becoming a burden on the community. With this goal, subsidizing someone who would otherwise need the community's help (for instance, because he would save only $100 per year on his own) generates more positive externalities than subsidizing someone who would be self-sufficient anyway (for instance, because she would

\textsuperscript{111} IRC § 42(h)(3)(C) (establishing a cap on the low-income housing credit available to each state).
save $1 million each year without a subsidy). When we are promoting self-sufficiency, then, marginal positive externalities decline as an individual engages in more of the favored activity, since society does not have to pitch in as much.

In contrast, sometimes only the aggregate activity level is relevant, while the per-person level is not. In these cases, once we identify the right pool of potential claimants, we can rely on a blunt allocation to this group, without worrying about how much each individual claims. Subsidized solar panels are an example. If the goal is to reduce greenhouse gas emissions, we want panels to be installed in sunny locations. But once we do that, it does not matter whether we subsidize one panel on each house, or two on every other house. Either way, we are replacing carbon-based energy. On a claimant-by-claimant basis, marginal positive externalities from solar panels do not decline in the same way (although they can decline as activity levels rise in the aggregate).

This Article uses the phrase “aggregate tax expenditure” to describe the solar panel example, as well as other tax expenditures whose marginal programmatic benefits vary primarily with aggregate activity levels. In contrast, this Article uses the phrase “individually-based tax expenditure” to describe the retirement example, as well as other tax expenditures whose marginal programmatic benefits also vary substantially with individual activity levels.

Different limits are appropriate for these two categories. If our goal is to encourage enough retirement savings so that people are self-sufficient, we should cap the amount of each claimant’s subsidized savings. This sort of cap focuses the subsidy on high-value uses (that is, the minimum needed for self-sufficiency). In contrast, setting a cap of, say, one solar panel per claimant does not offer the same advantage (although there could be other rationales for such a limit, grounded in budgetary impact, excess burden, or distribution.)

b. Examples of Individually-Based Tax Expenditures

The defining feature of an individually-based tax expenditure, then, is that programmatic benefits vary as individual activity levels change. There are several reasons why this can be the case. The first is that marginal positive externalities can decline. This is true of subsidies that encourage self-sufficiency, such as subsidized retirement savings and the EITC. After all, it makes sense to subsidize an extra dollar of earnings when someone’s annual pay is $10,000, but not $200,000. (Obviously, there is a distributional rationale as well, as noted
A similar analysis applies to education credits. If the goal is to encourage the minimum human capital people need to support themselves, marginal programmatic benefits decline in a similar way. If so, per-claimant caps on these tax expenditures are likely to enhance their “bang for the buck” (although we also have to consider excess burden and distribution).

Second, even if positive externalities remain constant (or increase) as the subsidy becomes more generous, there can still be a net marginal decline if programmatic costs increase (more). This is true of tax-free fringe benefits. To avoid administrative costs, employees are not taxed on occasional free meals, modest employee discounts, and the like. Yet this administrative savings comes at a price. Fringe benefits distort compensation practices, since their tax treatment is more favorable than cash. Because some industries can offer them more easily than others, their labor costs are lower. These distortions become more serious as fringe benefits become more valuable. As the subsidy per claimant increases in this way, programmatic costs come to outweigh the administrative savings. This shifting balance suggests that tax-free treatment should be limited to low-value fringe benefits, as generally is the case under current law.

The analysis is similar for subsidized health insurance. A subsidy for basic policies is sufficient to generate most of the positive externalities we want, while a subsidy for “gold-plated” policies introduces new problems. After all, basic policies keep people from depending on the community for health care. They also broaden the insurance pool, so risk is spread more effectively. In addition, basic policies ordinarily prevent people from infecting others and enable them to discharge responsibilities to co-workers, family, other drivers on the road, and the like. So what changes if we also subsidize “gold-plated” policies? There could be more funding for medical research, which generates positive externalities. Yet there also would be private benefits, such as more convenient health care without long waits, which do not justify a subsidy. In addition, we might encourage overspending and drive up health care costs (for example, if deductibles and copayments are lower), thereby generating negative externalities. It is

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112 See Subsection III.B.1. Yair Listokin has argued that there also is a separate macroeconomic effect. Since taxpayers are more likely to lose their jobs in a recession, EITC payments are likely to decline, rendering this tax expenditure countercyclical. See Listokin, note 43, at 62-85 (analyzing macroeconomic impact of a number of tax expenditures).

113 See IRC § 132.

114 See Jonathan Gruber, The Tax Exclusion for Employer-Sponsored Health Insurance, 64 Nat'l Tax J. 511, 515 (2011); McBride, note 1, at 6 (“This tax bias contributes to overspending on health insurance and healthcare, ultimately raising prices rather than the quality of health care.”); Andrew Pollack, Health Care Costs Climb Moderately, Survey Says,
plausible, then, that increasing the subsidy per claimant causes marginal programmatic benefits to decline on a net basis (for example, if the effect on costs outweighs the effect on research). If so, a per-claimant cap increases this tax expenditure’s bang for the buck (although, again, we also have to account for excess burden and distribution).  

Likewise, subsidized home ownership also involves increasing programmatic costs. The purchase of a more expensive home can inspire envy or pressure others to spend more so they “keep up with the Joneses.” There are also negative externalities if homeowners are less able to move for a new job, which could be more daunting with more expensive houses. On the other side of the ledger, there are positive externalities if homeowners are more committed than renters to improving neighborhoods, and if a homeowner’s investment enhances the value of her neighbors’ homes. It seems plausible that the balance of these competing effects becomes less favorable as the subsidy per claimant increases. If so, an individually-based cap increases the subsidy’s bang for the buck (although excess burden and distribution also must be considered).

Finally, although the focus so far has been on marginal programmatic benefits that decline, they also can increase as a claimant en-

N.Y. Times, Aug. 21, 2013, at B1 (indicating the average premium for a family in 2013 rose by 4% to $16,351, according to Kaiser Family Foundation survey, which is a slower rate of increase than the roughly 10% annual increases a decade earlier. Since 1999, premiums have nearly tripled, while wages are up only 50% and consumer prices only 40%).

The so-called “Cadillac tax” that takes effect in 2018—a 40% excise tax on health insurance plans worth more than a minimum level ($10,200 for individuals and $27,500 for families), see IRC § 4980(b)(3)(c)—has essentially the same effect as a direct limit on the health insurance exclusion, but it collects the tax from insurance companies. Thus, employees will not see it on their Form W-2. In response, 17% of employers changed plans in 2013 in anticipation of the law. See Kyle Pomerleau, Tax Found., Obamacare’s “Cadillac Tax” Working as Planned (May 29, 2013), http://taxfoundation.org/blog/obamacares-cadillac-tax-working-as-planned. The Bowles-Simpson Commission and the Bipartisan Policy Center also proposed capping and then phasing out the exclusion. See Nat’l Comm’n on Fiscal Responsibility and Reform, note 7, at 31; Bipartisan Comm’n Debt Reduction Task Force, Restoring America’s Future 16 (2010), available at http://concordcoalition.org/files/RivlinCommissionExecSummary.pdf; see also Bush Panel, note 107, at 61 (limiting exclusion to $11,500 for families and $5,000 for single individuals, which was average projected for health insurance in 2006); Jonathan Cohn, Tax My Health Benefits. Please., New Republic (Mar. 17, 2009), http://www.newrepublic.com/article/politics/tax-my-health-benefits-please.


See Zelinsky, note 104, at 998, 1007 (defending home mortgage deduction with “citizenship externalities,” the idea that home owners are “more responsible and stable members of the community than tenants,” the idea that renovations can raise the value of neighbor’s houses as well, and the need to offset other distortions that discourage investments in residential real estate, such as restrictive zoning, environmental laws, and trade unions).
gages in more favored activity. For example, if the goal is to create a public park, it is more helpful for one person to donate a two-acre plot than for twenty people to donate unconnected one-tenth-of-an-acre plots. In addition, charitable donors who give large gifts have a greater ability to monitor nonprofits, since they have added influence and also more at stake.\textsuperscript{118} When there are scale economies in generating positive externalities, caps can be counterproductive (although excess burden and distribution also must be taken into account).

Given these various context-specific effects, there is no reason to expect the same limit to be a good fit for each tax expenditure. Yet for individualized tax expenditures, if (net) externalities decline as taxpayers engage in more activity, capping the amount each claimant can claim can save money while preserving (most) programmatic benefits.

c. Examples of Aggregate Tax Expenditures

The analysis is quite different, though, for tax expenditures that seek to influence aggregate, rather than individual, activity levels. Calibrating how much each claimant receives is less important (and, indeed, can be unhelpful) in three situations. In the first, it does not matter which claimant engages in the favored conduct, as long as enough do. In the carpooling example above, a subsidy reduces negative externalities from traffic as long as a sufficient number of drivers share rides, but we do not care which do. Congestion, noise, and the risk of accidents are reduced as much when one commuter carpools all of the time as when two commuters carpool half of the time. There is no obvious rationale, then, to limit how much carpooling each claimant is encouraged to do.\textsuperscript{119}

Second, in some cases claimants are not fungible—so we have to ensure they are part of the group that uses the subsidy effectively—but the allocation \textit{within this group} is less important. For instance, we can reduce greenhouse gases more by installing solar panels in sunny climates, as noted above. But once we impose that constraint, it does not matter whether there is one on every house or two on every other house in a given neighborhood. In fact, a weather-related requirement may be unnecessary, since residents of sunny climates are the most likely buyers anyway, as noted above. Instead, requiring a claimant to bear some of the cost (a "matching mechanism") may be

\textsuperscript{118} See Schizer, note 36, at 247.

\textsuperscript{119} Of course, there may be other reasons why some vehicles add particular social value, such as ambulances and police cars. Although they also contribute to congestion, we still may want to exempt them from anti-congestion policies because of the unique social contribution they make.
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sufficient. We can offer the lowest subsidy needed to induce enough claimants to install solar panels, knowing that environmentalists and wealthier households (all in sunny climates) are most likely to claim it. Of course, excess burden and distribution could affect this assessment as well.

The analysis is similar when we want to reduce energy imports for national security reasons. Weather stripping conserves heating oil more effectively in cold climates, as noted above. Within this parameter, though, a subsidy can save the same amount of energy on Michigan Avenue as on the South Side of Chicago. If so, the most cost-effective way to generate these programmatic benefits is to subsidize the more responsive claimant. Indeed, if the Michigan Avenue family is more responsive—and they also have a ski cabin in Colorado—a second subsidy for them could make sense (again, setting aside excess burden and distribution). The analysis is similar for a subsidy that reduces energy imports by promoting fuel-efficient vehicles.

Third, in other cases it does matter who engages in the subsidized conduct, but the government is not well positioned to screen claimants. For example, we are not indifferent about who claims the R&D subsidy, since some are more likely to engage in promising research. But as noted above, the government often lacks the expertise (and political independence) to choose technological winners. Likewise, the charitable subsidy is supposed to promote experiments that the median voter would not (yet) fund; by definition, a politically accountable institution is not well suited to implement this strategy. Instead of relying on the government to choose among competing proposals, then, these tax expenditures use vague language (for example, "technological in nature"\textsuperscript{120}) or rough proxies (for example, the nonprofit form\textsuperscript{121}) to create a broad class of potentially eligible claimants. Further winnowing is accomplished with a matching mechanism. If we are reasonably confident in this allocation method, we can treat R&D and charity as more like aggregate than individualized tax expenditures. After all, the goal is not to ensure that every taxpayer engages in a minimum level of research and philanthropy, but to encourage more of this conduct overall at the lowest possible cost. Unlike with the EITC or subsidized health insurance, then, there is no obvious reason why marginal programmatic benefits decline as individual activity levels increase.

This third category of aggregate tax expenditures, which is premised on the government's inability to allocate the funding effectively, is perhaps the most contestable. Admittedly, we might still want a per-

\textsuperscript{120} IRC § 41(d).

\textsuperscript{121} IRC § 170.
claimant cap if we are skeptical about these nondirective allocations, since a cap can limit losses from misguided projects.\textsuperscript{122} Or we might want to limit the private benefits that claimants receive, such as prestige or personal satisfaction from giving to charity.\textsuperscript{123} Alternatively, in the case of the charitable deduction, we might favor a cap so taxpayers have to participate, at least to a degree, in funding publicly determined priorities; presumably, this communitarian notion underlies current law's cap on the charitable deduction.\textsuperscript{124} Yet these rationales for a cap are different from those for individualized subsidies: Instead of seeking more bang for the buck, they minimize risk or limit harm to other values. In any event, even if we do not want a per-claimant cap, we may want a per-claimant floor. If most businesses engage in some R&D and most taxpayers give at least some charity anyway, subsidizing the first dollar is wasteful, as noted above. In making these judgments, we also have to consider excess burden and distribution.

While this Article distinguishes between aggregate and individualized tax expenditures, the difference is more of a spectrum than a dichotomy. Some tax expenditures have elements of both. As a result, how we classify a tax expenditure—and, more importantly, how we limit it—depends on our policy priority. For example, while an education subsidy can create positive externalities in funding a basic education that leads to self-sufficiency, as noted above, it also can create positive externalities in funding an advanced education that leads to scientific research, public service, or entrepreneurship.\textsuperscript{125} Similarly, a retirement savings subsidy can generate positive externalities in promoting not only self-sufficiency, but also capital formation, which contributes to economic growth. In each case, a subsidy pursuing the first goal (self-sufficiency) generates externalities in encouraging a minimum level per claimant of education or savings, but not more; yet a

\begin{itemize}
\item \textsuperscript{122} For example, if wealthy people have idiosyncratic or unrepresentative preferences, this would counsel in favor of limiting the donations of each individual and encouraging a broader base of donors. Hines & Logue, note 1, at 4 n.15. However, if there is no systematic difference between small and large gifts, the aggregate approach is better. The same obviously is true if large donors make better decisions, for instance, if they invest more time and thought or provide useful monitoring. See Schizer, note 36, at 242-48.
\item \textsuperscript{123} If this "warm glow" declines with giving, that could justify a cap; on the other hand, if warm glow increases with giving (for instance, because larger gifts enable the donor to achieve a more ambitious goal), a cap could be problematic. In any event, the assumption that warm glow contributes to welfare is a contested point. See Diamond, note 31, at 909, 916 (arguing that warm glow might not add to social welfare).
\item \textsuperscript{124} Individuals may not claim a charitable deduction equal to more than 30% or 50% of their AGI. IRC § 170(b)(1)(B). For a critique of this limit, see Schizer, note 36, at 248-50.
\item \textsuperscript{125} See, e.g., Richard R. Nelson & Edmund S. Phelps, Investment in Humans, Technological Diffusion, and Economic Growth, 56 Am. Econ. Rev. 69, 69-71 (1966) (positing that education has positive externalities in facilitating technological innovation, and in enabling a society to apply these innovations more rapidly and more broadly).
\end{itemize}
subsidy pursuing the second goal (human capital or capital formation) also generates externalities at higher levels of education or savings, so we would want to encourage as much as possible across the board. As a result, a per-claimant cap may no longer be a good fit.

Likewise, a child credit can have this sort of hybrid quality, since it can be used to pursue different goals. One is to avoid societal problems from a shrinking population, such as an inadequate labor force or bankrupt social insurance.\textsuperscript{126} To do so, we would encourage more children overall, without regard to who is having them (an aggregate subsidy). However, a different goal is to provide assistance to families who especially need it.\textsuperscript{127} This goal requires us to account for each family’s particular circumstances (including income and the number of children), so that an individual-by-individual analysis becomes relevant.

To sum up, a subsidy generally should equal the (net) positive marginal externalities it generates. In structuring a tax expenditure, then, we have to account for the different reasons why it generates positive (or negative) externalities—or, at least, to decide which is our priority. As a result, some subsidies need to be calibrated on an individual-by-individual basis, while some do not. Obviously, these are difficult and contestable decisions, especially since we also should account for excess burden and distribution. Given the fine-tuning that is necessary, one-size-fits-all limits are unlikely to succeed.

7. Who Allocates the Funding?: Bureaucratic Strategies

In addition to defining the conduct, identifying the claimants, and calibrating the amount of the subsidy, we should consider who should make these decisions. Another tightening strategy, then, is to identify which part of the government is best positioned to make and implement these judgments.

There are familiar arguments for converting tax expenditures to direct expenditures, as Stanley Surrey and others have urged in an extensive literature.\textsuperscript{128} For example, instead of excluding the interest on state bonds from federal taxes, the federal government can make grants for state and local government projects vetted by federal experts. The hope is that these experts could generate more program-

\textsuperscript{126} See Elaine Maag, Simplicity: Considerations in Designing a Unified Child Credit, 63 Nat’l Tax J. 765, 768 (2010).
\textsuperscript{127} Id.
matic benefits per dollar than an inexpert tax bureaucracy.\textsuperscript{129} Likewise, congressional committees with greater substantive expertise could monitor these programs, instead of tax committees.\textsuperscript{130}

On the other hand, sometimes tax experts in Congress and the executive branch have a comparative advantage in making these judgments. This is likely to be the case, for instance, when subsidies are means-tested (like the EITC) or allocated passively to avoid politicized decisions (like R\&D and charity).\textsuperscript{131} The tax system also can have an advantage when the goal is to communicate information or influence norms. If the government wants to endorse particular behavior—as a way to promote more favorable attitudes about it among citizens—this "stamp of approval" has to be communicated in a way that citizens will notice. Nearly all citizens file returns, so the tax system can be an effective channel for this sort of message.\textsuperscript{132}

In any event, the issues discussed so far generally remain relevant if a tax expenditure is converted to a direct expenditure. We still have to decide how precisely to define the favored conduct, which claimants to favor, how generous the subsidy should be, whether it should be capped, and so on. Ultimately, the choice of whether to keep a subsidy in the tax system turns on the factual and institutional context.\textsuperscript{133} Obviously, excess burden and distribution are also relevant. So once again, a one-size-fits-all answer will not be reliable. In any event, given the extensive attention this issue has received elsewhere, it is not the focus of this Article.

8. \textit{Caveat: Transition Costs}

Finally, when we consider whether to scale back a tax expenditure, we also have to account for familiar issues that arise with any change of policy. Given the extensive literature on transitions,\textsuperscript{134} the discus-

\textsuperscript{129} One way to address this issue is for the tax system to partner with another part of the government. To claim a low-income housing credit, for instance, a taxpayer must be chosen by a state housing finance agency. Mihir Desai, Dhammika Dharmapala & Monica Singhal, Tax Incentives for Affordable Housing: The Low Income Housing Tax Credit, 24 Tax Policy and the Economy 181, 184 (Jeffrey R. Brown ed., 2010).

\textsuperscript{130} See Kleinbard, note 64, at 367 ("The substantive committees do not supervise how tax subsidies are designed or spent, they do not track the efficacy of the tax programs, they do not necessarily coordinate that spending with their own spending. . .").

\textsuperscript{131} See IRC §§ 32 (EITC), 170 (charitable contributions), 174 (R\&D expenditures). There may be institutional or structural constraints on the type of means testing possible under the tax system. See Alstott, note 35, at 289-97.


\textsuperscript{133} See Weisbach & Nussim, note 65, at 957-58.

\textsuperscript{134} For an analysis of transition issues, see generally Daniel Shaviro, When Rules Change: An Economic and Political Analysis of Transition Relief and Retroactivity (2000);
sion here is very brief. In deciding how rapidly to phase in an otherwise desirable reform, we need to balance long-term gains against short-term impact. Even for the same policy change, these short-term consequences vary with the context. For example, scaling back the mortgage interest deduction could have had positive short-term effects in 2003, taking steam out of the housing bubble. But in 2009, after the bubble burst, further pressure on this distressed market would have been problematic in the short term.\footnote{See Morrow, note 33, at 751.}

We also need to consider the benefits and costs of encouraging people to anticipate policy changes. There are familiar advantages when doing so persuades them not to engage in socially destructive behavior. At the same time, there is a downside. If taxpayers discount tax expenditures for the possibility of repeal, they are less responsive to them.\footnote{See Graetz, note 134, at 49.} This raises the cost of inducing socially valuable behavior. Again, the balance of these (and other) factors—and, thus, the transition policy we want in a given case—will depend on the context.

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To sum up, then, a key goal in scaling back tax expenditures is saving money while preserving (most) programmatic benefits. There are a number of ways to do this, and we should choose the one best suited to the policy priority and the factual context. In some cases, we should narrow the definition of what is funded. In others, we should target the right claimants or limit how much they can claim. In still other cases, we should use a different government agency to implement the subsidy. On all these policy dimensions, strategies that work for one tax expenditure will not necessarily work for another.

\section*{C. Potential Trade-off: Does Repealing or Limiting a Tax Expenditure Add to Excess Burden?}

Even if a limit is effective at preserving programmatic benefits, we face a trade-off if it exacerbates excess burden or undermines distributional goals. These issues are discussed in this and the following Section, respectively. To assess the impact on excess burden, this Section considers three questions. First, how (if at all) would repeal or a limit affect the effective marginal tax rate, or otherwise influence labor and savings decisions? Second, how would repeal or a limit influence


\footnote{See Morrow, note 33, at 751.}
\footnote{See Graetz, note 134, at 49.}
compliance, enforcement, and other administrative costs? Third, how would repeal or a limit impact deadweight loss from tax planning?

1. Effect on Labor and Savings Decisions

a. Weakening Tax Expenditures that Promote Work or Savings

Repealing or limiting a tax expenditure can affect labor and savings decisions in five ways. First, if a tax expenditure (or some other government program) is effective in encouraging work or savings, repealing or limiting it can have the opposite effect. For example, if the EITC successfully promotes work, scaling it back can induce some to leave the workforce. On the other hand, if a tax expenditure is a complement to leisure, repealing or limiting it can encourage work. For instance, if the tax-free treatment of workman’s compensation tempts claimants to seek it even if they are able to work, repealing this tax benefit eliminates this temptation.

b. Base-Broadening to Cut Marginal Rates (or Keep them from Rising)

Second, even if a tax expenditure has no obvious connection to savings or work choices, repealing or limiting it can still alter a taxpayer’s effective marginal rate. Even more than average rates, marginal rates influence labor and savings decisions. A familiar rationale for repeal or limits, then, is to fund a cut in marginal rates (or to keep these rates from rising). This effect does not stem from the limit itself, but from the way we use the savings it generates. Obviously, it can arise with direct expenditures as well (for example, if we cut government spending to fund a marginal rate cut).

137 See IRC § 104.

138 Hines & Logue, note 1, at 17 ("High marginal tax rates depress the production of taxable income by encouraging early retirement, reducing work effort of primary and secondary earners, and giving taxpayers incentives to pursue investments and other opportunities that reduce taxable income."); see also Manning & Andress, note 42, at 1586 ("This article concentrates on marginal rates rather than average rates or overall tax burden on the ground that marginal rates are the items that should affect economic decisions, determining the net after-tax value of engaging in activities to earn additional income or the net after-tax cost of making expenditures that result in additional deductions."); Harvey S. Rosen, What Is Labor Supply and Do Taxes Affect It?, Am. Econ. Rev., May 1980, at 171, 171-72; Emmanuel Saez, Joel Slemrod & Seth H. Giertz, The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review, 50 J. Econ. Literature 3, 3-5 (2012). Or it might be, as Joel Slemrod and Wojciech Kopczuk have argued, that broadening the base makes taxable income less elastic—for instance, by foreclosing certain types of planning—so that we can raise rates at a lower efficiency cost. See Joel Slemrod & Wojciech Kopczuk, The Optimal Elasticity of Taxable Income, 84 J. Pub. Econ. 91, 104-07 (2002).
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c. Bracket Creep

Third, repeal or a limit alters the effective marginal rate more directly by reducing a taxpayer’s deductions or exclusions, and thus bumping her into a higher bracket.\textsuperscript{139} For example, a taxpayer would be in the 25% bracket with $20,000 of deductions and $100,000 of income, but would move to the 28% bracket upon losing $10,000 of deductions (since the top of the 25% bracket for 2014 is $89,350).\textsuperscript{140} This Article calls this result “bracket creep,” analogizing to a comparable effect of inflation. Bracket creep can affect anyone who is not already in the top bracket. It arises in scaling back exclusions and deductions, but not credits (which offset tax directly, instead of reducing taxable income). This effect arises with (some) tax expenditures, but not with other government programs.

To eliminate bracket creep, we could “index” the bracket by raising its upper bound. For example, if a limit disallows an average of $5,000 of deductions, we could raise the top of each bracket by $5,000. Yet this remedy is imperfect since those who lose less than $5,000 receive a windfall, while those who lose more still experience some bracket creep.\textsuperscript{141}

d. Income-Based Limits

Fourth, some limits change the effective marginal rate by tying the disallowance of tax benefits to income. If earning more causes taxpayers to lose more deductions, exclusions, or credits, a limit functions as a marginal rate increase. By contrast, if earning more entitles taxpayers to use more of them, a limit reduces the effective rate. These changes in the effective tax rate are oblique instead of explicit, so taxpayers who do not notice them may not change their behavior.\textsuperscript{142} Part III analyzes seven types of limits to show which change the effective rate in this way, and which do not. In principle, any government benefit or penalty tied to income could have this effect, including direct expenditures (and fines) as well as tax expenditures.

\textsuperscript{139} See Sullivan, note 42, at 940 (“The basic intuition regarding why these limitations can raise marginal rates is that each one in its own way... shifts the higher rates of the progressive rate structure down the income scale...”).


\textsuperscript{141} A more comprehensive (and complicated) remedy would be to compute the tax without accounting for the new deduction limit, and then add a separate tax on the disallowed deduction, which would be computed with the marginal rate that would apply if not for the limit.

\textsuperscript{142} See Galle, note 27, at 62 (“[I]n order for a tax to induce behavioral changes from the taxpayer, the taxpayer must usually first be aware of the tax.”).
Finally, scaling back a tax expenditure (or, indeed, any subsidy) also makes the favored activity more expensive. For instance, if charitable contributions cannot be deducted, they cost more (in after-tax dollars). This reduced purchasing power weakens the incentive to work in some cases, but strengthens it in others. Someone whose main motive in working is to fund her favorite charity might be more tempted to retire. But someone who is already locked into a charitable pledge, which has become more expensive, must earn more to honor it. If a subsidy is cut, people who were spending marginal dollars on the subsidized activity—that is, dollars they might choose not to earn—are more likely to adjust work choices than people who spend inframarginal dollars. Likewise, heavy users of a newly limited tax expenditure obviously are affected more than light users. For example, limiting the mortgage deduction could have no effect on renters (unless, of course, rent increases as more want to rent). As a result, the magnitude (and even the direction) of these effects vary.

143 See Alan J. Auerbach & Joel Slemrod, The Economic Effects of the Tax Reform Act of 1986, 35 J. Econ. Literature 589, 602 (1997) (“Stating such a tax reform decreases the real wage in terms of the previously preferred activity”).

144 If the charitable deduction is unlimited, this goal can be funded with pretax income. In pursuing this goal, then, a taxpayer’s marginal rate is zero. This can be a powerful incentive to work. Cf. Diamond, note 31, at 898 (“For a given level of public good provision, higher private donations by high earners than low earners eases the incentive compatibility constraint for donors and so can raise social welfare.”).

145 For example, assume Ann and Bob each can earn either $360,000 or $400,000, depending on how much they work. Ann uses this extra money to fund all her charitable giving; if she earns $400,000, she donates $40,000, but if she earns only $360,000, she gives nothing to charity. In contrast, Bob gives one-tenth of every dollar to charity (that is, both marginal and inframarginal earnings). If charity is deductible, Ann’s effective marginal rate on the extra $40,000 is zero. Yet Bob’s effective marginal rate on this extra $40,000 is higher. Since he would deduct only $4,000 of this $40,000, his effective marginal rate is 35.64% on this extra earnings (assuming a 39.6% rate on the $36,000 he does not contribute to charity). If the charitable deduction is disallowed, both have to pay the full 39.6% rate on their extra $40,000 of earnings. Yet this is a much bigger jump for Ann (from 0% to 39.6%) than it is for Bob (35.64% to 39.6%).

146 If Congress repeals a tax expenditure to fund lower marginal rates, the effect on incentives to work turns on the balance of two competing effects: On one hand, reducing the marginal rates sweetens the return to work; on the other hand, reducing purchasing power erodes the return to work. The balance depends on the context-specific issues discussed above. Alan Auerbach and Joel Slemrod argue that “base broadening generally does not stimulate labor supply” if the reform is both revenue- and distributionally neutral. Auerbach & Slemrod, note 143, at 602 (“Lowering a tax rate from 25 percent to 20 percent by eliminating the deductibility of a consumption activity that comprised 20 percent of taxable income does not increase the incentive to work unless the former deductible consumption activity is relatively more complementary to leisure than are other goods, because such a tax reform decreases the real wage in terms of the previously preferred activity at the same time it increases the real wage in terms of other goods.”). Yet the analysis changes when the reform no longer needs to be distributionally neutral, so that
2. Effect on Administrative Costs and Planning

In addition to affecting labor and savings choices, repealing or limiting a tax expenditure can also affect administrative costs and planning. On one hand, if a tax expenditure adds significantly to these social costs (for instance, by precipitating rampant fraud), repealing or limiting it can reduce them. On the other hand, the limit itself can add to excess burden. It is another tax rule to be drafted, understood and enforced, and also can prompt new planning strategies. Once again, the net effect depends on the context. This Subsection gives examples of how the five tightening strategies discussed above can affect administrative costs and planning.

a. Definitional Strategies

Defining the favored activity more precisely prompts a familiar trade-off. A more tailored tax expenditure (or other subsidy) focuses more effectively on high-value activities, but is more challenging to draft. Enforcement and compliance may be costlier as well if the rule requires taxpayers to keep careful records or apply nuanced distinctions. For instance, assume we want to subsidize health care that creates positive externalities, but not health care that yields only private benefits. One option is to classify all types of care (for example, covering vaccinations but not cosmetic surgery). Alternatively, we can disallow a standard percentage of the deduction or exclusion (a "haircut") to approximate this effect, as we do with business entertainment. This blunter approach is cheaper to administer, but is only approximately right at best.

b. Elasticity Strategies

A similar trade-off arises in tailoring a tax expenditure (or other subsidy) to the claimant's responsiveness. Administrative costs increase, and planning may as well. For example, we can disallow charitable deductions below a certain amount each year. This floor reduces recordkeeping, and also avoids subsidizing some contributions that would be made anyway.

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heavy and light users, as well as people whose spending is marginal or inframarginal, can fare differently.

147 Indeed, Slemrod and Kopczuk have argued that base broadening can shut off the escape valves that tax-sensitive taxpayers use to avoid tax, so that we can then raise rates at a lower efficiency cost. See Slemrod & Kopczuk, note 138, at 104-07.

148 See Section III.B.

149 See IRC § 274(n).
Yet taxpayers can react by concentrating multiyear gifts into a single year. For example, a taxpayer who earned $500,000 and gave $25,000 to charity each year would lose 20% of her deduction ($5,000 of $25,000) with a 1% floor. But if she gave $50,000 every other year, she would lose only 10% ($5,000/$50,000). She gives the same amount on average but cuts her disallowed deductions in half.

This sort of "bunching" is less likely, though, when claimants do not fully control the timing of their giving. For example, they may have to make a gift for a particular event, such as a religious holiday or an annual dinner. It is likely, moreover, that some claimants would be less rigorous about shifting their donations, and some nonprofits would be less accommodating. For claimants who are unable to shift all their charity, there would be less advantage to shifting any of it. For instance, if the floor was $200—and a claimant had at least $200 of charity that could not be shifted—the floor no longer would create an incentive to shift other contributions. This is more likely to happen, of course, when the floor is low.

Even for high floors, moreover, the motive to concentrate deductions is offset, to an extent, by a countervailing incentive to spread them more evenly: If "bunching" moves a taxpayer to a lower tax bracket, it reduces the value of some of her deductions. For example, assume a married couple has $500,000 of income. If they claim $40,000 of deductions each year, they remain in the 39.6% bracket (which governs taxable income above $457,600 in 2014). As a result, all their deductions are worth 39.6 cents per dollar. But what if instead they claim $80,000 in 2014 and no deductions in 2015? This "bunching" moves them to the 35% bracket (which governs taxable income above $405,100). As a result, over $37,000 of the deductions they accelerate are worth only 35 cents per dollar (in reducing taxable income from $457,600 to $420,000). This cost of "bunching" arises only if a tax expenditure's value varies with the tax bracket; as a result, it applies to deductions and exclusions, but not credits. The magnitude of this cost depends on how steep the rate structure is, and also how close a claimant is to a lower bracket. For instance, those earning $3 million are unlikely to be affected, since they need to "bunch" almost $2.5 million of deductions to move to a lower bracket.

151 Id.
152 At the risk of belaboring the point, what if the couple concentrates three years of deductions into a single year? Their taxable income falls to $380,000, putting them in the 33% bracket (which governs taxable income above $226,850). As a result, over $25,000 of their accelerated deductions are worth only 33 cents per dollar (that is, in reducing taxable income from $405,100 to $380,000).
c. **Comparative Advantage Strategies**

Just as trade-offs arise in calibrating a subsidy to elasticity, they also can arise in targeting claimants who use a tax expenditure (or other subsidy) most effectively. For example, sorting with substantive criteria (like weather or geography) can add to administrative costs, since these conditions have to be formulated and enforced. Likewise, allocating the subsidy with a competitive process also can be expensive, since government personnel are needed to run it and claimants incur costs in participating. In contrast, matching requirements (like the ones used for R&D and charity) are simple to administer, once we set the right level for the match. Screening by income is also easy, since the tax system has to measure income anyway.

d. **Activity-Level Strategies**

Imposing an overall or per-claimant cap on tax expenditures (or other subsidies) also can add to administrative costs. Yet if we do not make this investment, the subsidy may not be allocated as effectively. In some cases, administrative costs are not only the consequence of varying the reimbursement rate, but also the cause. Tracking an expense (such as a charitable contribution) could be cost-justified at a high level, but not a low level. This trade-off will vary for different tax expenditures. For example, it is probably easier to track low levels of mortgage interest (usually paid to a single bank) than low levels of charity (often paid to multiple causes).

e. **Bureaucratic Strategies**

Finally, a familiar argument for converting tax expenditures to direct expenditures is reducing administrative costs. Yet the argument is not persuasive if costs are merely shifted within the government.153 Once again, the answer depends on the context. Administrative costs rise if the tax system has to develop expertise that already exists elsewhere in government, but not if the tax system already has the relevant expertise (for example, in making income-based judgments).154 Moreover, piggybacking on private sector judgments, as with R&D and charity, does not require much substantive expertise.

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153 See Weisbach & Nussim, note 65, at 958 ("If we mistakenly look only at the tax system instead of overall government policy, we will draw the wrong conclusions.").
154 See Zelinsky, note 104, at 1010 ("Tax incentives efficiently communicate government policies through an existing information network, that is, the network of professional advice and assistance that exists to comply with the tax law.").
To sum up, then, a second goal in scaling back tax expenditures is reducing excess burden (or, at least, minimizing increases). Effects on labor and savings choices, administrative costs, and planning are all important, and also context-specific. Sometimes our programmatic and excess burden goals are compatible, but sometimes they are in tension.

D. Potential Trade-off: Does Repealing or Limiting a Tax Expenditure Undermine Distribution?

In repealing or limiting tax expenditures, we want to save money, preserve programmatic benefits, and minimize excess burden. In assessing progress on these dimensions, we have to account for distribution. Effects on low-income taxpayers—both benefits and costs—are especially significant because of the declining marginal utility of money. How much of a premium we assign to their welfare depends on our social welfare function. To determine a limit’s effect on distribution, we should consider three issues. First, who is helped (or hurt) by a tax expenditure under current law? Second, how does the answer change if we limit the tax expenditure in various ways? Third, if a limit has adverse distributional effects, can we compensate by adjusting other aspects of the tax-and-transfer system? These issues are considered in turn.

155 For example, we have to choose how much weight, if any, to give to horizontal equity, the principle that people with like incomes should be treated alike. Horizontal equity is sometimes used to justify tax expenditures (for example, the mortgage interest deduction aligns the tax treatment of home purchases for cash and credit), to critique them (for example, tax is lower for those who receive health insurance through work), as well as to critique limits on them (for example, a cap on itemized deductions is more burdensome for residents of high-tax states). More generally, some have observed that taxpayers with the same income vary in their use of tax preferences. Boris I. Bittker, Charitable Contributions: Tax Deductions or Matching Grants?, 28 Tax L. Rev. 37, 47 (1972) (explaining that taxpayers in the same position utilizing deductions in differing amounts frustrates horizontal equity); Hines & Logue, note 1, at 4 (critiquing “disparities in effective tax rates between those taxpayers who have a strong taste (or comparative advantage) for tax preferences . . . and those who do not.”). Yet, the norm’s value is contested because it is malleable. For instance, we can debate whether taxpayers are similar enough to warrant the same treatment, while efforts to create horizontal equity between A and B might lead to horizontal inequity with C. In addition, market adjustments can sometimes mitigate horizontal inequities. See Daniel N. Shaviro, Selective Limitations on Tax Benefits, 56 U. Chi. L. Rev. 1189, 1241-42 (1989). As a result, the norm may not add much to vertical equity. See Louis Kaplow, Horizontal Equity: Measures in Search of a Principle, 42 Nat’l Tax J. 139, 143-44 (1989).
1. The Distributional Impact of Tax Expenditures Under Current Law
   
a. Tax Benefits for Most Tax Expenditures Flow Disproportionately to High-Income Taxpayers

   If a tax expenditure (or, indeed, any government program) disproportionately helps high-income taxpayers, scaling it back would enhance vertical equity. But how do we know who is benefitting? One measure for tax expenditures, which is conventional but imperfect, focuses on who claims the tax benefit. By this standard, high-income taxpayers are the clear winners with most tax expenditures. For example, 80% of the tax benefit for itemized deductions went to the top 20% in 2011.\(^\text{156}\) Likewise, two-thirds of exclusions went to the top 20%, including employer-provided health insurance and investment income in retirement accounts.\(^\text{157}\)

   These tax benefits flow mostly to high-income taxpayers for four familiar reasons. The first three apply only to tax expenditures, while the fourth could apply to other subsidies as well. First, if taxpayers do not earn enough to owe income tax, a tax expenditure cannot reduce their tax bill (unless it is refundable or applies to the payroll tax).\(^\text{158}\) Second, even among those who pay income tax, only those who itemize (instead of claiming the standard deduction) are eligible for some tax expenditures. This subset—less than one-third of filers in 2011 (46.2 million)—tends to have higher incomes. Nearly half (19.4 million) had more than $100,000 of income, while over 10% (4.7 million) had more than $200,000.\(^\text{160}\) Third, exclusions and deductions are more valuable in a higher bracket. Excluding a dollar—that is, not paying tax on it—saves thirty-five cents for someone taxed at 35%, but only twenty-five cents for someone taxed at 25%. This “upside down effect” does not arise with credits, which reduce the tax itself instead of taxable income (so a one-dollar credit reduces tax by one dollar).\(^\text{161}\) Finally, high-income taxpayers tend to spend more on subsidized expenses, such as health insurance, 401(k) plans, and mortgage

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\(^{157}\) Id. at 12.


\(^{159}\) See id. at 111-12 tbl.3.1.

\(^{160}\) See id. at 33-35 tbl.1.1.

\(^{161}\) Surrey, note 128, at 98-100; Surrey & McDaniel, note 128, at 108-11.
interest.\textsuperscript{162} For example, taxpayers earning over $200,000 averaged eight times more mortgage interest than those earning between $40,000 and $50,000 in 2011 ($5021 versus $642).\textsuperscript{163}

If a tax expenditure disproportionately reduces the taxes of high-income taxpayers, limiting it usually raises their taxes. If the limit also enhances efficiency—for instance, by offering more programmatic “bang for the buck” or reducing excess burden—it offers a unique opportunity. Although efficiency and distribution are often in tension, here they would be aligned.

\textbf{b. Refundable Credits and Other Safety Net Tax Expenditures}

Even so, distribution and efficiency sometimes are in tension for two reasons. First, some tax expenditures are claimed solely (or primarily) by low-income taxpayers, so that limiting them would disproportionately affect this cohort. For example, the EITC is available even to those who do not otherwise owe tax,\textsuperscript{164} as is the health coverage tax credit,\textsuperscript{165} the credit for excess social security withholding,\textsuperscript{166} the “making work pay” credit,\textsuperscript{167} the homebuyer credit,\textsuperscript{168} and portions of the child credit\textsuperscript{169} and American opportunity credit\textsuperscript{170} (for college expenses).\textsuperscript{171} The bottom 60\% of taxpayers claimed 80\% of tax benefits from refundable credits in 2011.\textsuperscript{172} Usually, refundable credits are justified as much by distribution as by externalities—and, in some cases, more so. As a result, there is a strong case for keeping them if they are successful. Yet even then, it would be better still to generate comparable distribution-based benefits at lower cost, if we can.

\textsuperscript{162} Admittedly, limiting tax expenditures is a less effective way to raise revenue from the “super rich.” As Shaviro has observed, someone earning $10 million is unlikely to receive employer-provided health insurance worth ten times what someone earning $1 million receives. Shaviro, note 39, at 429 n.14. If the goal is to slice distribution this finely, marginal rates (or changes in the treatment of capital gains and dividends) are likely to have more impact, although, of course, the efficiency considerations are different as well.

\textsuperscript{163} Joint Comm. on Tax’n, note 51, at 37 tbl.3.

\textsuperscript{164} IRC § 32(a).

\textsuperscript{165} IRC § 36B.

\textsuperscript{166} IRC § 45B.

\textsuperscript{167} IRC § 36A.

\textsuperscript{168} IRC § 36.

\textsuperscript{169} IRC § 24.

\textsuperscript{170} IRC § 25A.


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c. Challenges in Measuring Incidence

Second, even if low-income taxpayers are not the ones claiming a tax expenditure (or other subsidy), they may still benefit economically from it, so that scaling it back is costly to them. For example, when high-income taxpayers deduct charitable contributions for soup kitchens or need-based scholarships, economic benefits flow to low-income people. Yet charity to art museums or the opera is likely to have different distributional effects. Similarly, although the tax benefit for municipal bond interest goes to (wealthy) bondholders, much of the economic benefit goes to states (in reducing their borrowing costs). Likewise, while the deduction for state and local taxes is claimed by high-income people, it can help states collect more tax. For both of these tax expenditures, then, we need to know how states use the extra money. Enhancing social services for low-income citizens obviously has different effects than cutting property taxes on high-end residences.

Needless to say, sometimes economic benefits actually do flow to the person claiming the tax benefit. For instance, when a high-income taxpayer deducts mortgage interest on a vacation home in Vail or East Hampton, the government is funding private benefits for her (as well as neighborhood-related externalities for a wealthy community). Likewise, gold-plated health plans can provide private benefits to high-income taxpayers.

Ultimately, then, we need to know a tax expenditure's economic incidence to assess its distributional impact. Unfortunately, this is much harder than establishing who is claiming the tax benefit. A rough guess may be the best we can do. Nevertheless, a rough answer to the right question is more helpful than a precise answer to the wrong question. In deciding whether to repeal or limit a tax expendi-

173 There is very little empirical evidence on the overall distributional impact from charity, and the limited evidence is mixed. See, e.g., Charles T. Clotfelter, The Distributional Consequence of Nonprofit Activities, in Who Benefits from the Nonprofit Sector? 1, 22 (Charles T. Clotfelter ed., 1992) (“First, there is great diversity within the nonprofit sector, and no overarching conclusions about the distributional impact can be made. This said, a second finding is one stated in the negative: in no subsector is there evidence that benefits are dramatically skewed away from the poor and toward the affluent. Conversely, there is also evidence that relatively few nonprofit institutions serve the poor as a primary clientele.”).


175 See Michael J. Graetz, Assessing the Distributional Effects of Income Tax Revision: Some Lessons from Incidence Analysis, 4 J. Legal Stud. 351, 358 (1975) (“[E]stimates of the distribution of these ‘subsidies’ [tax expenditures] by income class fail to take into account instances where the incidence of the subsidy is different from its statutory impact”).
ture, then, we need to consider whether low-income taxpayers are its main economic beneficiaries, even if they are not the ones claiming the tax benefit.

2. The Distributional Impact of the Limit

Repealing a tax expenditure eliminates all the tax and economic benefits it provides. But a limit eliminates only some of these benefits, affecting some claimants more than others. For example, if we deny a tax expenditure to those earning more than $150,000, those earning less can still claim it. Sometimes this sort of disparity brings us closer to the distribution we want, but sometimes it has the opposite effect. A context-specific analysis is needed to determine a limit’s effect on distribution. This Subsection offers examples drawn from the five tightening strategies discussed above.  

a. Definitional Strategies

One approach is to define favored conduct in a way that advances distributional goals. For instance, some fringe benefits are subsidized only if offered to all employees. Including this “nondiscrimination” rule in the relevant definition creates an incentive to cover low-income employees, not just senior managers. Likewise, one subsidy for home ownership excludes gains from selling a primary residence, but not a vacation home. This carve-out is more likely to burden high-income taxpayers. Notably, there is no similar exception for the mortgage interest deduction. Adding one, as President Bush’s 2005 tax reform panel suggested, would save money in a progressive way.

In other cases, though, narrower definitions are an ineffective or costly way to pursue distributional goals. For instance, although we might want to offer the charitable deduction only to causes that help low-income beneficiaries, this would be difficult to administer. While soup kitchens obviously qualify, and the opera probably does not, many causes are hard to classify. Disaster relief, for example, is relevant to everyone, but can be especially important to low-income people. In addition, what if a charity has some functions that qualify, and some that do not? To deal with this, we could make separate judgments about each gift, depending on how it is used. For instance, gifts

176 See Section III.B.
177 See IRC § 132(j)(1).
178 See IRC § 121(a).
179 See Bush Panel, note 107, at 73 (“The Panel recommends that the deduction for interest on mortgages on second homes and interest on home-equity loans be eliminated.”).
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To educational institutions would pass muster if they support financial aid, but not professorships or building projects. Yet this approach founders on the fungibility of money. After all, some gifts to financial aid do not actually increase the financial aid budget; instead, they allow the school to allocate less tuition to financial aid, freeing up this revenue for other initiatives. An alternative, then, is to treat all contributions as tax-advantaged, as long as a sufficient percentage of the organization’s budget funds qualifying activities. But some budgetary items would be hard to classify (for example, the CEO’s salary or rent for the building), and we would have to re-test periodically. This approach also penalizes nonprofit “conglomerates” that serve low-income populations while also pursuing other goals. In any event, the more general point is that a more focused definition is an effective way to pursue distributional goals in some settings, but not others. Once again, the context matters.

b. Elasticity Strategies

The same is true when we tighten a tax expenditure by favoring claimants who are most responsive. High-income claimants usually are easier to influence because they have more capacity in their budgets, as noted above. While this is a reason to allocate a subsidy primarily to them, distributional goals are undercut if the subsidy offers them private benefits (as with subsidized vacation homes and “gold-plated” health insurance) or creates externalities that do not benefit low-income people (as with charity to the opera). Even so, there is no trade-off if the externalities benefit everyone (as with solar panels) or especially benefit low-income citizens (as with charity to soup kitchens). In these cases, focusing on elasticity can improve distribution by enabling the program to help low-income people more efficiently.

c. Comparative Advantage Strategies

Similarly, there is no one-size-fits-all answer when we favor claimants who can use a subsidy most effectively. If a claimant’s comparative advantage derives from financial need (as with subsidized retirement savings to promote self-sufficiency), favoring this claimant advances distributional goals. Yet in other cases, there can be a trade-off with distribution. For instance, what if a claimant’s comparative advantage derives from expertise, as with an R&D subsidy? Distributional goals are still advanced if the subsidy generates positive externalities for everyone (for example, in curing a disease), but can be undercut if the subsidy generates private benefits for experts with high incomes (for example, in raising the pay of medical researchers). The
economic incidence of the tax expenditure obviously is important, and it varies with the context.

d. Activity-Level Strategies

We also encounter this sort of context-specific variability in calibrating how much to subsidize each claimant. Sometimes this sort of fine-tuning advances distributional goals. For example, we might decide to cap a subsidy for health insurance because low-income claimants rarely have gold-plated policies. Indeed, if distribution is our priority, we might prefer to phase out the subsidy instead of capping it, so only low-income claimants are eligible. In other cases, however, a per-claimant cap or phase-out would undercut distributional goals. This would be the case with charity supporting soup kitchens, as well as with other tax expenditures that generates positive externalities for low-income people (instead of private benefits for high-income claimants).

e. Bureaucratic Strategies

Finally, we see the same variation in deciding whether to use a tax expenditure or a direct expenditure. For example, a familiar disadvantage of pursuing distributional goals with tax expenditures is the “upside down” effect: Deductions and exclusions offer more generous tax benefits in higher brackets (although refundable credits avoid this issue). In addition, the tax system sometimes is less effective in imposing distribution-based conditions on how money is used. For instance, if the federal government wants to fund states’ programs for low-income citizens, the deduction for state income tax offers less control than block grants. Nevertheless, the tax system has a notable advantage in pursuing distributional goals: a sophisticated capacity to measure income and dispense money.

3. Compensating Adjustments

To sum up, then, it is important to account for distribution when we consider scaling back tax expenditures. In some cases, distributional goals justify the limit (for example, if a tax expenditure disproportionately benefits high-income people). In other cases, distribution is a reason not to impose a limit, or at least is a cost to be managed (for example, if a tax expenditure helps low-income people, but in a costly or inefficient way). In other words, sometimes efficiency and distributional goals align, but sometimes they are in tension.
When there is a trade-off, a familiar way to manage it is to adopt a limit that promotes efficiency, while advancing distribution another way. For example, assume we want to limit the EITC to keep claimants from committing fraud, but this limit would undercut distribution by also affecting honest claimants. To offset this distributional cost, we can pair the limit with a payroll tax cut for low-income taxpayers. As a result, we achieve the distribution we want—or at least approximate it—in a more efficient way.

Unfortunately, this sort of offsetting distributional adjustment is not always feasible. Some involve efficiency costs of their own, while others are politically unattainable. When an offsetting adjustment is not available, it becomes more important to accommodate distribution within the four corners of the limit. In managing this sort of trade-off, we should compare different types of limits and choose the one that enhances welfare the most, once all the competing factors are considered.

IV. FLOORS, CAPS, AND FRACTIONS: SEVEN LIMITS AND THE TRADE-OFFS THEY INVOLVE

To determine what offsetting adjustments we need, or to select the limit that enhances welfare the most on its own, it is necessary to understand the trade-offs inherent in each limit. This Part analyzes seven types of limits: fixed-dollar floors, income-based floors, fixed-dollar caps, income-based caps, phase-outs, maximum fractions, and haircuts. Each modifies the marginal reimbursement rate in a different way. As a result, they have varying effects on programmatic incentives, excess burden, and distribution, and thus involve different trade-offs. Some are especially useful for activity-level strategies, while others are a good fit for elasticity strategies. Again, there is no one-size-fits-all answer, so context-specific analysis is critical.

A. Fixed-Dollar Floors

One option is to use a floor, which keeps a tax expenditure from supporting low levels of favored activity. A “fixed dollar” floor defines this level as a fixed amount (instead of a percentage of income). For example, charitable contributions could be subsidized only to the extent they exceeded $500.180

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180 The standard deduction is also a fixed-dollar floor. See IRC § 63(c).
1. **Programmatic Benefits**

A floor eliminates programmatic incentives for activity below the minimum level, but preserves them above this level. With a $500 floor, for instance, a taxpayer is subsidized for increasing charitable giving from $500 to $1,000,\(^1\) but not from $0 to $500.

In preserving programmatic incentives for high activity levels, fixed-dollar floors offer two advantages. First, they focus the subsidy on these higher levels. As a result, fixed-dollar floors are well suited to aggregate subsidies that encourage as much activity as possible, without regard to who is engaging in it (for example, green energy and charity). Second, floors help to avoid subsidizing what the taxpayer would do anyway. If most people give at least $500 to charity without a subsidy, a $500 floor concentrates the subsidy where it is more likely to change behavior. Thus, a floor is a good fit for elasticity strategies. Picking the right level is a challenge, though, since one that is marginal for some is too high (or low) for others.

While a floor is well suited to these goals, it is a poor fit for motivating the first dollar of spending. Subsidizing low activity levels is essential in encouraging everyone to commit at least a minimum amount to retirement savings, health insurance, or some other favored activity. These individually-based subsidies need to motivate claimants who otherwise would spend nothing (or very little). Floors keep subsidies from reaching these people.

2. **Excess Burden**

Floors have the further disadvantage of increasing planning costs. As noted above, they encourage taxpayers to concentrate multi-year spending into a single taxable year (for example, giving charity every other year). This strategy can reduce the amount disallowed by the floor.\(^2\) Even so, floors can reduce compliance costs. As noted above, those who spend less than the floor do not need to keep records.

3. **Distribution**

Just as fixed-dollar floors have mixed effects on programmatic incentives and excess burden, they also can affect distribution in different ways. To help low-income people, we sometimes have to subsidize the first dollar. This can be important, for instance, in encouraging

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\(^1\) Cf. Ackerman & Auten, note 14, at 512 (explaining that under the Pease 3% limitation, the "incentive for additional charitable contributions is not affected since the amount of disallowed deductions depends only on AGI").

\(^2\) See Subsection III.C.2.
them to save for retirement or buy health insurance. The first dollar is more likely to be marginal for low-income claimants than high-income ones, who usually take these steps on their own. In this sort of self-sufficiency initiative, then, a floor can disproportionately exclude low-income claimants. More generally, a fixed-dollar floor is likely to be more daunting to low-income claimants than high-income ones. Given the diminishing marginal utility of money, committing a fixed amount of money is harder for those who earn less.

Yet this is a problem only if low-income people have to claim a subsidy in order to benefit from it. This is not the case with charity for soup kitchens, for instance, or with some environmental initiatives. If a tax expenditure creates externalities that benefit low-income people—even when they are not the ones claiming it—a floor can generate these externalities more efficiently, thereby enhancing distribution.

4. Trade-offs

To sum up, then, fixed-dollar floors can be appealing when the goal is to encourage as much favored activity as possible (as with green energy or charity). These floors offer more programmatic bang for the buck by not funding (some) inframarginal activity. They also can reduce recordkeeping burdens. However, fixed-dollar floors are not at all tailored to heterogeneity. They will be too high for some claimants and too low for others. A further disadvantage is that they can encourage taxpayers to consolidate multi-year spending into a single year. In addition, fixed-dollar floors should not be used when the goal is to encourage at least a minimum level of favored activity (for example, ensuring that everyone has health insurance), and also in other contexts where the participation of low-income claimants is important.

183 See Ackerman & Auten, note 14, at 513; Louis Kaplow, The Standard Deduction and Floors in the Income Tax, 50 Tax L. Rev. 1, 27 (1994) (arguing that it is easy to “bunch” payments when we control the timing of them, so that charity is easier to “bunch” than mortgage interest).
B. Income-Based Floors

Instead of defining a floor as a fixed amount, it can be defined as a percentage of the taxpayer’s income (an “income-based floor”). For example, we can limit the charitable deduction to contributions above 1% of AGI, as President Bush’s tax reform panel suggested. While income-based floors share most of the advantages and disadvantages of fixed-dollar floors, they are somewhat more effective at accommodating elasticity and pursuing distributional goals. Nevertheless, they have the offsetting disadvantage of increasing the effective marginal rate.

1. Programmatic Incentives

Like fixed-dollar floors, income-based floors maintain programmatic incentives above the floor. In so doing, they are more effective in accounting for elasticity. When we estimate how much a claimant would give to charity without a subsidy, for example, a percentage of income is more reliable than a fixed dollar amount. After all, a $500 floor is probably too high for someone earning $30,000 and too low for someone earning $1 million. One percent of income is likely to be closer to the mark for each ($300 and $10,000, respectively). As a result, income-based floors are a good choice for encouraging as much activity as possible, without regard to who is engaging in it (for exam-
2. Excess Burden

With one important difference, income-based floors have the same effects on excess burden as fixed-dollar floors. On the positive side of the ledger, they eliminate some recordkeeping. On the negative side, both encourage taxpayers to bunch multi-year spending into a single year.

Yet income-based floors have a disadvantage that fixed-dollar floors do not share: When claimants earn more money, they lose more of the tax expenditure. For example, the Pease rule increases the effective marginal rate in this way. Although this provision often is described as a phase-out, it actually is an income-based floor.\footnote{See, e.g., Altshuler & Dietz, note 51, at 466-71.} Taxpayers lose 3 cents of itemized deductions for every dollar of income they earn above a threshold ($250,000 for an individual).\footnote{A taxpayer cannot lose more than 80% of her itemized deductions, so that someone with very few itemized deductions might not be governed by the 3% rule. See IRC § 68(a)(1).} For taxpayers in the 39.6% bracket, losing 3 cents of deductions costs 1.2 cents ($3 \times 0.396$). This is a 1.2% increase in the effective marginal rate.\footnote{See Manning & Andress, note 42, at 1602 ("[A]lthough called an overall limitation, the provision is basically an addition to the marginal rate above the threshold amount at 3 percent times the otherwise applicable rate . . . "); Shuldiner & Shakow, note 37, at 677-79.} A 1% floor on charitable deductions has a similar effect. An additional $100 of earnings eliminates $1 of deductions, thereby increasing tax by 39.6 cents, and thus increasing the effective marginal rate by 0.396% (for those in the 39.6% bracket). By contrast, fixed-dollar floors do not disallow more deductions as taxpayers earn more. A $500 floor remains $500, even if the taxpayer's income increases.\footnote{Even so, a fixed-dollar floor can weaken work incentives by reducing the purchasing power of marginal earnings, as discussed above. See Subsection III.C.1.b. For example, assume someone wants to use her last dollar of earnings to contribute to charity, but a floor disallows this deduction. In this case, the purchasing power of this marginal dollar of earnings—and thus the return to working more—is reduced.}

Of course, income-based floors increase the marginal rate in this way only when taxpayers actually have deductions to lose. Someone whose charitable giving is above the floor is affected, but someone who has not made any gift to charity is not. Earning an extra dollar would not affect how many deductions the latter can claim.\footnote{In addition, an income-based floor can also weaken work incentives by reducing a taxpayer's purchasing power. See note Subsection III.C.1.}
3. Distribution

Like fixed-dollar floors, income-based floors have mixed effects on distribution. On one hand, when a tax expenditure creates externalities that benefit low-income people, such as charity for soup kitchens, an income-based floor can help it to do so more efficiently. On the other hand, when a tax expenditure is supposed to encourage low-income people to spend their first dollar on favored conduct, such as health insurance or retirement savings, a floor can be counterproductive.

While the distributional implications of both types of floors are similar, they are not the same. There is a difference when the participation of low-income taxpayers is normatively important. In those cases, income-based floors have an advantage in not using the same floor for everyone. After all, giving more than $500 to charity is harder for someone earning $30,000 than someone earning $1 million. Yet although an income-based floor is better, it does not solve the problem entirely. Given the diminishing marginal utility of money, contributing 1% is harder for low-income claimants. In response, we could further reduce the floor for those with low incomes (for example, 0.5% for those earning $100,000 or less, and 1% for those earning more). Yet as is often the case, solving one problem compounds another: Increasing the percentage with income in this way creates a bulge in the effective marginal rate. For example, if the floor is 0.5% for those earning $100,000 and 1% for those earning more, earning a dollar more than $100,000 increases the floor by $500. This means a $1 increase in income (from $100,000 to $100,001) can increase the tax bill by $140. Alternatively, if the increase from .5% to 1% is phased in over a range, there would be a series of smaller bulges. Again, though, this is an issue only when the participation of low-income claimants is normatively important.

4. Trade-offs

Like fixed-dollar floors, income-based floors are helpful in encouraging as much favored activity as possible (as with green energy and charity), and in reducing recordkeeping burdens. These floors offer more programmatic bang for the buck by not funding (some) in-

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190 The floor increases from $500 to $1000.01. In 2014, a single person earning $100,000 has a (stated) marginal rate of 28%, so that losing $500 of deductions increases tax by $140. Rev. Proc. 2013-35, § 3.01, 2013-47 I.R.B. 537 (Oct. 31).

191 For example, if the floor increases by 0.1 at five different points (one of which is $100,000), then going from $100,000 to $100,001 increases the floor by $100, and thus increases tax by $28.
framarginal activity—indeed, they are better than fixed-dollar floors on this dimension.

Yet these programmatic advantages must be balanced against effects on excess burden. Like fixed-dollar floors, income-based floors encourage taxpayers to consolidate multi-year spending into a single year. In addition, income-based floors increase the effective marginal rate in a way that fixed-dollar floors do not, further sharpening the trade-off between programmatic benefits and excess burden. In any event, the programmatic advantages do not arise—so that income-based floors are a poor fit—when the goal is to encourage at least a minimum level of favored activity (for example, ensuring that everyone saves for retirement, has health insurance, and the like).

### Table 2

**Income-Based Floors**

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Benefits for high activity levels with valuable externalities</td>
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<tr>
<td>Increased complexity</td>
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<td>Yes</td>
</tr>
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</tr>
<tr>
<td>Bunching</td>
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<td>No</td>
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<td>Cost-effective externalities for low-income third parties</td>
<td>Yes</td>
</tr>
</tbody>
</table>

### C. Fixed-Dollar Caps

The mirror image of a floor is a cap, which imposes a maximum on how much claimants can claim. Caps can be defined as a fixed-dollar amount, as when Mitt Romney proposed a $25,000 cap on itemized deductions.\(^{192}\) Unlike floors, caps subsidize the first dollar of spending, but (potentially) not the last dollar. As a result, caps have quite different uses than floors.

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\(^{192}\) See Shaviro, note 39, at 426-27.
1. Programmatic Incentives

A fixed-dollar cap preserves programmatic incentives below the cap, while eliminating them above it. Therefore, this limit is useful for encouraging at least a minimum level of favored activity, but not more. For example, with a cap, the exclusion for employer-provided health insurance subsidizes only basic health insurance, without motivating claimants to get gold-plated policies.\(^{193}\) This increases the subsidy’s bang for the buck if basic insurance generates externalities, but gold-plated policies yield mostly private benefits. If marginal positive externalities also decline for retirement savings and home ownership subsidies, caps are useful for them as well. Not surprisingly, then, fixed-dollar caps already govern retirement savings and the health insurance exclusion (indirectly, through the “Cadillac tax”). Likewise, mortgage interest is deductible only for mortgages of $1 million or less.\(^{194}\) Needless to say, the cap for each tax expenditure should be different, since the relevant externalities are different.

Yet although caps can be a good fit for individualized subsidies, they are not a good fit for aggregate subsidies, such as charity or green energy. Since they eliminate programmatic incentives above the cap, they do not encourage as much favored activity as possible, regardless of who engages in it. They also are not a good fit for elasticity strategies, since they do not deny the subsidy—or, at least, the first dollar of it—to those who would engage in favored activity anyway.

The level of the cap should depend on context-specific factors, such as the rate of decline in marginal externalities. This means it is likely to vary for different tax expenditures. We will not successfully account for these differences if we apply the same cap to each tax expenditure—or, for that matter, a single “basket” cap to limit a group of them.

2. Excess Burden

Fixed-dollar caps can exacerbate excess burden by increasing compliance and enforcement costs. Taxpayers have to understand and comply with these limits and the government must police them. In addition, caps can encourage taxpayers to shift expenses from one year to another, where there is still capacity in the cap. For instance, assume the sum of all itemized deductions cannot exceed $25,000, and a taxpayer earning $200,000 owes $12,000 in state tax. Since she has only $13,000 of capacity left to deduct mortgage interest and charity,\(^{195}\) The “Cadillac” tax in the Affordable Care Act effectively caps the exclusion, albeit indirectly through an excise tax on the health plan. See IRC § 4080I. \(^{194}\) IRC § 163(h)(3)(B)(ii).
she has reason to defer some charity until she has paid off the mortgage. This sort of spreading is the mirror image of the bunching triggered by floors.

While fixed-dollar caps share this problem with floors (or, at least, a variation of it), they avoid another: Unlike income-based floors, fixed-dollar caps do not disallow more deductions as taxpayers earn more. After all, Romney’s cap would remain $25,000, whether someone earned $50,000 or $150,000. As a result, fixed-dollar caps do not increase the effective marginal rate in the same way.

Even so, fixed-dollar caps can still affect work incentives by disallowing deductions, and thus shifting taxpayers to a higher bracket. In addition, by reducing after-tax purchasing power, caps can induce people to work less (if they work to support their favorite charity) or to work more (if they already made a charitable pledge, and need more after-tax dollars to honor it). These effects vary depending on whether claimants are heavy users of the relevant tax expenditure, and whether they devote marginal earnings to it, as discussed above. High-income taxpayers are more susceptible to these effects, since they spend more on tax-favored expenses, such as charity, mortgage interest, and state taxes.

3. Distribution

For this reason, a fixed-dollar cap is more likely to take away tax benefits from high-income taxpayers than low-income taxpayers. For example, a $25,000 cap on itemized deductions is a tight constraint for someone earning $1 million, but is unlikely to disallow any deductions for someone earning $60,000. This is a tax increase almost exclusively for high-income taxpayers. Yet if we focus on the economic benefits provided by the tax expenditure, instead of the tax benefits, the assessment becomes more complex. For instance, if a cap discourages a high-income taxpayer from donating to a soup kitchen, its clientele is also affected.

4. Trade-offs

Caps are extremely appealing when low activity levels generate externalities, but higher levels do not add much. In these cases, caps save money while foreclosing only modest externalities. They also make the tax system more progressive, at least if we focus on tax burdens instead of economic benefits. Although caps can add to compliance costs and planning, they do not increase marginal rates in the

195 See Subsection III.C.1.e.
same way that income-based floors do. As a result, caps can offer a “grand slam” for tax expenditures whose marginal benefits decline as activity levels rise. This might be the case, for instance, for health insurance, mortgage interest, and retirement savings. Yet caps are less helpful when the goal is to encourage as much favored activity as possible, since they eliminate programmatic incentives above the cap. They also do not help to avoid subsidizing what claimants would do anyway.

TABLE 3
FIXED-DOLLAR CAPS

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D. Income-Based Caps

Instead of a fixed amount, a cap can be defined as a percentage of income (an “income-based cap”). For example, current law limits charitable deductions to 30% (or in some cases 50%) of AGI.196

1. Programmatic Incentives

Income-based caps offer largely the same programmatic costs and benefits as fixed-dollar caps. Since they eliminate programmatic incentives above the cap, they are a poor fit for encouraging as much activity as possible. In subsidizing the first dollar of favored activity, they risk subsidizing what claimants would do anyway. Yet like fixed-

196 IRC § 170(b)(1)(B). Or the cap can be defined in terms of the tax benefit, rather than the favored expenditure, as Feldstein has proposed. See Feldstein et al., note 8, at 505-06.
dollar caps, income-based caps are useful for subsidizing a minimum level of favored activity, but not more.

A notable difference, though, is that income-based caps are less effective when a fixed dollar amount is the most precise way to specify the targeted level. For example, if the goal is to subsidize basic (but not gold-plated) health insurance, we should reference the price of an average premium. Since this price represents a different percentage of income for each claimant, an income-based cap is a blunt way to target this level.

Yet income-based caps have an offsetting advantage. At least to an extent, they are automatically indexed for inflation (since incomes rise with inflation), as well as for regional variation (since income correlates with regional costs of living). This is not a trivial advantage. After all, if we use the average 2014 premium as a fixed-dollar cap for health insurance, but do not adjust it for inflation, the cap becomes too low over time. Likewise, if we use the same fixed-dollar cap for the entire nation, it will be too low in some places and too high in others. While this problem can be fixed with indexation, income-based caps have the virtue of not requiring this remedy.

2. Excess Burden

Income-based caps have another advantage not shared by fixed-dollar caps: They reduce the effective marginal rate, since earning more frees up more deductions. For instance, if itemized deductions are capped at 10% of AGI, a taxpayer with $500,000 of income can deduct only $50,000. Earning an extra dollar increases deductions by 10 cents, reducing tax by 3.96 cents in the top bracket. This cuts the effective marginal rate by 3.96% (from 39.6% to 35.64%). In this way, income-based caps are the mirror image of income-based floors, which increase the effective marginal rate. As a result, income-based caps have the added advantage of potentially mitigating labor and savings distortions. Otherwise, they have the same effect on excess burden as fixed-dollar caps. They increase compliance and enforcement costs. Both also can induce a taxpayer to shift expenses from one year to another.

198 Even so, an income-based cap can weaken work incentives by reducing the purchasing power of marginal earnings. See note 188.
3. Distribution

While fixed-dollar caps are tighter constraints on high-income claimants than low-income claimants, as noted above, this is not necessarily true of income-based caps. Although high-income claimants spend a larger absolute amount on tax-favored expenses, do they spend a larger percentage of their income? They probably do in some cases (for example, state income tax), but not in others (for example, health insurance). In addition, we should focus not only on tax benefits generated by the tax expenditure, but also on economic benefits. Again, if a cap keeps high-income donors from supporting a soup kitchen, the low-income clientele is affected as well.

4. Trade-offs

Like fixed-dollar caps, income-based caps are useful when marginal programmatic benefits decline as the activity level rises. They save money while eliminating programmatic incentives that are not especially valuable (although probably in a less precise way than fixed-dollar caps). They reduce effective marginal rates (something that fixed-dollar caps do not do), and may also make the tax system more progressive, at least if we focus on tax benefits instead of on economic benefits. As a result, income-based caps can offer a grand slam for tax expenditures whose marginal benefits decline as activity levels rise. Depending on the empirics, this could be true of health insurance, retirement savings, and mortgage interest.

Yet like fixed-dollar caps, income-based caps are less helpful when the goal is to encourage as much favored activity as possible, since they eliminate programmatic incentives above the cap. They also do not help us avoid subsidizing what claimants would do anyway.

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TABLE 4: Income-Based Caps
E. Phase-Outs and Cliffs

Phase-outs and cliffs deny tax benefits to those who earn more than a minimum amount. The disallowance occurs all at once with a cliff, and over a range with a phase-out. Under current law, phase-outs apply to the EITC, child credit, Roth IRAs, and various education credits.

1. Programmatic Incentives

These limits preserve programmatic incentives for taxpayers with sufficiently low incomes, while eliminating them for everyone else. As a result, phase-outs and cliffs avoid subsidizing what (some) claimants would do anyway. High-income claimants need less encouragement to enter the workforce, seek an education, and save for retirement. Excluding these claimants can focus the subsidy where it has the most impact. Indeed, when the goal is to encourage at least a minimum level of favored activity (for example, so claimants become self-sufficient), a phase-out can be paired with a cap, as with education subsidies, the EITC, and Roth IRAs under current law.

At the same time, phase-outs and cliffs are not a good fit for maximizing the volume of activity, without regard to who engages in it. For instance, phasing out the charitable deduction for high-earners could significantly reduce charitable giving, since these donors have more capacity to give and are more responsive to financial incentives.
2. **Excess Burden**

Phase-outs and cliffs also increase the effective marginal tax rate.\(^{205}\) Earning more causes taxpayers to lose deductions, exclusions, or credits.\(^{206}\) The EITC thus creates offsetting incentives: The credit itself encourages work, but the phase-out has the opposite effect.

3. **Distribution**

Even so, phase-outs and cliffs can promote distributional goals, especially when tax expenditures generate mostly private benefits. For instance, since the EITC is supposed to help claimants, a phase-out enhances distribution by ensuring they actually need this assistance. In contrast, the charitable deduction helps third-party beneficiaries more than claimants. When these beneficiaries have low incomes, phasing out this subsidy is a counterproductive way to pursue distributional goals.

4. **Trade-offs**

Phase-outs and cliffs offer a familiar trade-off between programmatic benefits and distribution, on one hand, and excess burden, on the other. These limits permit precise income-based allocations. This can focus the subsidy where it does the most good, especially when subsidies generate private benefits. For these individually-based tax expenditures, the main disadvantage is that phase-outs and cliffs increase effective marginal rates. They also are a poor fit for aggregate subsidies that increase the overall amount of favored activity, without regard to who engages in it.

\(^{205}\) See Manning & Andress, note 42, at 1592 ("A phase-out of a deduction is effectively the same as an adjustment of the tax rate for those otherwise entitled to the deduction.").

\(^{206}\) See id. at 1593 ("Because all exemptions are phased out simultaneously, possibly reflecting the practical difficulties of doing it seriatim with such a large range, this process also has the perverse effect that the larger the family, the higher the marginal rate throughout the phase-out range. Talk about negative family values!"); Daniel N. Shaviro, Effective Marginal Tax Rates on Low-Income Households, Emp't Policies Inst., Feb. 1999, at 1, 13-16, available at https://www.epionline.org/wp-content/studies/shaviro_02-1999.pdf (estimating effective marginal rate of over 100% in increasing income from $10,000 to $25,000, given phase-out of various state and federal welfare and other benefits, such as Medicaid, the EITC, Temporary Aid to Needy Families, food stamps, and rent subsidies).
LIMITING TAX EXPENDITURES  

Table 5
Phase- Outs and Cliffs

Programmatic Benefits
- Benefits for high activity levels with valuable externalities: Yes (in theory)
- Benefits for high activity levels with diminishing returns: Yes (in theory)
- Benefits for essential first dollar: Yes
- Benefits for inframarginal first dollar: Yes
- Benefits for responsive wealthy claimants: No
- Benefits for inframarginal wealthy claimants: No

Excess Burden
- Increased complexity: Yes
- Increased cost for favored activity: Yes
- Bracket creep: Yes
- Disguised rate increase: Yes
- Spreading: No
- Bunching: No

Distribution
- Disproportionate cuts for wealthy claimants: Yes
- Mitigated upside down effect: Yes
- Cost-effective externalities for low-income third parties: No

F. Maximum Fraction

Another option is to fund an unlimited amount of the favored activity, but at a lower rate. For example, although the taxpayer’s marginal rate usually defines the government’s share of deductions and exclusions, President Obama has proposed a maximum 28% rate to apply to certain deductions. This Article calls this limit a “maximum fraction,” since it specifies a maximum percentage that the government will reimburse.

1. Programmatic Incentives

President Obama’s proposal affects only those in brackets above 28%. It weakens their programmatic incentives, but does not eliminate them. A key question is whether this reduced rate induces the desired level of favored activity. The answer varies with the context. All else being equal, the rate should be higher when activities gener-

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207 A phase-out becomes a tighter constraint as income rises, but not as activity level rises. On their own, then, phase-outs do not limit the amount of activity that is subsidized. But they usually are paired with caps, so it is rare for a tax expenditure that is subject to a phase-out to support an unlimited level of activity. See 2 Joint Comm. on Tax’n, 170th Cong., Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(b) of the Internal Revenue Code of 1986, at 80-84 tbl.7 (Comm. Print 2001) (describing individual tax provisions with income-based phase-ins or phase-outs). Even if they did, moreover, the low income of the claimant would itself constrain how much favored activity is feasible.

208 Office of Mgmt. and Budget, note 55, at 36.
ate more externalities. At the same time, it should be lower when claimants are more responsive to tax incentives.

A flaw in the Obama proposal, then, is that 28% is unlikely to be right for all tax expenditures. Current law has a similar flaw in using the marginal tax rate as the reimbursement rate (for deductions and exclusions). There is no reason why the marginal tax rate (or 28% percent) always would be optimal. Instead, we should use different rates for mortgage interest, health insurance, charity, and other subsidies. To do so, we could use credits with rates tailored to the context. Admittedly, this approach has its own problems. This tailoring raises administrative costs. The government also may not have the expertise to distinguish among different subsidies, and would face intense lobbying in doing so. Yet even if the result is not perfect, there is room to improve on current law.

A further downside is that a maximum fraction accords the same treatment to the first and last dollar spent on favored activity, even if the relevant elasticities or externalities vary. As a result, this limit is more likely than a floor to subsidize what claimants would do anyway (such as the first dollar of charity). Unlike a cap, it subsidizes an unlimited amount of favored activity, which is undesirable when marginal externalities decline (as with gold-plated health insurance).

2. Excess Burden

Like other limits, a maximum fraction can complicate the calculation of tax liability, although tax preparation software alleviates this cost. Even so, a maximum fraction has an advantage over caps and floors: It does not create an incentive to shift spending from one year to another. Under the Obama proposal, each dollar of deductions is still worth 28 cents (for those in higher brackets), whether we concentrate two years of deductions into a single year or spread them evenly

209 Admittedly, there might be some correlation. For instance, tax-sensitive people may be more responsive not only in their labor supply decisions, but also in their use of tax expenditures. See Slemrod & Kopczuk, note 138, at 106-07 (positing that elasticity may be controllable instead of a pure preference). If all else were equal, then, we would want lower rates—both tax rates and subsidy rates—for those who are especially tax-sensitive. Yet even for them, we should be concerned that elasticities of labor supply differ from those for subsidized activities, such that the rates should be different.

210 See Saez, note 31, at 2659 (“There is no theoretical reason to link the subsidy rate on the contribution good to the income tax rate as is currently done in the US income tax code.”); see also Batchelder et al., note 10, at 28 (“It is extremely unlikely that externalities and elasticities change in an abrupt and discontinuous fashion exactly at the point of zero income tax liability or the marginal tax rate thresholds.”).

211 In other work, I have discussed the potential advantages of this approach for charitable subsidies. See Schizer, note 36, at 239-41.
across both years. In other words, a maximum fraction avoids the bunching and spreading associated with floors and caps.\textsuperscript{212}

A maximum fraction differs from caps and floors in another respect as well: It does not disallow (or authorize) more deductions as claimants earn more. For instance, by earning another dollar, and thus moving from the 28\% bracket to the 33\% bracket, claimants do not lose any deductions. As a result, a maximum fraction does not change the effective marginal rate in the way that income-based floors and caps do. Yet a maximum fraction obviously makes some deductions less valuable than they otherwise would be. As a result, this limit increases the cost of previously-subsidized consumption.\textsuperscript{213} It also imposes a form of bracket creep, since claimants can no longer use itemized deductions to avoid moving from the 28\% bracket to the 33\% bracket.\textsuperscript{214}

3. Distribution

A maximum fraction can enhance distribution by offering a more uniform tax benefit to claimants with different incomes. Under President Obama's proposal, for instance, claimants in the 28\% bracket receive the same tax benefit as claimants in higher brackets. Put another way, a maximum fraction disallows more tax benefits for those in higher bracket (for example, the Obama proposal disallows 11.6\%\textsuperscript{212} For similar reasons, it also avoids the incentive to spread, discussed above, that can arise even without a cap. Bunching can move claimants to a lower bracket, thereby reducing the value of deductions or exclusions. Yet the Obama proposal eliminates this issue for claimants in the top three brackets. See Office of Mgmt. and Budget, note 55, at 36. Whether they stay in their current bracket or move to a lower one, their deductions and exclusions are still worth 28\%. This value declines only if they move to a bracket below 28\%.

\textsuperscript{213} For example, if someone wants to use their last dollar of earnings to pay mortgage interest, but a maximum fraction reduces the tax benefit, the purchasing power of this marginal dollar of earnings—and thus the return to working more—is reduced. See Subsection III.C.1.e.

\textsuperscript{214} Under the proposal taxpayers would determine their tax bracket based on their income before they subtract their itemized deductions (that is, using AGI instead of taxable income). For example, since the 33\% bracket applies to income above $186,350, consider a taxpayer who has an AGI of exactly $186,350, and also has $10,000 of itemized deductions. Toder et al., note 40, at 820, 822, 827. Under the Obama proposal, an additional dollar of income is taxed at 33\%. In contrast, under current law, this additional dollar is taxed at 28\% because brackets are applied to taxable income (that is, AGI minus itemized deductions), and not to AGI (the prededuction amount). IRC §§ 1, 63(a). As a result, under current law—but not under the Obama proposal—deductions can keep taxpayers from moving up to the 33\% bracket: AGI is $186,357, but taxable income (that is, AGI minus $10,000 of itemized deductions) is only $176,357. Under current law, then, a dollar of deductions is reducing tax by 33 cents—something that President Obama's proposal does not allow. In contrast, instead of applying the brackets after subtracting deductions, the Obama proposal would apply the brackets to AGI, calculate the tax, and then separately subtract an amount equal to 28\% of the itemized deductions (28\% of $10,000 or $2800).
in the 39.6% bracket, but only 7% in the 35% bracket). Even so, claimants in lower brackets would still receive a less generous tax benefit. A dollar of deductions would still be worth 15 cents to claimants in the 15% bracket, but its value would become the same 28 cents for claimants in the 28%, 35% and 39.6% brackets. As a result, the “upside down effect” would be mitigated but not eliminated.

Again, the distributional analysis becomes more complicated when one focuses on economic benefits, instead of tax benefits. By cutting the reimbursement rate, maximum fractions can reduce the volume of favored activity. This has an adverse effect on low-income third parties who benefit from it (as with charity to soup kitchens).

4. Trade-offs

A maximum fraction is, in a sense, a compromise between floors and caps. Instead of preserving programmatic incentives for high levels of activity (like floors), or eliminating them (like caps), a maximum fraction preserves them, but at a reduced level. This limit’s effects on excess burden and distribution are comparably moderate. A maximum fraction does not encourage bunching or spreading, or alter effective marginal rates in the way that an income-based floor or a cap does. Although a maximum fraction targets only high-income taxpayers (for example, above the 28% bracket in the Obama proposal), it does not eliminate their subsidy (as phase-outs do). Likewise, this limit mitigates the upside down effect, but does not eliminate it.215

Table 6
Maximum Fraction

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215 In a simulation, Eric Toder, Joseph Rosenberg, and Amanda Eng raise $83.4 billion with a 19.2% rate-based fraction, concluding that 89% of the impact is on the top 20%, and 41.4% is on the top 1%. This is significantly more progressive than a haircut and an income-based limit, but less progressive than a fixed-dollar limit. Toder et al., note 40, at 820, 822, 827.
G. Haircuts

Finally, instead of setting a maximum tax benefit for a favored expense (for example, 28 cents per dollar), we could disallow a fixed percentage of it. Under current law, for instance, only 50% of business-related entertainment expenses can be deducted. A similar "haircut" can be applied to any deduction, exclusion, or credit. For example, we could exclude only 50% of health insurance premiums funded by employers.

1. Programmatic Incentives

Like maximum fractions, haircuts weaken programmatic incentives, but do not eliminate them. A haircut is useful, then, when the marginal reimbursement rate otherwise would be too high. This can be true when claimants are especially responsive, so a lower subsidy still offers sufficient motivation. In addition, a subsidy generally should equal the marginal positive externalities it generates. If another dollar of mortgage interest generates only 10 cents of positive externalities, the marginal subsidy should be 10%. A haircut can bring us closer to this optimal level.

It would be cleaner, though, to use a credit that specifies the rate we want. With this approach, we do not need a haircut. After all, if we want the subsidy to be 20%, we can simply use a 20% credit, instead of a 40% credit with a 50% haircut. In contrast, with deductions and exclusions, a uniform haircut generates a different reimbursement rate in each bracket. For example, a 50% haircut creates a 17.5% reimbursement rate in the 35% bracket, but only a 7.5% reimbursement rate in the 15% bracket. Just as the marginal tax rates themselves are unlikely to be optimal for a given subsidy, fractions of these rates also are unlikely to be optimal. A haircut that yields the right reimbursement rate in one bracket could yield the wrong rate in another.

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216 IRC § 274(n).
217 The alternative minimum tax also is a haircut of sorts, although the fraction disallowed varies with a number of factors, including the AMT and regular marginal tax rates, as well the amount of tax preferences the taxpayer has. For a discussion of the AMT, see Hines & Logue, note 1, at 1-10.
Haircuts have another limitation as well: They offer the same subsidy for low- and high-activity levels. In this way, haircuts resemble maximum fractions and differ starkly from caps and floors. As a result, haircuts risk subsidizing what claimants would do anyway (such as the first dollar of charity), or funding high levels of activity that yield fewer marginal externalities (such as gold-plated health insurance).

2. Excess Burden

This difference between haircuts, on one hand, and caps and floors, on the other, means these limits affect excess burden in different ways as well. For example, income-based caps authorize more deductions as claimants earn more. Yet haircuts do not reduce the effective marginal tax rate in this way. By earning more, a claimant cannot somehow turn a 50% haircut into a 30% haircut.

If anything, haircuts become a tighter constraint as claimants earn more. Since deductions and exclusions offer more generous tax benefits in higher brackets, the tax benefit disallowed by a haircut becomes more valuable as claimants earn more. For example, losing 50% of the mortgage interest deduction costs more in the 39.6% bracket than in the 15% bracket (19.8 cents versus 7.5 cents per dollar).

In imposing a heavier burden on high-income claimants, then, haircuts are more like income-based floors, which disallow more deductions as claimants earn more. Yet floors and haircuts are by no means the same. While haircuts become more burdensome as taxpayers move to a higher bracket, they accord the same treatment to claimants in the same bracket. Income-based floors, by contrast, differentiate even among claimants in the same bracket. For example, assume a claimant in the top bracket (earning $500,000) contributes $50,000 to charity, and is subject either to a 10% haircut or a 1% floor. Each limit would disallow $5000 of charitable deductions, raising the tax bill by $1980. But what happens if the claimant earns an additional $1000? The income-based floor would disallow another $10 of deductions, raising tax by $3.96. In contrast, nothing changes with the haircut, which still disallows $5000 of deductions. Like maximum fractions, then, haircuts do not change the effective marginal rate in this way.

Similarly, haircuts do not encourage bunching or spreading in the same way that floors and caps do. A haircut disallows the same percentage of deductions, whether they are concentrated in a single year
or spread across multiple years. Unlike with a floor (or cap), this percentage cannot be reduced by concentrating (or spreading) deductions. In the example above, the claimant can reduce the percentage of deductions she loses under the 1% floor—from 10% to 5%—by contributing $100,000 in a single year, instead of $50,000 this year and $50,000 next year. Yet under the 10% haircut, she loses 10% either way.

Notwithstanding these differences, haircuts share three effects on excess burden with all the limits discussed so far. First, like these other limits, a haircut can increase the after-tax cost of favored activity, thereby influencing work and savings choices. Second, in disallowing a portion of a claimant’s deductions or exclusions, a haircut can move a claimant into a higher tax bracket. (Limits on credits do not have this effect, as discussed above.) Third, any limit can complicate the calculation of tax liability, although tax preparation software alleviates this concern.

3. Distribution

Unlike maximum fractions, which focus on higher brackets, haircuts apply to all brackets. They differ from maximum fractions, then, in reducing tax benefits claimed by low-income claimants. Even so, a haircut has more impact on high-bracket claimants, since their deductions and exclusions—and, therefore, the fraction disallowed by a haircut—are worth more. For example, a 50% haircut on a dollar of deductions costs 17.5 cents in the 35% bracket but only 14 cents in the 28% bracket. Thus, although a haircut preserves the so-called “upside down” effect—since tax benefits still correlate with the marginal tax rate—it burdens high-income claimants more for the same reason.

Again, the distributional analysis becomes more complicated when the focus is on economic benefits instead of tax benefits. Like maximum fractions, haircuts cut the marginal reimbursement rate. This can lower the level of favored activity, which (in some cases) will eliminate externalities benefitting low-income people.

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219 If she contributes $50,000 each year, she loses 1% of her income (or $5000) in both years, for a total of $10,000. But if she contributes $100,000 in one year, she loses only $5000 in that year, and $0 in the next year.

220 She either loses $10,000 in a single year (on the $100,000 contribution), or $5000 each year (on the two $50,000 contributions). As noted above, bunching can have the disadvantage of bringing a taxpayer into a lower bracket, so the value of the deduction is reduced. This effect, which is different from the one described in the text, endures under a haircut, but in somewhat diminished form (since the haircut reduces the deduction’s value anyway).

221 See note 188.

222 See Subsection III.C.1.c.
4. **Trade-offs**

Like maximum fractions, haircuts also carve out a middle position between floors and caps. They reduce programmatic incentives without eliminating them. In addition, haircuts do not encourage bunching or spreading, or affect the marginal tax rate, in the way income-based floors and caps do. Unlike maximum fractions, though, haircuts apply to all brackets. Even so, the deductions and exclusions they partially disallow are worth more in higher brackets.\textsuperscript{223}

<table>
<thead>
<tr>
<th>TABLE 7</th>
<th>HAIRCUTS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Programmatic Benefits</strong></td>
<td>Yes (but reduced)</td>
</tr>
<tr>
<td>Benefits for high activity levels with valuable externalities</td>
<td>Yes (but reduced)</td>
</tr>
<tr>
<td>Benefits for high activity levels with diminishing returns</td>
<td>Yes (but reduced)</td>
</tr>
<tr>
<td>Benefits for essential first dollar</td>
<td>Yes (but reduced)</td>
</tr>
<tr>
<td>Benefits for inframarginal first dollar</td>
<td>Yes (but reduced)</td>
</tr>
<tr>
<td>Benefits for responsive wealthy claimants</td>
<td>Yes (but reduced)</td>
</tr>
<tr>
<td>Benefits for inframarginal wealthy claimants</td>
<td>Yes (but reduced)</td>
</tr>
<tr>
<td><strong>Excess Burden</strong></td>
<td>Yes</td>
</tr>
<tr>
<td>Increased complexity</td>
<td>Yes</td>
</tr>
<tr>
<td>Increased cost for favored activity</td>
<td>Yes</td>
</tr>
<tr>
<td>Bracket creep</td>
<td>Yes</td>
</tr>
<tr>
<td>Disguised rate increase</td>
<td>Yes (in a sense)\textsuperscript{224}</td>
</tr>
<tr>
<td>Spreading</td>
<td>No</td>
</tr>
<tr>
<td>Bunching</td>
<td>No</td>
</tr>
<tr>
<td><strong>Distribution</strong></td>
<td>Yes</td>
</tr>
<tr>
<td>Disproportionate cuts for wealthy claimants</td>
<td>Yes (in a sense)</td>
</tr>
<tr>
<td>Mitigated upside down effect</td>
<td>Yes</td>
</tr>
<tr>
<td>Cost-effective externalities for low-income third parties</td>
<td>Yes</td>
</tr>
</tbody>
</table>

V. **Implications: “Grand Slam” Opportunities, Trade-offs, and the Value of Context-Specific Tailoring**

A. **Grand Slam Opportunities**

In some cases, when we limit a tax expenditure, all the goals align. We can save money while preserving programmatic benefits, mitigating excess burden, and enhancing distribution. This Article identifies

\textsuperscript{223} Toder, Rosenberg, and Eng raise $85 billion with a 29.5% haircut, and find that 71.7% of the impact is on the top 20% (compared with 71.5% for an income-based cap and 94.9% for a fixed-dollar cap). They estimate that 24.9% comes from the top 1% (compared with 28.8% for an income-based cap and 71.4% for a fixed-dollar cap). Toder et al., note 40, at 820, 822, 827.

\textsuperscript{224} By earning more, and thus moving to a higher bracket, a claimant loses a portion of a *more valuable* deduction, as noted above. Yet unlike income-based floors and phase-outs, haircuts do not increase the effective marginal rate of a claimant who stays *in the same bracket*. 
two circumstances in which these grand slam situations arise. In the first, programmatic benefits are not worth preserving. This can be true if a tax expenditure pursues unwise goals or, for that matter, if it pursues valuable goals ineffectively.

In the second "grand slam" scenario, programmatic benefits are valuable, but only at low activity levels. Depending on the relevant empirics, subsidized health insurance, retirement savings, and mortgage interest could all involve declining marginal externalities. If this is the case, caps can save money while largely preserving programmatic benefits. Admittedly, caps can add to compliance costs and also can increase effective marginal tax rates in some ways (for example, bracket creep). But unlike phase-outs and income-based floors, caps are not mathematically equivalent to a rate increase; on the contrary, income-based caps reduce effective marginal tax rates. Caps also improve distribution if they disproportionately burden high-income taxpayers. This may be true of caps on health insurance, retirement savings, and mortgage interest. After all, high-income claimants disproportionately claim these tax expenditures. When a tax expenditure satisfies these empirical parameters, capping it can save revenue, enhance progressivity, and preserve valuable externalities, while adding only modestly to excess burden.

B. Trade-offs and the Value of Context-Specific Tailoring

Yet in other cases, there is tension among the competing goals. The seven limits discussed in Part IV strike different balances among programmatic benefits, excess burden, and distribution.

They all have four common effects: First, they raise revenue; second, they increase the after-tax cost of the favored activity; third, they can move a claimant into a higher tax bracket; fourth, they add complexity to the tax system by introducing another rule that must be understood and enforced, although some of these limits can also have the offsetting effect of simplifying the law (for example, as floors do in eliminating the need for recordkeeping).

Yet despite these commonalities, these limits have quite different effects on programmatic incentives. For high activity levels, some eliminate the subsidy (fixed-dollar caps and income-based caps); others do not change it (fixed-dollar floors and income-based floors); and still others preserve it in weakened form (maximum fractions and haircuts). Likewise, for the first dollar of activity, some withhold the subsidy (income-based floors and fixed-dollar floors); others maintain

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226 See Section IV.C.
it (fixed-dollar caps and income-based caps); and others weaken but do not eliminate it (maximum fractions and haircuts).

These limits also affect excess burden in different ways. Some are mathematically equivalent to a marginal rate cut (income-based caps) or increase (income-based floors, phase-outs, and arguably haircuts as well); in contrast, others do not influence the effective marginal tax rate in this way (fixed-dollar caps, fixed-dollar floors, and maximum fractions). Some limits encourage bunching (income-based floors and fixed-dollar floors) or spreading (income-based caps and fixed-dollar caps), and others do not have either effect (phase-outs, maximum fractions, and haircuts).

These limits also influence distribution in different ways. Some deny the subsidy to high-income claimants (phase-outs) or otherwise disproportionately reduce their tax benefits (fixed-dollar caps, maximum fractions, and haircuts), while others do not (income-based floors, fixed-dollar floors, and income-based caps). The table below summarizes these various effects.

### Table 8
**The Diverse Effects of Seven Different Limits**

<table>
<thead>
<tr>
<th>Programmatic Benefits</th>
<th>Fixed-Dollar Floors</th>
<th>Income-Based Floors</th>
<th>Fixed-Dollar Caps</th>
<th>Income-Based Caps</th>
<th>Phase-Outs and Cliffs</th>
<th>Maximum Fractions</th>
<th>Haircuts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Benefits for high activity levels with valuable externalities</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>Yes (in theory)</td>
<td>Yes (but reduced)</td>
<td>Yes (but reduced)</td>
</tr>
<tr>
<td>Benefits for high activity levels with diminishing returns</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>Yes (in theory)</td>
<td>Yes (but reduced)</td>
<td>Yes (but reduced)</td>
</tr>
<tr>
<td>Benefits for essential first dollar</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes (but reduced)</td>
<td>Yes (but reduced)</td>
</tr>
<tr>
<td>Benefits for inframarginal first dollar</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes (but reduced)</td>
<td>Yes (but reduced)</td>
</tr>
<tr>
<td>Benefits for responsive wealthy claimants</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes (but reduced)</td>
<td>Yes (but reduced)</td>
</tr>
<tr>
<td>Benefits for inframarginal wealthy claimants</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes (but reduced)</td>
<td>Yes (but reduced)</td>
</tr>
<tr>
<td>Excess Burden</td>
<td>Increased complexity</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>Increased cost for favored activity</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>Bracket creep</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>
Since each limit involves a different mix of trade-offs, we should pick the limit (or combination of limits) that is the best fit for a particular tax expenditure. For example, a phase-out has the advantage of focusing a subsidy on those who most need it, but the disadvantage of raising effective marginal rates. This balance of benefits and costs is more plausible for subsidies that generate private benefits, such as the EITC. It is less appealing for subsidies that generate externalities for low-income claimants, such as charity for soup kitchens.

Likewise, a well-crafted floor on the charitable deduction can save money while (largely) preserving incentives to give. Yet floors also trigger welfare costs. Since the mix of costs varies for different floors, we need to pick our poison. For example, a fixed-dollar floor has the disadvantage of not adjusting to a claimant’s giving capacity. But it has the offsetting advantage of not raising the effective marginal rate in the way income-based floors do. Likewise, if we set the floor at a low level, we save less money and subsidize more inframarginal contributions. But a higher floor triggers more bunching. High floors also keep us from motivating donors whose marginal contributions would be below the floor. We need to weigh these competing effects in order to choose the right limit.

As these examples illustrate, we should tailor each limit to the context, since every tax expenditure involves a different mix of externalities and elasticities. For similar reasons, we may also want a different marginal reimbursement rate for each tax expenditure. While administrative and information costs limit how much tailoring we can do, the right number is unlikely to be the marginal tax rate, as discussed above.

In setting marginal reimbursement rates, and also in crafting limits, we also should remember that the relevant facts can change. Over the past thirty years, for example, many tax expenditures have stopped providing tax benefits to middle- and low-income claimants; the rea-
son, noted above, is that marginal tax rates have been cut so substantially. When essential facts change, we may need to adjust the limit or the marginal reimbursement rate (or both). We have reason, then, to re-evaluate these issues periodically.

C. Basket Limits

The value of context-specific tailoring has another implication: We should be skeptical of basket limits. Although they may be good politics, as discussed above, they are not usually good policy. The problem is that baskets are a clumsy way to calibrate the level of favored activity. To see why, assume a subsidy of $X$ induces the optimal level of health insurance, while $Y$ induces the optimal level of retirement savings. What happens if we set a single basket limit, $X + Y$, for these two activities combined? A taxpayer can spend all of $X$ and $Y$ on health insurance and nothing on retirement savings, or vice versa.

Given the blunt incentives they create, basket limits are not easy to justify (setting politics aside). One potential rationale is that they allow taxpayers to choose the tax expenditures they value the most. Yet choice is counterproductive if it undercuts the purpose of the limit. For example, if we do not want to subsidize the first dollar of charity, a floor that can be met with other deductions does not keep the first charitable dollar from being subsidized.

Alternatively, the advantage of basket limits may be that claimants are less likely to notice them. If so, the government may be able to change behavior on the cheap, inducing favored activity without actually paying for it. Yet claimants presumably will notice eventually; they could be tipped off, for example, by advisors, media coverage, or unexpectedly high tax bills. When they realize their error, claimants could start worrying about hidden traps in other subsidies (even when there are none). This erosion of trust could make it harder, and more expensive, to motivate them again.

Finally, the case for basket limits may lie in administrative savings. With baskets, we avoid the cost of crafting multiple limits, and of policing the lines among different tax expenditures. Even so, it does not seem especially difficult to craft a separate limit for each tax expendi-

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227 See Toder et al., note 40, at 811 ("[A]cross-the-board limits on spending . . . may make it politically easier to sustain spending cuts. Overall limits on spending or tax expenditures are suboptimal ways to reduce deficits because they equally cut high-value and low-value activities. No well-functioning organization, either private or governmental, would reduce its costs in this manner. . . . And if tax expenditures more often than not misallocate resources, overall limits on them could yield net improvement in the tax system and budgetary policy, even while falling far short of the ideal.").

228 For example, the Pease rule's 3% floor can be met with state income taxes. See IRC § 68.
ture, or to determine whether a payment is mortgage interest instead of charity. At the same time, any administrative savings we reap comes at a cost: Baskets can warp the relevant incentives, as noted above. As a result, it seems unlikely that the administrative savings from baskets routinely offset the programmatic costs of having blunter incentives. Yet like so many issues in this Article, this is an empirical question that should be resolved with context-specific analysis.

\section*{D. Empirical Research}

 Needless to say, the centrality of empirical questions is a recurring theme in this Article. Since empirical research on the right questions can add a lot of value, Treasury should devote more resources to this research. It also should provide more data to academic partners, and can consider grants and other support as well.

\section*{E. Should Benefits Vary by Income? A Response to Batchelder, Goldberg, and Orszag}

Finally, the importance of context has still another implication: When externalities and elasticity vary systematically with income, the marginal reimbursement rate should vary as well. However, Lily Batchelder, Fred Goldberg, and Peter Orszag resist this sort of income-based tailoring, at least as a general matter. Instead, they recommend using refundable credits as a default practice, so the same marginal reimbursement rate applies to everyone. They accept income-based variation only based on “specific knowledge that [high-income] households are more responsive to the incentive or that their engaging in the behavior generates larger social benefits.” But they consider this the exception, not the rule. In defending uniformity as a default, they ground their argument in efficiency. They claim that uniformity minimizes the risk of large errors, and thus reduces distortions, which are a function of the square of errors.

Default rules are more appealing, though, if they are correct most of the time. As a result, a key question is how often elasticities and externalities vary with income. Batchelder, Goldberg, and Orszag’s proposal is more compelling if these variations are rare, but variations are likely to be common for a number of reasons. For example, if the

\begin{enumerate}
\item[229] See Kaplow, note 183, at 26-29 (noting that policing the lines among tax expenditures is not difficult).
\item[230] Batchelder et al., note 10, at 27 n.16 (noting the “default assumption” should be that “underlying price elasticities and behavior do not vary systematically across income distribution”).
\item[231] Id. at 24.
\item[232] See id. at 47-48 (grounding case in efficiency, rather than in distribution).
\end{enumerate}
goal of a subsidy is to provide private benefits, subsidizing low-income claimants usually is preferable. The same is true if the goal is to encourage self-sufficiency; since high-income claimants are likely to enter the workforce or save for retirement on their own, more externalities are generated in focusing on low-income claimants. In contrast, instead of targeting those who are most in need, we sometimes target those who are most responsive. In these cases, we have reason to focus on high-income claimants. Whether these scenarios are typical or unusual is, of course, an empirical question which this Article does not seek to resolve definitively. Yet there certainly are a number of contexts where externalities and elasticities do vary with income.

Even so, Batchelder, Goldberg, and Orszag offer another argument for uniformity: Even if elasticity and externalities do vary with income, uniformity is better if we are unsure how they vary. Nevertheless, this argument is persuasive only if we have no idea whether to subsidize low- or high-income claimants. Batchelder, Goldberg and Orszag rely on just such an example. They assume a 10 cents subsidy should be given either to a high-income group (H) or a low-income group (L), and we have no sense of which is more likely. On these facts, Batchelder, Goldberg, and Orszag show that giving 5 cents to each group (and thus undersubsidizing by five cents each time) minimizes deadweight loss: Five cents, after all, is the mean of the possible shortfalls in the subsidy (that is, 10 cents or zero). But the key assumption in their example—the reason why uniformity is the error-minimizing default—is that H and L are equally plausible.

However, this analysis no longer holds when we have at least some sense of which income cohort should be funded. In this case, uniformity no longer minimizes distortions. For instance, assume L should get more of the subsidy, but we do not know how much. There is a 50% chance that 75% should go to L and 25% should go to H. There is also a 50% chance that all should go to L. On these facts, uniformity (5 and 5) does not minimize errors or deadweight loss. Instead, always undersubsidizing by 5 cents minimizes the square of deviations (and thus deadweight loss) at 25. (The deadweight loss is the square of the errors, or \(1/2(5 \times 5 + 1/2(5 \times 5) = 25\).) By contrast, if we give the full subsidy to one group, we have a 50% chance of being right and a 50% chance of undersubsidizing by ten cents, which generates twice as much deadweight loss (that is, 50). (Deadweight loss = \(1/2(10 \times 10) + 1/2 (0 \times 0) = 50\).) See id. at 47-48 ("Although the expected error would be the same irrespective of whether the entire subsidy was given to one group or spread evenly over both groups, the expected deadweight loss would be minimized by a uniform subsidy because the loss from failing to correct for a positive externality rises with the square of the uncorrected externality.").

233 As a result, always undersubsidizing by 5 cents minimizes the square of deviations (and thus deadweight loss) at 25. (The deadweight loss is the square of the errors, or \(1/2(5 \times 5 + 1/2(5 \times 5) = 25\).) By contrast, if we give the full subsidy to one group, we have a 50% chance of being right and a 50% chance of undersubsidizing by ten cents, which generates twice as much deadweight loss (that is, 50). (Deadweight loss = \(1/2(10 \times 10) + 1/2 (0 \times 0) = 50\).) See id. at 47-48 ("Although the expected error would be the same irrespective of whether the entire subsidy was given to one group or spread evenly over both groups, the expected deadweight loss would be minimized by a uniform subsidy because the loss from failing to correct for a positive externality rises with the square of the uncorrected externality.").

234 If L should receive the entire subsidy, a 5-5 split undersubsidizes L by 5. But if L should receive 7.50, a 5-5 split undersubsidizes L by 2.50. As a result, the expected shortfall in the subsidy is 3.75: \(1/2(5) + 1/2(2.5) = 3.75\). Expected deadweight loss from the shortfall is 15.625: \(1/2(5 \times 5) + 1/2(2.5 \times 2.5) = 15.625\).
it is better to split the difference between the most likely scenarios (8.75 and 1.25).\textsuperscript{235} Accordingly, when we are able to make even a rough guess, the default should not be uniformity, but context-specific tailoring. If externalities and elasticity vary with income, but we are not sure precisely how, we should use our best estimate of the relevant facts. A probability-weighted mean of likely outcomes minimizes the square of deviations.\textsuperscript{236}

Admittedly, this "best estimate" approach is not helpful if the relevant elasticities and externalities are a complete mystery. If even a ballpark estimate is impossible, Batchelder, Goldberg, and Orszag's argument for uniformity has force. But if we truly have no idea, does a subsidy really make sense? Before committing scarce resources, we should have at least a rough prediction of a subsidy's effects. Otherwise, how can we conclude that it is cost-justified? Once this sort of prediction is feasible, uniformity is no longer the efficient answer.\textsuperscript{237}

Of course, there may be other reasons to favor uniformity, such as a social welfare function that especially values equal treatment in the relevant setting. But if we seek to promote equality more generally—whether to reduce income inequality or to promote economic mobility—we often should vary the subsidy by income. For example, if a subsidy provides private benefits (like the EITC), it usually should favor low-income claimants. In contrast, a subsidy that generates positive externalities for low-income people (like charity for soup kitchens) should focus on high-income claimants if they are more responsive. Ultimately, when we decide whether the marginal reimbursement rate of a tax expenditure should vary with income, we need to account for all the issues in this Article's framework. The point here is merely that we need a context-specific analysis, instead of assuming uniformity is the answer.

\textsuperscript{235} If \( L \) should receive the entire subsidy, an 8.75-1.25 split undersubsidizes \( L \) by 1.25. If \( L \) should receive 7.50 and \( H \) should receive 2.50, an 8.75-1.25 split undersubsidizes \( H \) by 1.25. As a result, the expected shortfall in the subsidy is 1.25: \( 1/2(1.25) + 1/2(1.25) = 1.25 \). Expected deadweight loss falls to 1.5625: \( 1/2(1.25 \times 1.25) + 1/2(1.25 \times 1.25) = 1.5625 \). This is 1/10 the deadweight loss created by the 5-5 split.

This analysis does not treat an overpayment as an error, since that is the approach Batchelder, Goldberg and Orszag follow. If we do treat overpayment as an error, the numbers change but the conclusion does not.

\textsuperscript{236} Cf. Kaplow, note 183, at 14 n.38 ("It is a familiar statistical property that the mean minimizes the sum of the squares of deviations.").

\textsuperscript{237} Another potential problem with subsidies that vary by income is that they promote clientele effects. Those who receive more generous subsidies might outbid others who otherwise value the asset more. See Shaviro, note 39, at 431.
VI. Conclusion

To sum up, then, this Article offers a three-part framework for deciding whether to repeal or limit a tax expenditure. First, what programmatic benefits would we lose? What positive externalities are created, and how much would we have without the subsidy? Can we tighten up the tax expenditure to get all (or most) of the benefits at a lower cost? Second, do we incur an offsetting welfare cost by increasing excess burden? What are the effects on labor and savings decisions, administrative costs, and planning? Third, do we incur an offsetting cost in distribution? Who is claiming the tax benefit? What is the economic incidence of this benefit?

This Article shows that repeal or a limit can sometimes enhance all of these goals. These grand slam opportunities can arise, for instance, when we can repeal a tax expenditure that offers only meager programmatic benefits, and also when we cap a tax expenditure whose marginal programmatic benefits decline significantly as an individual engages in more of the favored activity.

In other settings, the elements of this Article’s framework are often in tension with each other. Steps to preserve programmatic incentives, for example, might increase excess burden or undercut distributional goals (or both). This Article also shows that various limits balance these trade-offs in different ways. Income-based caps have essentially the opposite effects as income-based floors, while maximum fractions are a compromise between the two. We should choose the trade-off that yields the most favorable balance of benefits and costs in a particular context.

Given these nuances, it is important to tailor limits to the context. This is less feasible for limits that apply to baskets, instead of expenditure-specific limits. For similar reasons, this Article counsels against tax expenditures that are uniform at all income levels, since externalities and elasticity are likely to vary with income.

The bottom line, then, is that limits need to be fine-tuned to account for externalities, elasticity, administrative costs, labor and savings decisions, planning, and distribution. Admittedly, the relevant facts will not always be known, at least with certainty. We will have to make the best judgments we can with limited information. Although the results will not be perfect, we should be able to improve on current law.

A key question, of course, is whether we have the political will to repeal or limit tax expenditures that are not cost-justified. These tax expenditures are jealously guarded by interest groups, who will resist repeal or limits in predictable ways. In ordinary fiscal conditions, their higher stakes would give them a formidable political edge. But
these are somewhat unusual times. Soaring national debt and anemic economic growth, sobering as they are, may offer an opportunity. These challenges can focus popular attention on what otherwise would be obscure debates. This higher profile is crucial in repealing or limiting a tax expenditure that is not cost-justified. Voters who have no direct stake in it must become a political counterweight to those who do. These seemingly unaffected voters must come to recognize that they will pay the price – in the form of higher tax rates, spending cuts, or more deficit spending – if we do not repeal or limit someone else's sacred cow. This insight could motivate the uninvolved to become involved. While it is too optimistic to consider this outcome inevitable, it is too pessimistic to rule it out. If it happens, we should not let the opportunity go to waste.
### Tax Expenditure FY 2014 Cost (Billions)

**Business Investments**
- Dividends and Long-Term Capital Gains: 96.5239
- Domestic Production Expenses: 16.8240
- Expensing Depreciable Business Property (IRC § 179): 7.0241
- Research Activities Credit (IRC § 41): 5.5242
- Research and Experimental Expenditures Deduction: 4.7243

**Charity**
- Charitable Contributions Other than for Education and Health Care: 35.8244
- Charitable Contributions for Education: 6.3245
- Charitable Contributions for Health Care: 4.8246

**Education**
- Employer-Provided Education Assistance and Tuition Reduction: 1.5247
- Parental Personal Exemption for Students Aged 19-23: 4.7248
- Post-Secondary Education Tuition Credit: 23.0249
- Savings Exclusions and Coverdell: 0.1250

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238 Joint Comm. on Tax’n, note 51, at 21-34, tbl.1 (offering tax expenditure estimates by budget function). In some cases, the number represents the sum of both the corporate and personal income tax revenue.
239 Id. at 27.
240 Id. ($12.2 billion for corporations plus $4.6 billion for individuals).
241 Id. at 26 ($2.5 billion for corporations plus $4.5 billion for individuals).
243 Joint Comm. on Tax’n, note 51, at 23 tbl.1 ($4.6 billion for corporations plus $1 billion for individuals).
244 Id. at 31 ($1 billion for corporations plus $34.8 billion for individuals).
245 Id. at 29 ($3 billion for corporations plus $6 billion for individuals).
246 Id. at 31 ($1.8 billion for corporations plus $3 billion for individuals).
247 Id. at 29 ($1.2 billion for employer-provided education assistance and $3 billion for tuition reductions).
248 Id.
249 Id. at 30.
250 Id. at 29.
Scholarship and Fellowship Income
Exclusion 2.6251

Student Loan Interest 1.7252

Employment
Cafeteria Plan Benefits 34.5253
Miscellaneous Fringe Benefits 7.3254
Meals and Lodging 2.0255

Green Energy
Energy Credit and Renewable Electricity Production 1.8256
Energy Efficient Improvements to Residential Property 1.8257

Plug-in Hybrids 0.2258

Health Care
Employer-provided Health Insurance Exclusion 143 259

Health Savings Accounts 1.6260
Medical Expenses and Long-Term Care Deduction 9.9261

Medicare Benefits Exclusion 61 262
Self-Employed Deduction 5.4263
Worker’s Compensation 4.8264
Small Business Credit 0.9265
Health Exchange Subsidies 15.5266

Housing
Low-Income Housing 7.1267
Home Mortgage Interest 67.8268

251 Id.
252 Id.
253 Id. at 30.
254 Id.
255 Id.
256 Id. at 23 ($0.5 billion for corporations and $0.1 billion for individuals for energy credit; $1.1 billion for corporations and $0.1 billion for renewable energy production).
257 Id. at 23-24 ($0.6 billion for existing residential properties, $1.1 for energy-efficient property credit and $0.1 billion for advanced-energy property credit).
258 Id. at 24.
259 Id. at 31.
260 Id.
261 Id.
262 Id. at 32. ($31.8 billion for hospital insurance, $22.7 billion for supplementary medical insurance and $6.5 billion for prescription drug insurance).
263 Id. at 31.
264 Id.
265 Id. ($0.1 billion for corporations and $0.8 billion for individuals).
266 Id.
267 Id. at 26 ($6.8 billion for corporations and $3.3 billion for individuals).
268 Id. at 25.
Exclusion of Capital Gains on Principal Residence
Property Taxes
Retirement Savings
IRAs
Pension Contributions Exclusion
Social Security and Railroad Benefits Exclusion
Social Services and Income Support
Child Credit
Child and Dependent Care
Disability and Public Assistance Benefits Exclusion
EITC
State and Local Governments
Municipal Bond Interest Exclusion (General Bonds)
State and Local (Nonbusiness) Income Taxes
Transportation
Employer-Paid Transportation Benefits

Id. at 26.
Id. at 25.
Id. at 32 ($11.8 billion for traditional IRAs and $4.9 billion for Roth IRAs and $1.2 billion for elective deferrals).
Id. at 32 ($5.8 billion for Keogh plans, $26 billion for defined benefit plans, and $44.9 billion for defined contribution plans).
Id. at 33.
Id. at 30.
Id.
Id. at 32.
Id.
Id. at 33 ($9.3 billion for corporations plus $23.8 billion for individuals).
Id.
Id. at 28.