

How to Raise Revenue and Further Progressive Goals:

Reform Tax Incentives for Individuals

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Potential Rationales for Tax Provisions

- Measuring income or ability to pay
- Allocate tax burdens and redistribute
- Limiting complexity
- **Creating incentives for behavior with social benefits**

Progressivity by Type of Tax Incentive

Most regressive

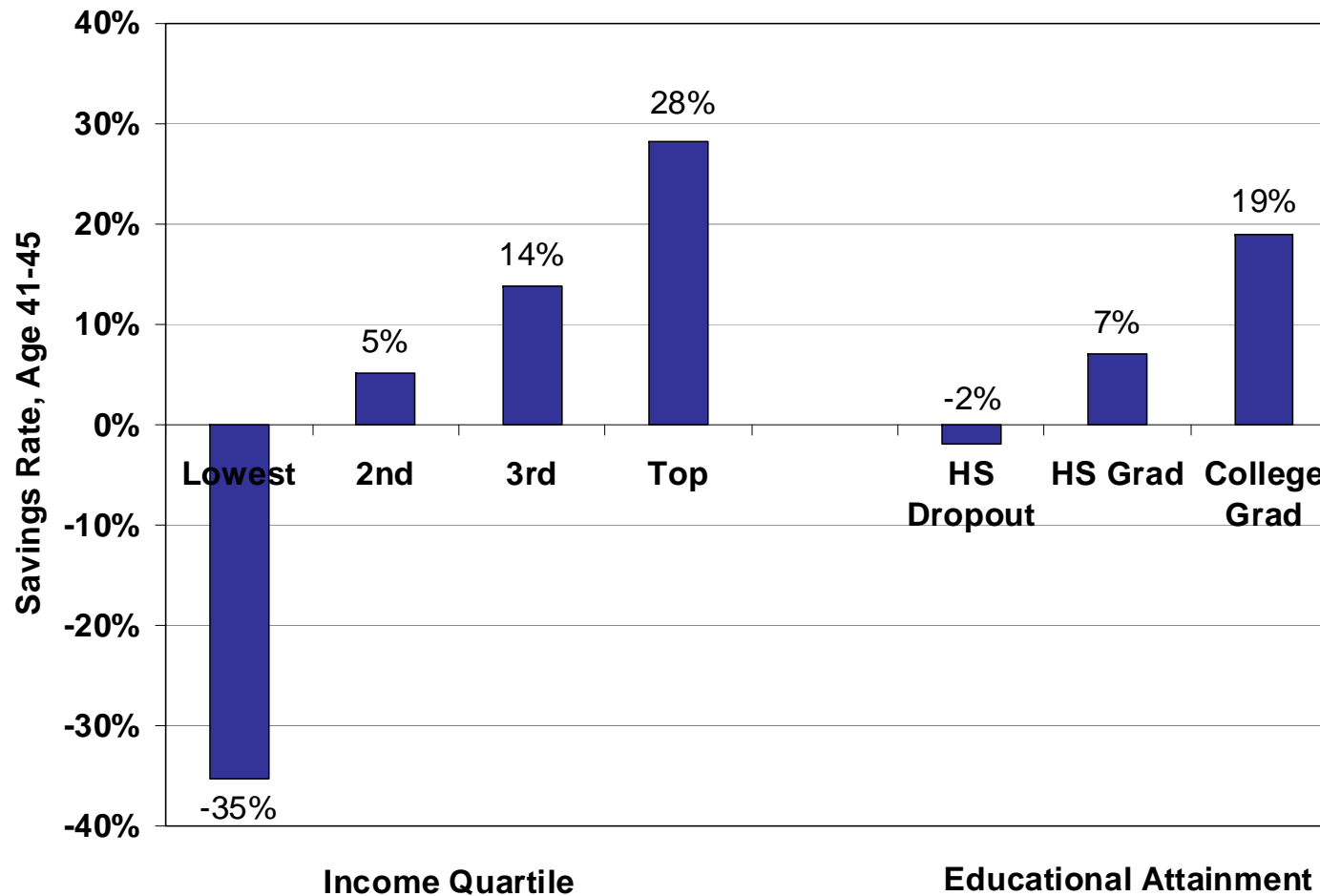
1. Reduce or Eliminate Tax on Income from Savings



Uniform
Progressive

1. Reduce or Eliminate Tax on Income from Savings

Better-Off Households Save a Larger Share of Their Income



Source: Attanasio (1994).

Progressivity by Type of Tax Incentive

Most regressive

1. Reduce or Eliminate Tax on Income from Savings

2. Itemized Deduction

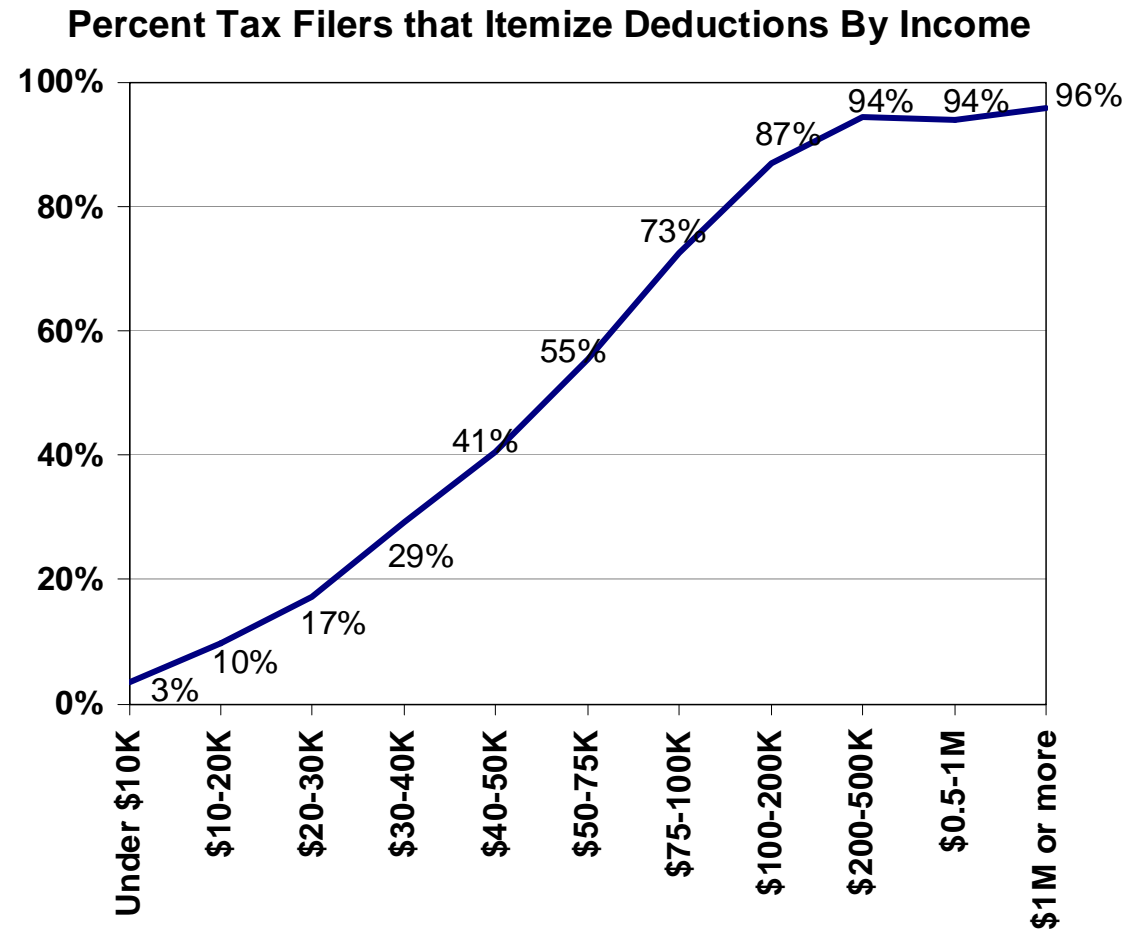
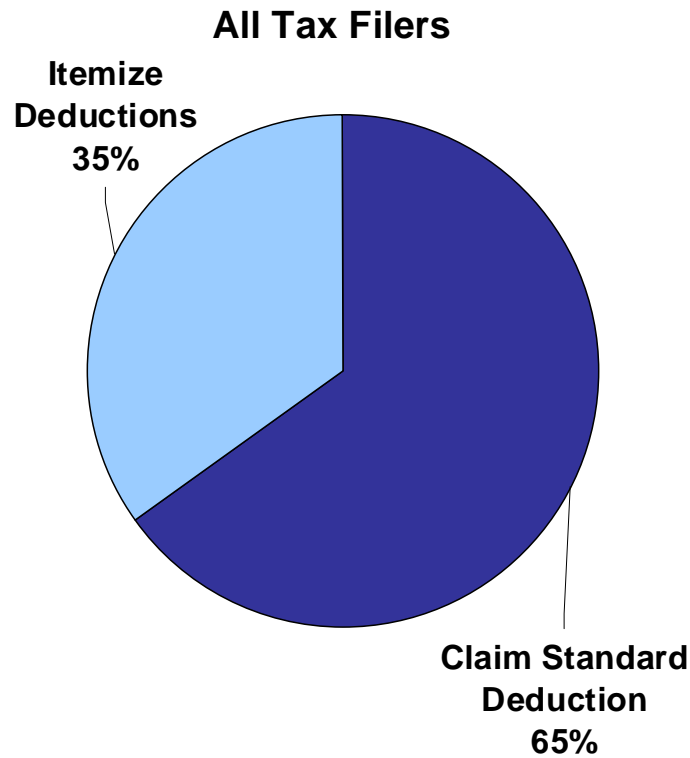
Uniform

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Only 1/3 of Households Itemize and They Are Relatively High Income



Source: IRS, Statistics on Income (2007).

Progressivity by Type of Tax Incentive

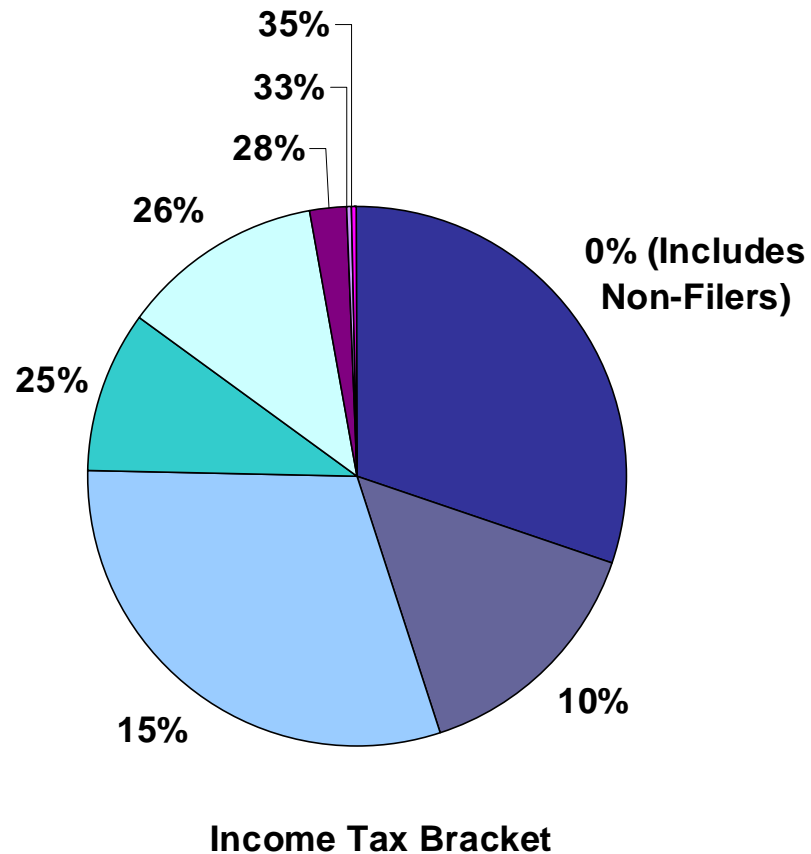
Most regressive



**Uniform
Progressive**

1. Reduce or Eliminate Tax on Income from Savings
2. Itemized Deduction
3. Exemption or Above-the-Line Deduction

The Value of Deductions and Exemptions Rises Rapidly with Income



Source: Tax Policy Center (2007) (includes AMT).

Progressivity by Type of Tax Incentive

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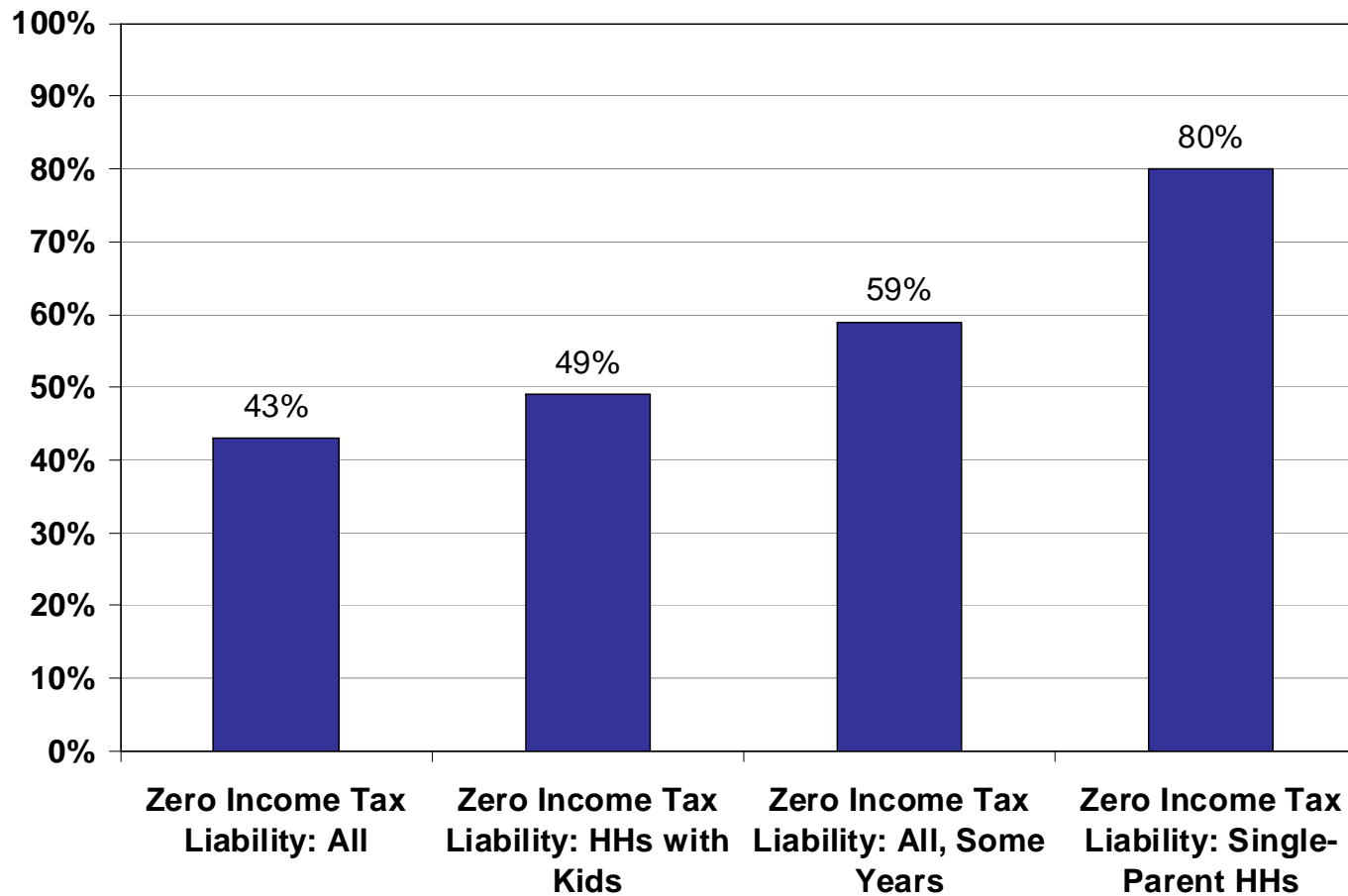
2. Itemized Deduction

3. Exemption or Above-the-Line Deduction

4. Non-Refundable Credit

Uniform
Progressive

Deductions, Exemptions and Non-Refundable Credits are Worthless for Many



Source: Batchelder, Goldberg and Orszag (2006); TPC (2009).

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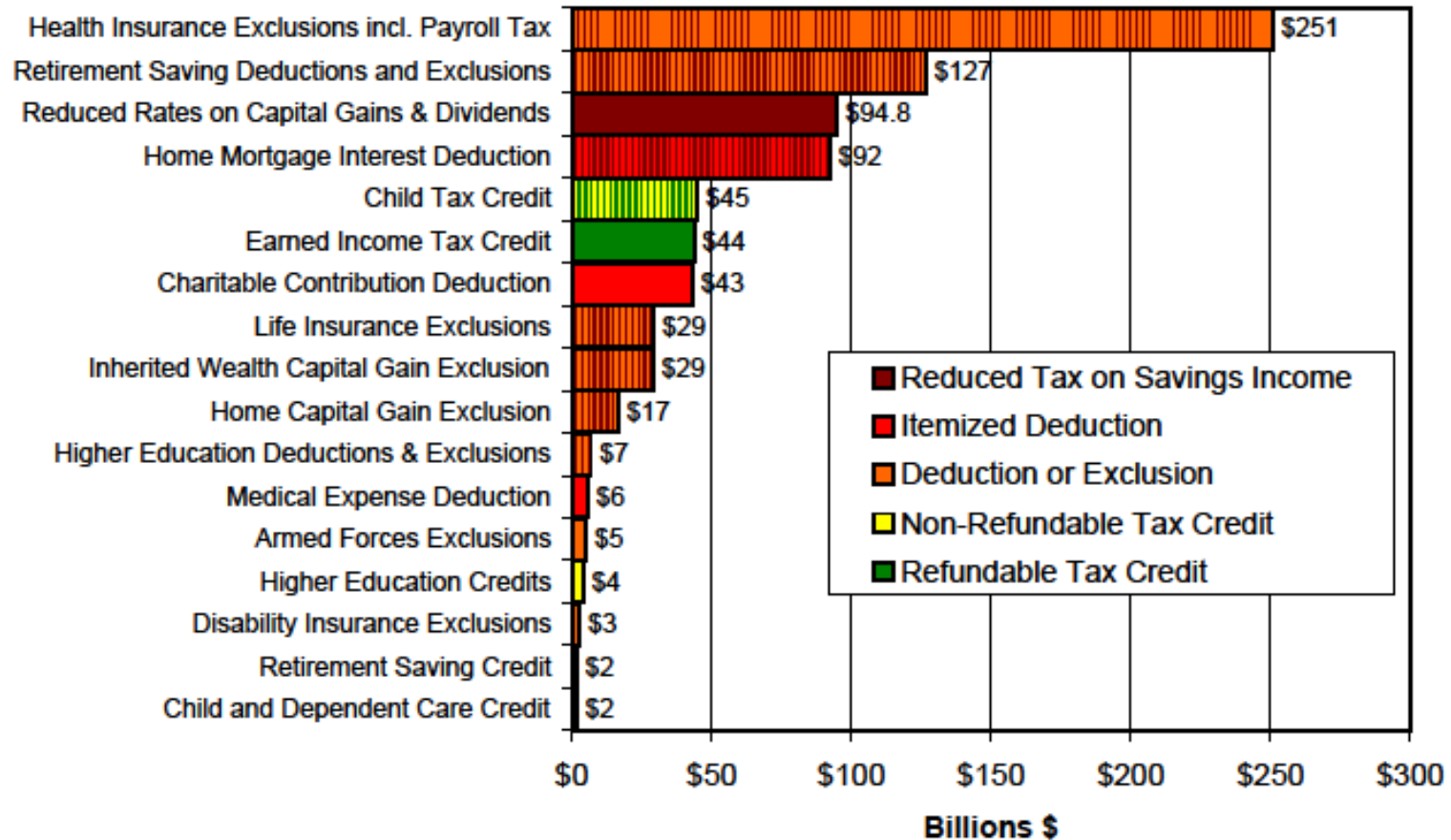
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5. Refundable Credit

Uniform
Progressive

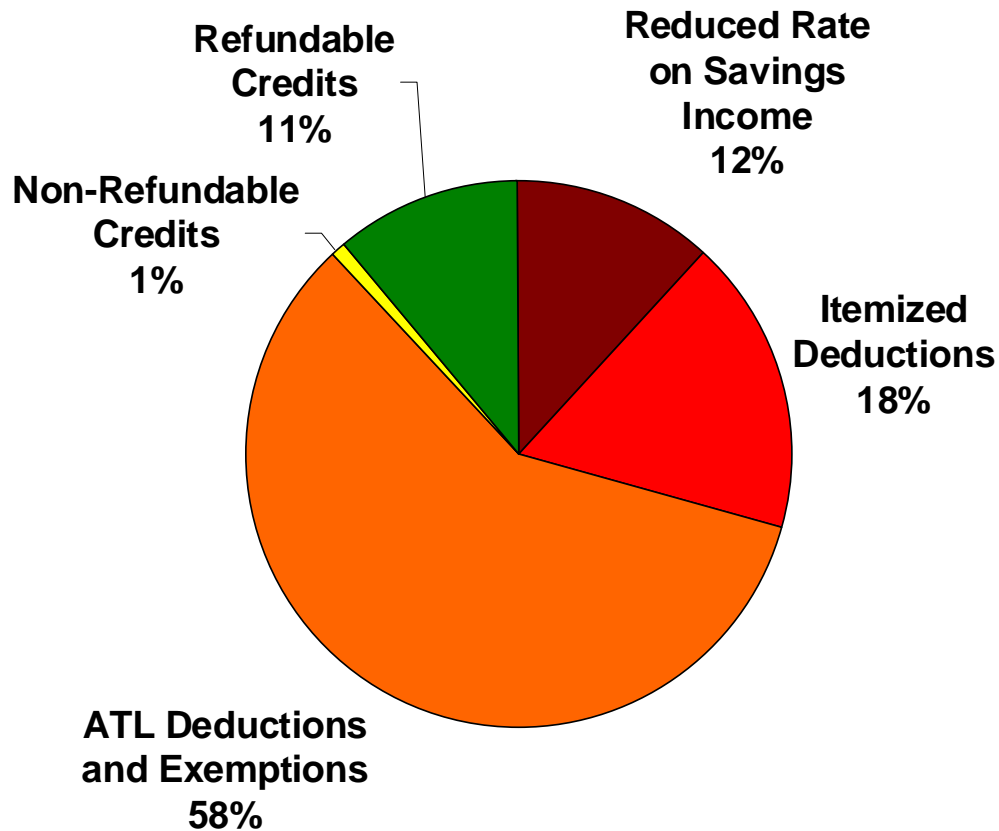
Individual Tax Incentives Are Expensive: \$800B!



Sources: Burman, Geissler & Toder (2008) (includes AMT); JCT (2008). Excludes JCT tax expenditures that sunset in three years or less, cost less than \$0.2B, are predominantly allocated to business by JCT, and that do not appear to be tax incentives because based on relatively immutable characteristics (i.e., deductions and exclusions for blind and elderly, casualty losses, state and local taxes and bonds, and government-determined benefits, including Social Security, Railroad Retirement, Medicare, veterans, torts, and workers compensation).

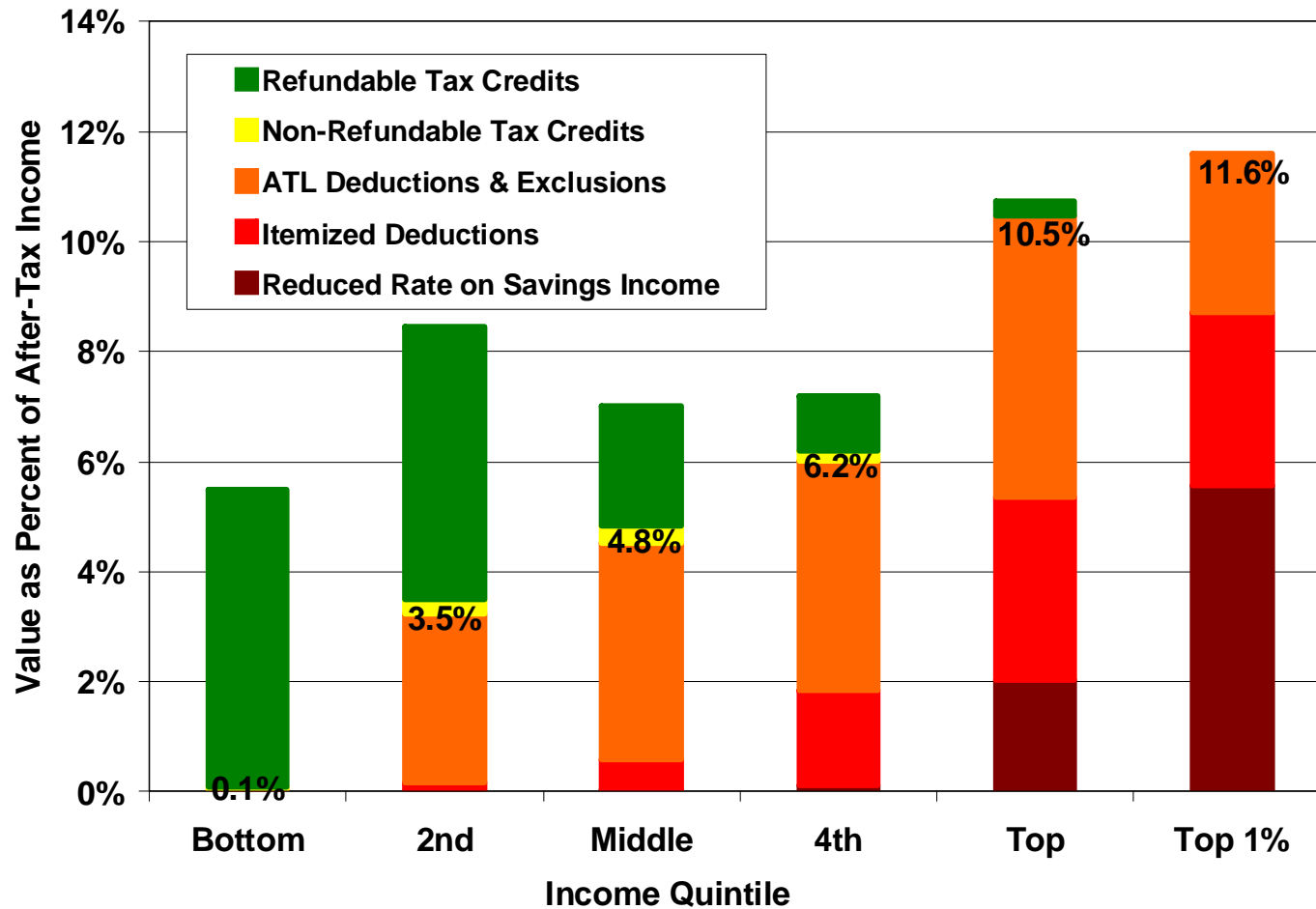
Few Are Refundable Tax Credits

Form of Tax Incentive by Cost



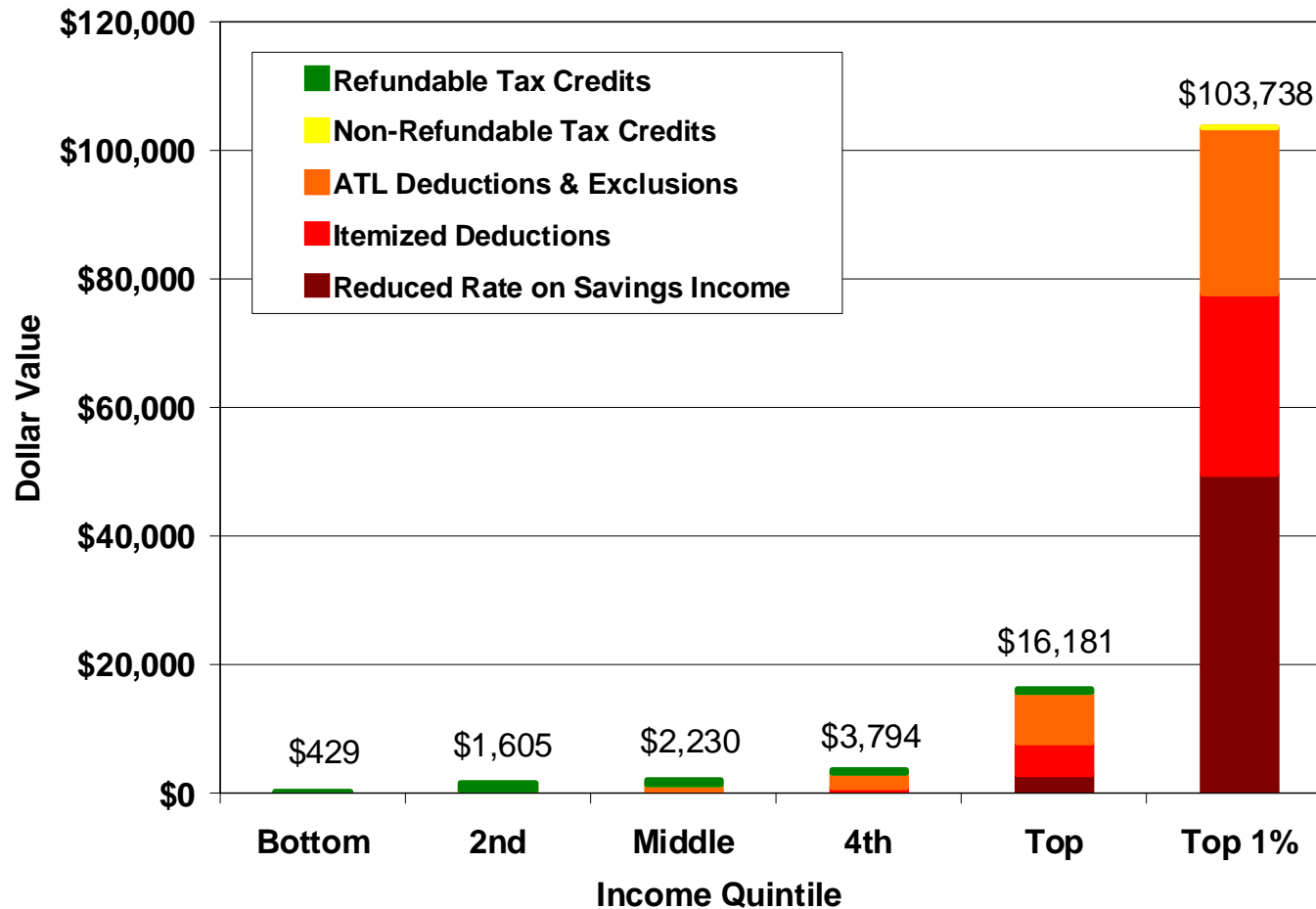
Sources: Burman, Geissler & Toder (2008) (includes AMT); JCT (2008).

Aside from Refundable Tax Credits, They Are Highly Regressive



Sources: Burman, Geissler & Toder (2008) (includes AMT but not interactions).

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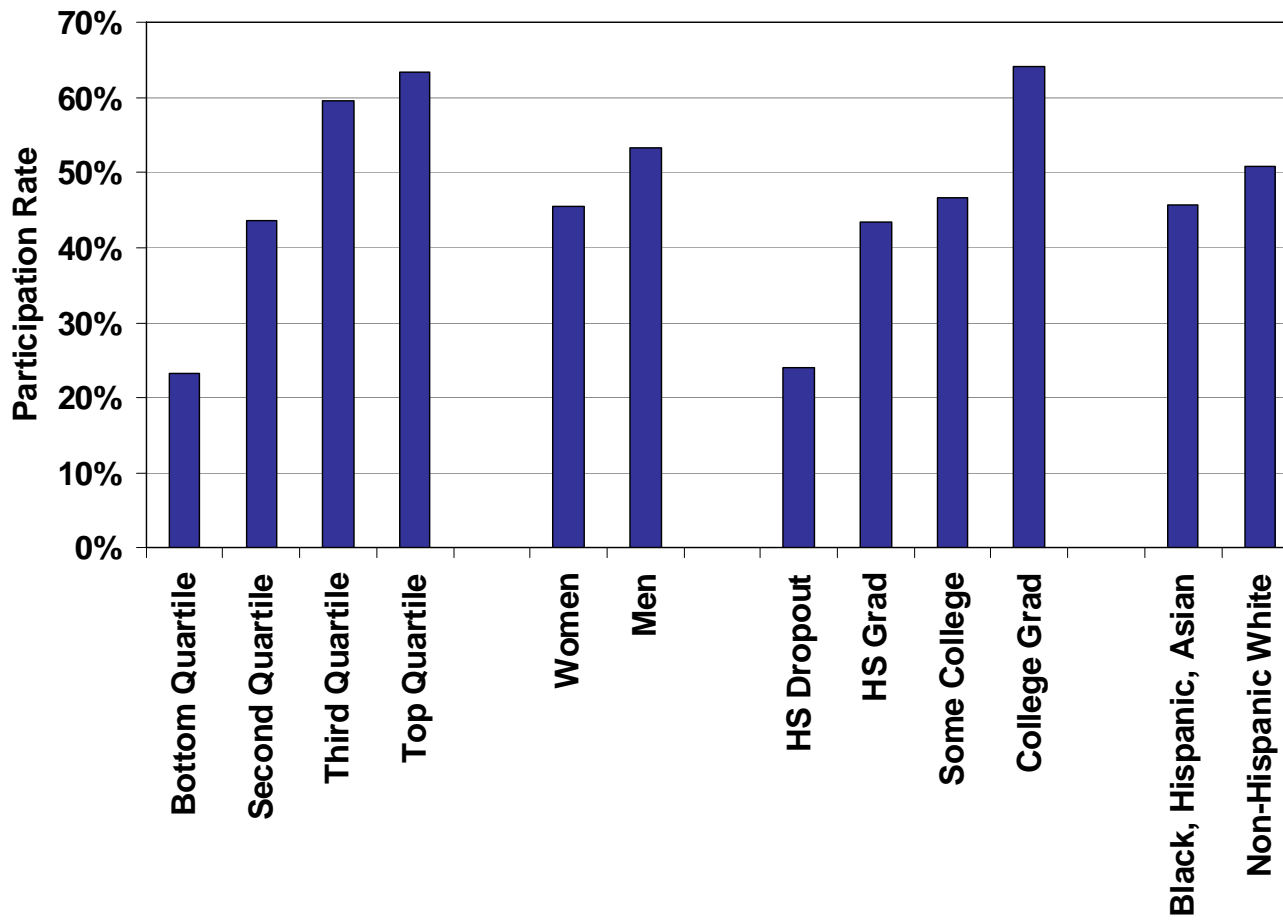


Sources: Burman, Geissler & Toder (2008) (includes AMT but not interactions).

An Example: Retirement Savings

- Types of Plans
 - Employer-sponsored defined contribution: 401(k), 403(b), 457
 - Employer-sponsored defined benefit: Traditional pensions
 - Individual: IRAs
- Two types of tax benefits:
 - Traditional: Deductible contributions, no tax on accrued earnings, ordinary income tax on withdrawals.
 - Roth: Contributions not deductible, no tax on accrued earnings or withdrawals.
 - Under certain assumptions, economically equivalent.

Participation Rates Rise with Socioeconomic Status

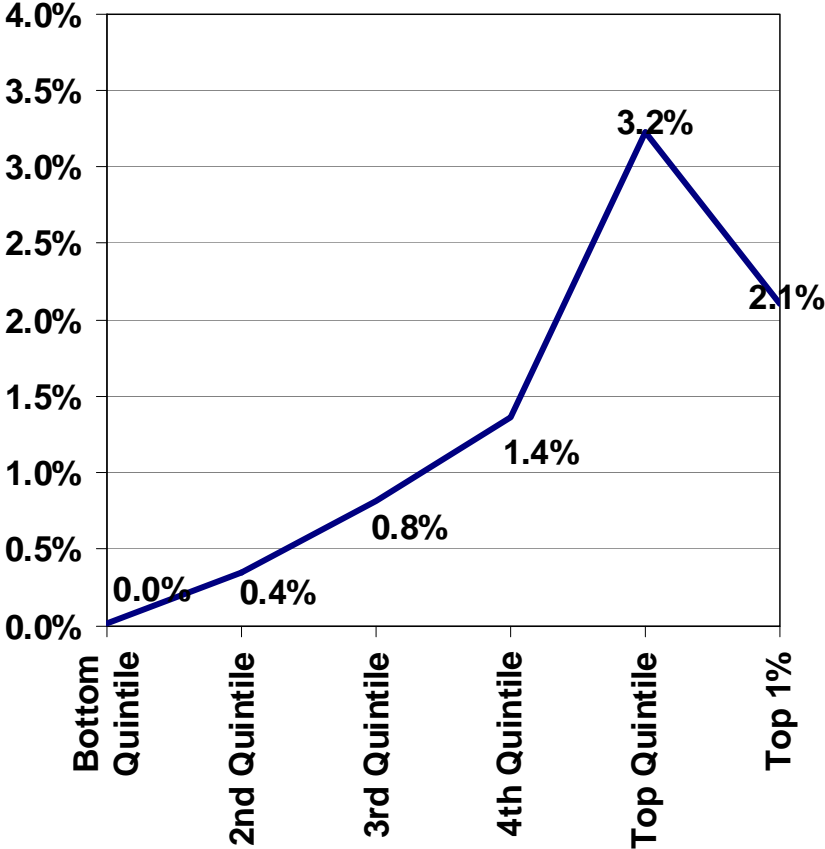


Source: Purcell (2006).

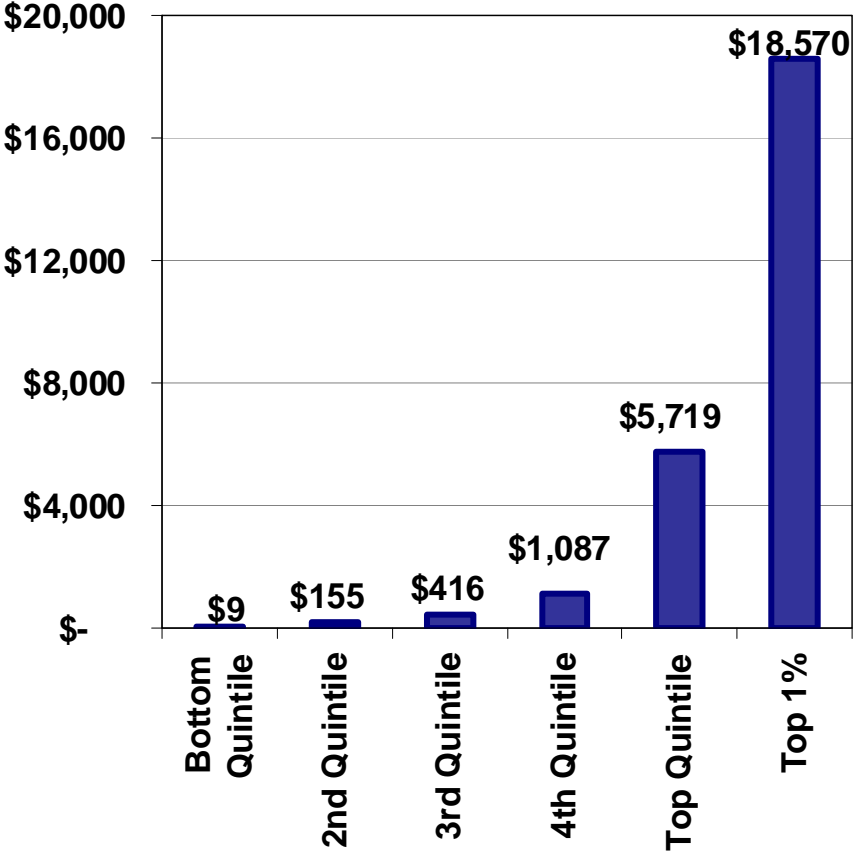
Value of Tax Incentives for Retirement Savings



Value as Percent of After-Tax Income



Dollar Value



Source: TPC (2009 preliminary).

A Guide to Reform

Questions to ask:

1. What precise choice, if any, generates social benefits?
2. Do social benefits vary by income?
3. Does responsiveness, if any, vary by income?
4. Do social benefits vary by amount saved?
5. Are there behavioral devices that increase responsiveness to financial incentives?
6. Are there behavioral devices that accomplish the same results without a financial incentive?

Implications for Retirement Savings

- If retain tax incentives
 - Create universal opt-out system through increased payroll withholding
 - Replace with refundable credit that phases out as income rises
 - Frame as a match by depositing credit in account
 - Condition match on annuitizing or purchasing retiree health and long-term insurance
 - Do not issue further matches once reach age-adjusted balance cap
- Consider repealing financial incentives
 - Create universal opt-out system through increased payroll withholding that is automatically annuitized as near retirement

Other Reforms Worth Consideration

- Homeownership
 - Gradually convert to first-time homebuyers refundable credit or eliminate
- Charitable Giving
 - Convert to charitable match
 - Issue larger match if contribute to disadvantaged groups
- Life Insurance
 - Eliminate exclusions
- Inherited Wealth
 - Repeal exclusion for built-in capital gains
- Higher Education
 - Convert to grant or upfront refundable credit that phases out as income and wealth rise