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Rationally Cutting Tax Expenditures

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I. INTRODUCTION

To increase tax revenues, policymakers have two general options: they can raise tax rates or broaden the tax base. Economists prefer the latter option because it will be less distortive.[1] Raising tax rates reduces the returns to labor and investment, thereby discouraging work (in favor of leisure)[2] and saving (in favor of present consumption).[3] Broadening the base, on the other hand, has less impact on the labor/leisure and consume/save decisions because, while overall tax revenues are increased, the returns to labor and investment *at the margin* remain the same.

Many of the tax reform provisions of the various recent deficit reduction plans are premised on this intuition. While the plans differ in important ways, many have at least one common denominator—the eradication of many tax expenditures in one fell swoop.[4] Tax expenditures are statutorily defined as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability. . . ."[5] Tax expenditure items are taxpayer-favorable departures from a "normal income tax" baseline, and the amounts of tax expenditures are the revenue losses resulting from the departure.[6] The

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[1] *See* Gary S. Becker & Casey B. Mulligan, *Deadweight Costs and the Size of Government*, 46 J.L. & ECON. 293, 317 (2003).

[2] *See* 1 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 3.2.2 (3d ed. 2001) (noting that "taxing compensation from personal services decreases the economic reward for labor . . . [and] other things being equal, this alters the labor-leisure balance in favor of leisure.").

[3] *See id.* at ¶ 3.2.3 (discussing the effect of income taxation on the consume versus save decision).

[4] *See* Linda Sugin, *Tax Expenditures, Reform, and Distributive Justice*, 3 COLUM. J. TAX L. 1, 4 (2011) ("Serious proposals for tax reform are on the table, and they share a simple, fundamental approach to reshaping the law: strip the Code of the myriad special deductions, credits, and exclusions that allow individuals and corporations to reduce their tax liability.").

[5] 2 U.S.C. § 622 (2006).

[6] JOINT ECON. COMM., 106TH CONG., TAX EXPENDITURES: A REVIEW AND ANALYSIS 1, 4 (Comm. Print 1999).

determination of the normal tax baseline is made, depending on the report, by the Joint Committee on Taxation or the Treasury Department.[7]

The term "tax expenditures" is used because the revenue losses can be easily re-conceptualized as direct spending programs. In lieu of a tax expenditure, Congress could combine baseline tax treatment with direct grants of cash equal to the amount of increased tax liabilities. Due to the circular cash flow (from affected taxpayers to the government in the form of increased tax liabilities relative to the baseline tax treatment and then from the government to the taxpayers in the form of cash grants), the taxpayers and the government end up in the same place. Thus, tax expenditures are colloquially known as "spending through the tax code."[8]

As noted, a number of serious proposals would eliminate most, if not all, tax expenditures. The problem with this approach is that the category of tax expenditures, as determined either by the Joint Committee or the Treasury, is not a monolithic category.[9] Professor Daniel Shaviro characterizes tax rules as allocative or distributional.[10] Allocative rules affect how resources are allocated among different activities by stimulating or discouraging certain behavior, while distributional rules affect how benefits and burdens are distributed among citizens.[11] Some tax expenditures are mostly allocative, while others are mostly distributional.[12] Other tax expenditures are intended to be (or are defended as) allocative, but in fact have little allocative effect in practice; as a result, these "faux" allocative rules are in fact mostly distributive.[13] Allocative expenditures should be evaluated to determine whether the desired behavioral response (and resulting allocative effect) is in fact desirable, whether the expenditure is an efficient way to deliver the desired behavior, and whether the desired behavior is of sufficient priority to justify its revenue cost in light of the current budget situation. In other words, allocative tax expenditures should be evaluated like any other spending program designed to encourage or discourage behavior. Distributional tax expenditures, on the other hand, should be evaluated to determine whether the distributional adjustment they deliver makes the tax system more or less fair. Blanket treatment of tax

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7 *Id.* at 2–3.

8 *E.g.*, Ruth Mason, *Federalism and the Taxing Power*, 99 CALIF. L. REV. 975, 1027 (2011).

9 *See* Sugin, *supra* note 4, at 7 (criticizing reform proposals that "erroneously treat [tax expenditures] as an undifferentiated mass").

10 *See* Daniel Shaviro, *Rethinking Tax Expenditures and Fiscal Language*, 57 TAX L. REV. 187, 188 (2004).

11 *Id.*

12 *Id.*

13 *See, e.g.*, *infra* Part IV.

expenditures ignores the fact that these two distinct types of tax expenditures—allocative and distributional—share nothing in common, other than the fact that they are formally categorized as tax expenditures.

This article illustrates the differences between the two types of tax expenditures by examining the child tax credit (a distributional expenditure), the charitable deduction (an allocative expenditure), and tax-free saving accounts and the mortgage deduction (both of which are usually defended on allocative grounds but probably have mainly distributional impacts). These differences should be well understood by policymakers as they consider tax expenditure reform as part of a deficit reduction plan.

II. A DISTRIBUTIONAL TAX EXPENDITURE: THE CHILD TAX CREDIT

The child tax credit provides a fixed tax credit for taxpayers with dependents who are characterized as a qualifying child.[14] The child tax credit is expected to cost nearly $122 billion from 2010 through 2014.[15] The $1,000 per child credit begins to phase out at $110,000 of adjusted gross income (for married couples filing joint returns) and is fully phased out at $130,000.[16] It is currently partially refundable for those whose tax liability becomes, as a result of the credit, negative.[17] Because of the phaseout and refundability, the child tax credit is targeted at lower- and middle-income class taxpayers.

The child tax credit can be easily re-conceptualized as an additional dependency deduction (on top of the current dependency deduction of $3,700).[18] For taxpayers in the 25% tax bracket, the $1,000 credit operates as an additional $4,000 dependency deduction; for 15% bracket taxpayers, it operates as an additional $6,667 deduction.[19] Because it is phased out at $130,000 of adjusted gross income, the additional dependency deduction is generally zero for those subject to marginal tax rates higher than 25%.[20] Accordingly, the child tax credit can be seen as an accommodation to the

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[14] I.R.C. § 24 (2006).

[15] *See* STAFF OF JOINT COMM. ON TAXATION, 111TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2010–2014 47 (Comm. Print 2010) [hereinafter JCT 2010–2014 REPORT] (scoring the child tax credit at $121.9 billion).

[16] I.R.C. § 24(b).

[17] *Id.* § 24(d).

[18] *See* Rev. Proc. 2011-12, 2011-2 I.R.B. 297 (providing for $3,700 personal exemption amount for 2011).

[19] A $4,000 deduction saves a 25% marginal rate taxpayer $1,000 in taxes, just like a $1,000 credit. To adjust a credit amount into an equivalent deduction amount, the credit amount is divided by (1-t), with t equal to the taxpayer's marginal tax rate.

[20] *See* Rev. Proc. 2011-12, 2011-2 I.R.B. 297 (indicating that, for married couples filing jointly, the 28% rate applies to taxable income in excess of $139,350).

fact that very basic child care is more expensive than the $3,700 dependency deduction implies. Yet the conclusion that the dependency deduction is too low would support an across-the-board additional dependency deduction for all taxpayers, whether they are in the 15% bracket or the 35% bracket. Under this theory (i.e., that the dependency deduction does not reflect the additional basic costs of raising a child), the diminishing value to higher-income taxpayers might be justified on a "two wrongs can make a right" ground.

Put differently, if one accepts the view that the dependency deduction is too low, then the phaseout of the child tax credit results in an overstatement of the tax bases of higher-income taxpayers with children. The resulting overtaxation could be defended by arguing that higher-income taxpayers are undertaxed in other ways and that the phaseout simply offsets this undertaxation.

Alternatively, the child tax credit can be re-conceptualized as providing different tax rate schedules for differently sized families. As a formal matter, there is only one special rate schedule that applies to dependent caregivers. The head of household bracket applies only to an unmarried taxpayer who has at least one dependent in the household.[21] Absent the dependent, the taxpayer would be subject to the higher rates applicable to unmarried taxpayers.[22] For married taxpayers, there is no special rate bracket for those with dependents.[23] As a result, there is very little nuance in the tax rate schedules for family size (beyond the distinction between married and unmarried taxpayers). The child tax credit can be viewed as providing some such nuance. Whether the additional nuance is appropriate depends on one's view of how progressive the tax system ought to be with regard to differently-sized families.

In any event, it seems quite clear that the child tax credit is not an allocative provision. It is not designed to encourage child-related spending, as the tax benefit (i.e., a fixed per child credit) is granted irrespective of how any amounts are spent. Nor is it designed to encourage more child bearing, as one would expect the relatively small tax credit of $1,000 per year per child to have no impact on the life-altering decision of whether to have an additional child. Instead, the child tax credit is intended to alter the distribution of tax burdens between the lower/middle-class with children and all other taxpayers (namely, the lower/middle-class without children and the upper class). Thus, whether the credit should be increased,

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21 I.R.C. § 2(b).

22 *Id.*

23 I.R.C. § 1.

decreased, or eliminated depends on one's view of a fair tax burden distribution.

It is important to note here that Congress's decision to provide the distributional adjustment through a tax credit, as opposed to an economically equivalent additional personal exemption or a separate rate schedule for different family sizes, has the potential to have a significant policy impact. The child tax credit is characterized as a tax expenditure, but personal exemptions and different tax brackets are not.[24] Yet the formal delivery mechanism (credit, additional deduction, or rate schedule) of the distributional adjustment should not affect the decision of whether they are maintained or not. This shows the logical error in treating tax expenditures as a monolithic category: certain provisions whose main function is to make distributional adjustments will be captured by such an approach. Meanwhile, other substantively identical mechanisms are not denominated as tax expenditures and therefore would be spared if tax expenditures were eliminated.

III. AN ALLOCATIVE TAX EXPENDITURE: THE CHARITABLE DEDUCTION

Taxpayers can deduct gifts made to charitable organizations.[25] The charitable deduction is expected to cost the government approximately $250 billion from 2010 through 2014.[26] Some have argued that a charitable deduction is necessary to arrive at a proper calculation of one's income based on the view that charitable gifts result in a non-consumptive reduction of wealth.[27] While this argument has some merit, that does not necessarily mean that the charitable deduction should be characterized as a primarily distributional tax expenditure. Charitable gift-giving is a purely voluntary choice. If the charitable deduction were eliminated, givers could simply reduce their gifts to account for the additional tax burden they bear. For instance, consider a 35% marginal tax rate taxpayer who makes a

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[24] *See* JCT 2010–2014 REPORT, *supra* note 15, at 5, 47 (stating "[t]he Joint Committee staff views the personal exemptions and the standard deduction as defining the zero-rate bracket that is a part of normal tax law. An itemized deduction that is not necessary for the generation of income is classified as a tax expenditure" and treating the child tax credit as a tax expenditure).

[25] I.R.C. § 170.

[26] *See* JCT 2010–2014 REPORT, *supra* note 15, at 45, 47, 48 (estimating revenue loss from charitable contributions to schools at $33.3 billion; $187.5 billion from contributions to organizations other than schools and health organizations; and $25.3 billion from contributions to health organizations).

[27] *See, e.g.*, Johnny Rex Buckles, *The Case for the Taxpaying Good Samaritan: Deducting Earmarked Transfers to Charity Under Federal Income Tax Law, Theory and Policy*, 70 FORDHAM L. REV. 1243, 1280 (2002).

$100,000 deductible charitable gift. If the deduction were disallowed, the taxpayer could give $65,000 and retain the extra $35,000 to pay the tax on the extra $100,000 of taxable income.[28] Because the taxpayers could easily alter their behavior in response to the elimination of the charitable deduction, the primary impact of the charitable deduction is allocative, not distributional.[29]

Thus, the typical justification for the charitable deduction is that it encourages additional charitable giving, thereby resulting in an allocation of more resources to the charitable sector.[30] This justification appears premised on the idea that donors respond to the charitable deduction by giving an additional amount above and beyond merely the tax break they are getting. Consider again the 35% rate taxpayer who gives a $100,000 charitable donation. The incentives-based justification for the charitable deduction is based on the premise that, had the taxpayer not received the deduction, the taxpayer would have given less than the $65,000 after-tax cost of her gift. If the taxpayer would have given exactly $65,000, then all the charitable deduction did is direct the $35,000 of foregone governmental tax revenues (which would have been used for the public good) to the charity of the taxpayer's choosing. Other proponents of the charitable deduction justify the deduction precisely because it allows the government to piggyback off of taxpayers' choices as to which charitable endeavors to support.[31] This, as the pluralistic argument goes, allows worthwhile societal pursuits to obtain financing without the necessity of going through the

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[28] *Cf.* Gregg D. Polsky, *A Tax Lawyer's Perspective on Section 527 Organizations*, 28 CARDOZO L. REV. 1773, 1776–77 (2007) (explaining that the after-tax cost of a deductible expense is the product of the pre-tax cost and (1-*t*), where *t* represents the taxpayer's marginal tax rate). In the hypothetical, the after-tax cost of a $100,000 deductible contribution is $100,000 x (1-.35). If the deduction were disallowed, then the pre-tax cost would equal the after-tax cost, and the taxpayer could remain in the same position by reducing the contribution to $65,000.

[29] The likelihood of behavioral change in the face of a tax change is a key distinction between a distributional provision like the child tax credit and an allocative provision like the charitable deduction. In theory it is possible that changing the child tax credit could change a taxpayer's decision to have a set number of children, but practically we do not expect it to have any such impact. On the other hand, a behavioral response to a change in the charitable deduction is much more likely.

[30] *See* J. COMM. ON TAXATION, PRESENT LAW AND BACKGROUND RELATING TO THE FEDERAL TAX TREATMENT OF CHARITABLE CONTRIBUTIONS, JCX-55-11, 32 (2011) [hereinafter JCT REPORT ON CHARITABLE CONTRIBUTIONS] ("Tax deductibility of charitable contributions reduces the economic cost to the donor of his or her donation and, therefore, encourages charitable giving."); *id.* at 34 ("Because the deduction for charitable contributions lowers the after-tax cost of giving, theoretically, it will increase the ability and willingness of donors to increases donations."); Brian Galle, *The Role of Charity in a Federal System*, 53 WM. & MARY L. REV. 777, 787 (2012) ("Most commentators embrace the idea that the deduction is a subsidy and argue that the subsidy is justified as a tool for encouraging the production of goods that would otherwise be underproduced by the private market.").

[31] *See id.* at 788–89 (describing this justification).

political process.[32] It also allows the government to indirectly support religious organizations—something it could not do directly because of the First Amendment.[33] Both of these justifications are allocative. The incentives-based justification assumes that more resources are devoted to charitable causes, while the pluralistic justification is that more resources are devoted to the "right" charitable causes even though the overall amount of spending on public goods remains constant.

The proper design of the charitable deduction depends on which of the two justifications is invoked.[34] A justification based on incentives would provide increasing incentives to those who have larger amounts of disposable income, as the tax law currently does by granting a deduction, whose value increases as the taxpayer's marginal tax rate increases. On the other hand, the pluralistic rationale would support a fixed credit (e.g., 20% of the charitable contribution), which gives the same governmental "match" to all donations, regardless of the donor's income level.

Regardless, in a time of significant budgetary concerns where all government spending must be critically evaluated, government spending through the wide-ranging, and nearly unlimited[35] charitable deduction is a definite candidate for reform. Shannon Weeks McCormack has recently proposed restricting the charitable deduction to those that flow to charitable organizations that would, absent the deduction, be underfunded.[36] But it is unclear whether distinguishing between "worthy" and "unworthy" charitable beneficiaries in this manner is administratively feasible. If not, a better approach might be to turn the deduction into a fixed credit and to significantly reduce the current limits for charitable contributions that provide tax benefits.[37]

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[32] *See* David M. Schizer, *Subsidizing Charitable Contributions: Incentives, Information, and the Private Pursuit of Public Goals*, 62 TAX L. REV. 221, 246 (2009) (explaining that the charitable deduction lends support to minority preferences which may be underrepresented in the political process).

[33] *See id.* (noting that the charitable deduction allows public funding of religious groups in a way that would be unconstitutional if directly affected by government officials).

[34] The empirical evidence is mixed as to how donors actually respond to the charitable deduction. Some studies suggest that donors give more than the tax break they receive, while others arrive at the opposite conclusion. For a discussion of the empirical evidence, see JCT REPORT ON CHARITABLE CONTRIBUTIONS, *supra* note 30, at 34–35.

[35] Section 170 does limit the charitable deduction to 50%, 30%, or 20% of the taxpayer's adjusted gross income (with carry-overs of the excess for up to five years) depending on the nature of the contributed property and type of donee, but these limits are quite high and therefore only rarely triggered. I.R.C. § 170(b)(1).

[36] *See generally* Shannon Weeks McCormack, *Too Close to Home: Limiting the Organizations Subsidized by the Charitable Deduction to Those in Economic Need*, 63 FLA. L. REV. 857 (2011).

[37] Current law limits the charitable deduction to 50%, 30%, or 20% of the taxpayer's adjusted gross income, depending on the nature of the beneficiary and whether appreciated property (rather than cash) is contributed. I.R.C. § 170(b)(1). In light of budgetary constraints, the limit could be reduced to, for

IV. DISTRIBUTIONAL TAX EXPENDITURES DISGUISED AS ALLOCATIVE TAX EXPENDITURES: TAX-FAVORED RETIREMENT ACCOUNTS AND THE MORTGAGE INTEREST DEDUCTION

Some tax expenditures are commonly justified on allocative grounds, but in reality do not substantially affect the allocation of resources in the manner intended. As a result, their impact is mostly distributional. Two prominent examples of these "faux" allocative tax expenditures are provisions for tax-favored retirement accounts and the home mortgage interest deduction.

A. Tax-Favored Retirement Accounts

A number of tax provisions are designed to encourage dedicated retirement saving.[38] The general effect of these provisions is to exempt from tax the investment yield attributable to amounts saved for retirement, though the precise mechanics differ.[39] 401(k) and traditional IRA accounts are funded with pre-tax dollars, and distributions are subject to tax.[40] On the other hand, Roth IRA accounts are funded with after-tax dollars, and distributions are exempt.[41] Regardless, the economic effect of yield exemption is, under reasonable assumptions, nearly identical.[42]

From 2010 through 2014, the tax expenditures for retirement savings are expected to cost the government over $700 billion.[43] The most common justification for this outlay is that these provisions encourage retirement

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example, 10% of adjusted gross income across the board. Thus, for example, taxpayers could be allowed a 20% tax credit for contributions not in excess of 10% of the taxpayer's adjusted gross income. In addition, taxpayers should be required to recognize any built-in gain on the contribution of appreciated property; as a result, there would be no need to provide a different limit for contributions of property.

[38] *See, e.g.*, I.R.C. §§ 401(k), 408(a).

[39] *See* 3 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS ¶ 61 (3d ed. 2001) (describing the effect of the qualified retirement plans).

[40] *See, e.g.*, §§ 219, 408(d) (providing for tax-deductible contributions and taxable distributions with respect to IRAs); *see also Tax Topics: Pensions and Retirement Savings*, TAX POLICY CTR., http://www.taxpolicycenter.org/taxtopics/Retirement-Saving.cfm (last visited Apr. 17, 2012).

[41] TAX POLICY CTR., *supra* note 40; *see* § 408A (providing for nondeductible contributions and nontaxable distributions with respect to Roth IRAs).

[42] *See* Gregg D. Polsky & Brant J. Hellwig, *Taxing Structured Settlements*, 51 B. C. L. REV. 39, 47 n.31 (2010) (showing the general equivalence between traditional IRA and Roth IRA tax treatment). Certain assumptions are necessary for this equivalence to hold. For example, tax rates must remain constant between the time the IRA is funded and the time of distributions. For discussion of these conditions, see CHRIS H. HANNA, COMPARATIVE INCOME TAX DEFERRAL: THE UNITED STATES AND JAPAN 11–12 (2000).

[43] *See* JCT REPORT 2010–2014, *supra* note 15, at 49 (estimating revenue loss attributable to pensions and IRAs at $711 billion).

saving and that, absent the expenditures, the amount of such saving in the United States would be suboptimal.[44] Thus, these provisions are defended on allocative grounds: they generate more saving and less consumption.

However, even assuming that the amount of dedicated retirement savings in the United States would be suboptimal absent these expenditures, there are several reasons to question their effectiveness. Most significantly, the tax incentive often does not result in additional savings (new savings); instead it merely moves from one account (taxable) to another account (IRA) money that would have been saved regardless.[45] The wealthy practically cannot spend all of their income currently; they are, in effect, forced to save at least a portion of their income. In those cases, the tax expenditures are paying the taxpayer to do something that she has no choice but to do. Furthermore, many taxpayers with even modest wealth would choose to save for retirement regardless of the tax breaks. Every dollar of new savings generated by the tax expenditures must be evaluated against all of the foregone revenue stemming from tax breaks granted with respect to amounts that would have been saved regardless.

To increase saving (as opposed to moving saving from one form to another), a tax incentive should be targeted at reluctant savers. Yet, several design features of the current tax breaks would appear to deter reluctant savers. First, taxpayers generally cannot withdraw money from a tax-favored account before retirement age without paying a penalty for early withdrawal.[46] For reluctant savers with modest income, this inflexibility will be a significant concern. Second, the sheer complexity of the numerous overlapping tax-favored savings vehicles and the varying investment options within them can deter reluctant savers, especially those who are financially unsophisticated or do not have access to investment advice. Third, the value of the tax benefits granted to a taxpayer corresponds directly with the taxpayer's income level.[47] Because the tax benefits come in the form of deductions and exclusions (rather than credits), the greater the taxpayer's income, the greater the benefit derived by the taxpayer, and

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[44] *See* Elizabeth Bell et al., *Tax Notes: Retirement Savings Incentives and Personal Saving*, TAX POLICY CTR. (Dec. 20, 2004), http://www.taxpolicycenter.org/publications/url.cfm?ID=1000739.

[45] *See* Karen C. Burke & Grayson M.P. McCouch, *Lipstick, Light Beer, and Back-Loaded Savings Accounts*, 25 VA. TAX REV. 1101, 1107 (2006).

[46] *See, e.g.*, I.R.C. § 72(t) (providing for 10% penalty for early distributions from qualified retirement plans); *see also Tax on Early Distributions from Traditional and ROTH IRAs*, INTERNAL REVENUE SERV. (Dec. 22, 2011), http://www.irs.gov/taxtopics/tc557.html.

[47] *See, e.g.*, Leo P. Martinez & Jennifer M. Martinez, *The Internal Revenue Code and Latino Realities: A Critical Perspective*, 22 U. FLA. J.L. & PUB. POL'Y 377, 403 (2011) ("In order to take advantage of tax benefits, a taxpayer must not only reach a certain income level, a taxpayer must also know about the tax benefits.").

vice versa. This upside-down result means that taxpayers with modest income receive relatively little incentive to save.

All of these features are counterproductive as to the goal of stimulating new savings. Wealthy taxpayers will save at least the maximum tax-favored amount[48] regardless of any incentives (because of the practical inability to spend the vast majority of their income). Highly motivated and well-advised savers will not be deterred by the inflexibility, complexity, and upside-down effect. On the other hand, reluctant savers are likely to be deterred. This suggests that, in practice, the tax expenditures for saving will have little incentive effect (other than the insignificant effect of moving money from taxable accounts to tax favored accounts), despite the huge revenue loss. There is some empirical support for this intuition.[49] If the intuition is true, the tax expenditures for saving function mainly as a distributional device. And given the demographics of savers and the fact that the value of the tax benefit is directly related to the taxpayer's income level, the distributional impact of the saving expenditures is significantly regressive. The result is a worst-of-both-worlds combination of reduced progressivity without any efficiency gain from a reduction in the marginal tax rates.[50]

In contrast, the saver's credit, found in § 25B of the Code, is much better designed to stimulate new saving. Section 25B provides a credit of 10%, 20%, or 50% of contributions to savings accounts.[51] The credit phases out at adjusted gross income levels of $30,000.[52] Simplifying and expanding this credit would provide a far more targeted and efficient saving incentive than the current tax breaks provide.

Alternatively, tax-favored accounts could remain available on a much smaller scale and in a simpler form, with some additional flexibility. This

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[48] The maximum amount saved that is eligible for tax benefits is $49,000 per year, which is the cap for employer defined contribution plans. I.R.C. § 415(c). 401(k) limits are $15,500 per year, but older taxpayers are eligible for an additional $5,500 "catch-up" contribution. §§ 402(g), 441(v).

[49] *See* Karen M. Pence, *401(k)s and Household Savings: New Evidence from the Survey of Consumer Finances* (FEDS, Working Paper No. 2002-06); William G. Gale & John Karl Scholz, *IRAs and Household Savings*, 84 AM. ECON. REV. 1233 (1994). Other studies, however, have found a larger response. *See* David J. Benjamin, *Does 401(k) Eligibility Increase Saving? Evidence from Propensity Score Subclassification*, 87 J. PUB. ECON. 1259 (2003); James M. Poterba, Steven F. Venti, & David A. Wise, *Do 401(k) Contributions Crowd out Other Personal Saving?*, 58 J. Pub. Econ. 1 (1995); James M. Poterba, Steven F. Venti, & David A. Wise, *How Retirement Programs Increase Saving*, 10 J. Econ. Persp. 91 (1996).

[50] Note that while a saver's *effective* tax rate goes down because of the retirement tax expenditures, their marginal tax rate remains the same. And it is the marginal tax rate that affects incentives whether to work and save to earn the additional dollar.

[51] I.R.C. § 25B(a)–(b)(1) (2006).

[52] *Id.*

would be far less expensive than current law and more likely to motivate reluctant savers. Relative to complete repeal of the saving subsidies, this reform would also simplify tax reporting—if all investment accounts were taxable, many more taxpayers would need to keep track of basis, and report dividends, gains, and losses. Under the current rules, low-income and-middle class taxpayers typically make most of their stock and securities investments in tax-favored accounts.[53] Retaining tax-favored accounts, albeit in much more modest form, would maintain this simplicity.

Under a proposed smaller, simpler, and more flexible tax-favored account, all taxpayers could be allowed to invest up to, say, $5,000 of after-tax cash per year into a Roth-style account; this would represent the only tax-favored savings account available. (Therefore, college savings accounts—§ 529 programs and prepaid tuition plans[54]—would no longer be available.) Distributions after retirement age (or for certain specified purposes, such as education) would be tax-free. To provide flexibility to taxpayers of modest means, taxpayers could be allowed to withdraw up to $1,000 per year for any reason without tax or penalty before retirement age.

While most commentators have pointed to the encouragement-of-saving rationale in defending tax-favored saving accounts, others defend them on the ground that they move the U.S. tax system closer to a consumption tax regime.[55] Amounts invested in these accounts are generally taxed only when they are pulled out to purchase consumption. (In Roth-style accounts, the mechanics are different but the tax effect is generally the same.[56]) Accordingly, tax-favored saving accounts represent a partial move towards a consumption tax. Some believe that a consumption tax is superior to an income tax, mostly on the grounds that a consumption tax (i) does not (relative to an income tax) discourage saving[57] and (ii) is simpler to administer.[58] However meritorious these arguments are in the debate about which tax base—income or consumption—is best, they have far less merit as justifications for the current tax expenditures for saving. The current rules apply only to a limited dollar amount of saving, ranging from $5,000

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[53] *See* William Gale & Benjamin Harris, *The Tax Policy Briefing Book*, TAX POLICY CTR. (Dec. 14, 2007), http://www.taxpolicycenter.org/briefing-book/key-elements/savings-retirement/who.cfm.

[54] I.R.C. § 529(b)(1)(A)(i)–(ii).

[55] *See, e.g.*, Sugin, *supra* note 4, at 43–44 (arguing that the retirement savings provisions should be maintained because they represent a modification of the tax base that reflects reasonable differences about the ideal tax base—consumption or income).

[56] *See supra* note 42.

[57] Janet A. Meade, *The Effects of Income and Consumption Tax Regimes and Future Tax Rate Uncertainty on Proportional Savings and Risk-Taking*, 70 ACCT. REV. 635, 651 (1995).

[58] SUBHAJIT BASU, GLOBAL PERSPECTIVES ON E-COMMERCE TAXATION LAW 57–58 (2007).

for IRA contributions[59] to $49,000 for defined contribution plans provided by employers.[60] These relatively low limits mean that the wealthy are inevitably taxed on an income tax basis *at the margin*, which is what matters for both incentive and simplification purposes. And the wealthy, whose saving behavior is most elastic,[61] are the most significant group in terms of affecting the amount of overall national saving.[62] Put differently, the relatively low limits on tax-favored retirement accounts effectively put lower- and middle-class people on a consumption tax while leaving wealthy people mostly (and, importantly, at the margin) on an income tax. Leaving wealthy people on the income tax disposes of much of whatever efficiency and simplifications gains that the system would generate by moving fully to a pure consumption tax. Accordingly, the argument that the retirement savings tax expenditures are justified as a partial move to a consumption tax does not appear persuasive. This is not to say that a full-fledged move to a consumption tax might not be worthwhile. But that is a completely different discussion.

B. The Home Mortgage Interest Deduction

The home mortgage interest deduction is expected to cost nearly $500 billion from 2010 through 2014.[63] Proponents of the deduction may defend it in a number of ways. Some argue that all consumer interest should be removed from the tax base on the ground that the cost of accelerating consumption (i.e., the cost of borrowing to consume now rather than later) is not itself consumption.[64] Under this view, all consumer interest should be deductible, which means that the Code punishes consumer interest other than mortgage interest (and certain other deductible consumer interest) rather than subsidizing mortgage interest. Others disagree with this view, arguing that consumer interest is itself consumption.[65] Regardless, this theoretical dispute is not particularly relevant to the current topic. Whether

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[59] I.R.C. § 219.

[60] I.R.C. § 415(c); *see also* U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2012 REVENUE PROPOSALS 5 (2011).

[61] Poor people are unable to save, while middle-class people are forced to save a certain amount to maintain a decent standard of living after retirement.

[62] Mariacristina De Nardi, *Wealth Inequality and Intergenerational Links*, FED. RESERVE BANK OF MINNEAPOLIS RESEARCH DEP'T 2 (Nov. 26, 2002), http://www.nber.org/~denardim/research/FedStaffReport.pdf.

[63] *See* JCT Report 2010–2014, *supra* note 15, at 39 (estimating the revenue loss at $484.1 billion).

[64] *See* Barbara H. Fried, *Fairness and the Consumption Tax*, 44 STAN. L. REV. 961, 967–97 (1992). Nor, to complete the Haig-Simons formulation of income, does paying interest increase net worth.

[65] *Id.* at 1002 n.116.

consumption or not, paying mortgage interest is voluntary because taxpayers can avoid it by renting their housing rather than buying it. Thus, there is no ability-to-pay argument in favor of excluding mortgage interest from the tax base (assuming that residential rental payments remain nondeductible).

Generally, proponents of the mortgage deduction argue that home ownership creates positive externalities and that, therefore, the purchase of owner-occupied housing should be encouraged.[66] This is the most common justification for continuing the mortgage interest deduction. Under this view, the home mortgage interest deduction is an incentive designed to increase the stock of owner-occupied housing. The underlying premise—that home ownership needs to be encouraged through the tax laws despite other existing significant government interventions in housing—is highly debatable. Even assuming this premise, the mortgage deduction is not well-designed to fulfill the goal of increasing the stock of owner-occupied housing. The deduction applies to interest on mortgage loans up to \$1,100,000,[67] which is much higher than necessary to influence those on the rent-versus-own margin. The deduction also applies to a second residence[68] (or yacht[69]). The large limitation amount and the availability of the deduction for second residences mean that the deduction is significantly overbroad. Furthermore, the deduction is unavailable to those who do not itemize (who tend to be far less wealthy than those who do itemize).[70] Also, because the tax expenditure is distributed through a deduction (rather than a credit), it is much more valuable to higher-income taxpayers than poorer ones. This means that the home buying incentive is perversely targeted to those who would inevitably buy houses, regardless of any tax breaks. At a minimum, this analysis suggests that, if the deduction is supposed to encourage home ownership, it should be redesigned with a substantially

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66 *See, e.g.*, J. MICHAEL COLLINS, NEIGHBORHOOD FUNDERS GROUP EXPANDING THE AMERICAN DREAM: A HOMEOWNERSHIP GUIDE FOR GRANTMAKERS 4–6 (2004), *available at* http://www.nfg.org/index.php?ht=a/GetDocumentAction/i/3660.

67 The deduction for interest on acquisition indebtedness covers the first \$1,000,000 of debt. I.R.C. § 163(h)(3)(B)(ii). Another \$100,000 of mortgage indebtedness is covered by the home equity indebtedness interest deduction. § 163(h)(3)(C)(ii). The \$1,000,000 limit and \$100,000 limit can be stacked together to allow \$1.1 million of acquisition indebtedness to qualify for the interest deduction. *See* Rev. Rul. 2010-25.

68 I.R.C. § 163(h)(4)(A)(i)(II) (extending the deduction for debt related to one non-principal residence at the taxpayer's choosing).

69 *See* Temp. Treas. Reg. § 1.163-10T(p)(3)(ii) (1986) (extending the definition of qualified residence to include mobile homes, recreational vehicles, and boats that have sleeping and cooking facilities and restrooms).

70 *See* I.R.C. § 62(a) (listing above-the-line deductions; list does not include home mortgage interest deduction).

lower limit and a prohibition against second-home loans and restructured as a fixed credit (e.g., 15% of interest paid) rather than a deduction.

As currently designed, however, the deduction likely provides little effect on the overall stock of owner-occupied housing. (The deduction likely does significantly influence the sizes and value of homes, but those effects are not cited by defenders of the deduction.) Thus, the main effect is distributive, by reducing the tax burdens of the middle and upper class who borrow to buy first and second homes.

At first glance, this distributive effect seems very problematic. By reducing the tax burdens of home owners relative to less wealthy renters, the deduction appears to make the tax system less progressive. But the deduction also reduces the tax burdens of leveraged home owners relative to the more wealthy outright home owners (those who buy their homes for cash and therefore do not receive mortgage interest deductions). Thus, whether the distributive effect of the mortgage interest deduction is beneficial depends on one's point of reference.

This distributive effect is a result of the way the tax law treats "imputed income."[71] Homeowners (whether leveraged or outright) enjoy the use of their home, and they are not taxed on that benefit. This exclusion of imputed income is, as a theoretical matter, an imperfection in our tax system. In theory, taxpayers should be taxed on the imputed rental value of their homes (as well as the imputed rental value of other consumer durables, such as cars and refrigerators), and they should be allowed to take deductions for the costs associated with generating that rent (such as depreciation and interest). For practical and political reasons, however, imputed income is not directly taxed.[72] Disallowing an interest deduction for the leveraged purchase of a consumer durable serves as a proxy tax on the imputed income from the durable. Providing the interest deduction, on the other hand, allows the owner-borrower to retain the imputed income exclusion. Viewed this way, the mortgage deduction puts the owner-borrower on par with an outright owner; each receives, in effect, the tax-

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[71] BLACK'S LAW DICTIONARY 831 (9th ed. 2009) (defining "imputed income" as "The benefit one receives from the use of one's own property, the performance of one's services, or the consumption of self-produced goods and services.").

[72] The exclusion of imputed income is not considered a tax expenditure by the Joint Committee, despite the fact that it is a departure from a pure income tax, because the exclusion is considered an administrative necessity. *See* J. COMM. ON TAXATION, BACKGROUND INFORMATION ON TAX EXPENDITURE ANALYSIS AND HISTORICAL SURVEY OF TAX EXPENDITURE ESTIMATES, JCX-15-11, 5 (2011). The Treasury Department does consider the exclusion of net rental imputed income of homeowners (though not the exclusion of imputed income generally) a tax expenditure in its report. *See id.* at 5 n.10. *See also* JIM SAXTON, STAFF OF J. ECON. COMM., 107TH CONG., A GUIDE TO TAX POLICY ANALYSIS: PROBLEMS WITH DISTRIBUTIONAL TAX TABLES 19 (Comm. Print 2000).

free rental value of their house. On the other hand, renters always must pay their rent with after-tax dollars. Disallowing the mortgage deduction would treat owner-borrowers the same as renters, but would still favor outright owners. The only way to tax everyone (outright owners, leveraged owners, and renters) consistently would be to either tax imputed income from houses or allow a deduction for rent paid, both of which are not politically feasible.[73]

It is also important to note that wealthy leveraged owners would be able to respond to a repeal of the mortgage interest deduction simply by selling financial assets, which would have generated future taxable income, and using the cash proceeds to pay off their mortgages, thereby turning taxable income—income from financial assets—into tax-free imputed income (rent-free use of their home). As a practical matter, repeal of the mortgage deduction would indirectly tax the imputed rental income of owners who lack existing financial resources to pay off their mortgages. Thus, repealing the mortgage interest deduction would have a significant generational impact. Older taxpayers are more likely to have paid off their mortgages or to have the financial assets to do so. Younger people are more likely, even if they have high incomes, to have substantial mortgages.[74]

V. CONCLUSION

The discussion above shows that rationally cutting tax expenditures is no easy task. First, tax expenditures must be categorized as mostly allocative or mostly distributive provisions. This is difficult, as some tax expenditures are claimed to be allocative but in reality may function mostly as distributive because they do not affect behavior in a significant way. Allocative tax expenditures should be evaluated to determine whether the desired behavioral effect is beneficial, whether the tax expenditure is well-designed to accomplish that effect, and whether that effect is worth the revenue loss in light of the current budget situation. In other words, allocative tax expenditures should be evaluated like any other spending program. Distributive tax expenditures, on the other hand, should be evaluated to determine whether they either increase or decrease the fairness of the tax system.

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[73] For further discussion of the interaction between the mortgage interest deduction and the exclusion of imputed rental income, see MARVIN CHIRELSTEIN & LAWRENCE ZELENAK, FEDERAL INCOME TAXATION 216–19 (12th ed. 2011).

[74] Michael S. Knoll, *Taxation, Negative Amortization and Affordable Mortgages*, 53 OHIO ST. L.J. 1341, 1348 (1992).