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Raising Revenue: The Options - Opening Remarks

So, that is a great segue for what I want to talk about, which is how to raise revenues and further progress goals at the same time. I want to argue that tax is essential to everything that progressives care about. Our tax system is one of the most important ways we express our values as a country. It's necessary to raise revenue in order to fund and maintain and create social programs. If we want to help people who are less well off, we need to have a progressive income tax. By progressive, we have a particular meaning of progressive in the tax context, which is that tax burdens, as a share of income, rise with income. Of course you can have a more demanding view as progressives, but that's sort of our technical term for progressivity. And right now we have a mildly progressive federal tax system, but it could be much more so.

And then finally as Ed explained, there are a number of ways that we deliver spending programs through the tax code, and these are huge spending programs. They are almost all regressive, and that means that if we want to cut spending in a way that doesn't hurt low-end middle-income families, then the tax code is the place to look. So what I want to talk about is particularly tax incentives for individuals, where the benefits and burdens are clearest. I'll first give a basic primer on how to further progressive goals through reforming individual tax incentives, and then I want to put out some brief reform options that are worth consideration.

So there are four reasons why we may want to have tax provisions. The first is measuring income, or how well off households are. The next is allocating tax burdens and potentially redistributing based on that measure. Some tax provisions are also meant to limit complexity. And what I want to focus on is provisions that are intended to create incentives for behaviors that arguably have social benefits. These can overlap, but I'll try to create a rough taxonomy for you.

So what I want to do is go through different forms of tax incentives by how regressive they are and move from the most regressive to the most progressive. And just by way of background, I can't tell you how often I have very committed, very smart, very progressive friends come to me with an idea that they're very excited about. Say they're working on education or disabilities, and they say "why don't we create a new tax provision that allows people to save in tax-free saving accounts" for whatever cause they care about. And I have to tell them that this is a horrible idea. And I want to emphasize its not just a mediocre idea, it's basically the single worst program you can imagine to further these goals on a progressive basis. It ends up helping the affluent the most, doing basically nothing for less affluent people, and I want to explain why.

So the most regressive kind of tax incentive is those that reduce or eliminate tax on income from savings. And the reason is that the savings rate rises very rapidly with measures of socio-economic status. So the share of incomes that households get from

savings is very correlated with their socio-economic status. And as I'll get in to, when you eliminate a tax rate it tends to disproportionately benefit higher-income households.

The second slightly less regressive but still highly regressive type of tax incentive are itemized deductions. You choose between taking either the standard deduction or the itemized deduction. It turns out only about a third of people itemize, and these tend to be people who are very high-income. They're highly correlated with income. So here's a picture of that.

The third is exemptions and above-the-line deductions. These any one can claim, but the value of an exemption or an above-the-line deduction depends on your marginal tax rate. So if you deduct a dollar, it's worth nothing if you're in the zero bracket; it's worth 35 cents if you're in the top marginal tax bracket. And as you can see people are very spread out and your tax bracket rises with incomes.

Fourth are non-refundable credits. These are actually still regressive because most – not most, but a very large proportion – of people do not have positive income tax liability, about 43 percent of households. If you're trying to create an incentive for single-parent households, it turns out to be 80 percent do not have positive income tax liability.

So the only potentially progressive benefit is a refundable tax credit, where you can get the credit even if you have zero income tax liability.

So here is a list of individual tax incentives that I grouped by these different forms, and as you can see there are very few that are refundable and they cost an awful lot of money, about 800 billion dollars-ish, if we go by Ed's measure. This is more than we spend on national defense, it's more than we spend on non-defense discretionary spending, it's more than we spend on social security, more than Medicare, it's a lot of money.

Relatively few of these provisions are refundable – only the green ones there. And they're also highly regressive if you ignore the refundable credit. So this is the change in after tax income and without refundable credits you have an increase of about 11 percent in after tax income for the top 20 percent of the income distribution, and no change for the bottom. By dollar value, it's even more stark. \$429 for the bottom of the income distribution and 16,000 for the top 20 percent, at an average of about 104,000 for the top 1 percent worth of tax benefits.

So what I want to do now is provide an example of retirement savings, which I think is an area that is really ripe for reform. The estimates are that we currently spend between 130 and 200 billion dollars on retirement savings incentives, and these come in several forms. We have defined contribution plans, defined benefit plans, IRAs, there's two different ways that tax incentives are usually structured on a traditional basis, but they're generally economically equivalent under certain assumptions and they are structure-based on deductions and exemptions.

So the issue is that most retirement savings occur through the employer context. And the participation rates vary again very heavily by socio-economic status. This is because

employers that offer retirement plans tend to have higher socio-economic status employees and also they tend to take up the program more. So when you couple that with the fact that deduction and exclusion are regressive themselves, you end up with dramatically regressive distributions of incentives for retirement savings.

So in thinking about how to reform this, I want to put out 6 questions that I think are worth considering in reforming any of these tax incentives. The first is what the precise choice is that's generating social benefits. And with retirement savings, it would seem that if you save enough for retirement and invest responsibly enough, then you're not going to be relying on others or radically changing your standard of living in retirement. We don't usually hear retirement savings plans justified as a way of encouraging people to give to the next generation. But that's what a lot of them end up doing. If we're only concerned about retirement income security, then we should limit these incentives to savings that are annuitized, which means you receive a payment over the rest of your course of your life that takes account for or doesn't vary depending on how long you live on investment returns.

So the next question is whether the social benefits vary by income. The evidence here is disputed but in general I would say that low-income households are under-saving the most. Then it is also important to consider the responsiveness to any incentive and again it appears that low-income households are more responsive because higher-income households are able to shift their income from one kind of account into a tax-preferred savings account.

The fourth question is whether there are ways to increase the responsiveness to retirement savings incentives. And here there are. If you structure there's a match that goes directly into the account, people tend to respond more to that. And people have also probably heard that opt-out plans tend to induce much higher participation rates, to the point where it's questionable whether you actually would get that much different results if you just shifted to opt-out accounts.

So the implications here I think are that if we want to retain tax incentives we should create some kind of universal opt-out system that doesn't depend on whether your employer offers a plan. We should have a refundable credit that phases out as income rises and create it as a match. We should condition the match on annuitizing and not issue further matches once you reach an age-adjusted balance cap, on the theory that once you have a million dollars of retirement savings, these aren't really the people we're concerned about under savings. But we also may want to consider repealing them because we may be able to accomplish many of the same objectives or just as much now or more by just creating this universal opt-out system

And you can extend these arguments in a number of other areas. With home ownership, we might want to gradually convert to a first-time home buyers refundable credit. With charitable credit we might want to convert to a charitable match that is maybe higher if you give to more disadvantaged groups. Life insurance exclusions I would summarize in one word, also stupid. And higher education is another area where it really does not make

sense to be excluding the bottom 40 percent of the income distribution who are the families that are least likely to send their kids to college from higher education credits.