Options for Broadening the U.S. Tax Base

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Key Findings

- Broadening the U.S. tax base and using the revenues to lower marginal tax rates remains a sound template for tax reform. Moving to a broader tax base and lower rates would simplify the tax code, remove unfair preferences, and create economic growth.

- In recent tax reform proposals, policymakers have declined to pursue ambitious base-broadening measures, limiting their ability to cut tax rates.

- Three promising directions for broadening the U.S. tax base are ending the exclusion of employer-sponsored health insurance, removing the cap on the Social Security payroll tax, and capping itemized deductions at a fixed dollar level.

- Each of these options would have negative economic effects, if implemented without accompanying rate cuts. However, combined with marginal rate cuts, each would lead to economic growth.

- Together, all three options would raise enough revenue on a static basis to lower the corporate tax rate to 20 percent, the top rate on ordinary income to 29.5 percent, and the top rate on capital gains and dividends to 13 percent. Doing so would grow the U.S. economy by 6.0 percent over the long term.
Introduction

The template of "broader bases and lower rates" has motivated conversations about tax policy in the United States for over 50 years, and has served as the guiding principle behind several bipartisan tax reform efforts.¹ Today, it remains one of the most promising paradigms for tax reform, but is often misunderstood and inadequately applied.

The case for "broader bases and lower rates" is simple. The United States levies higher tax rates on corporate income, capital gains, and dividends than average in the Organisation for Economic Co-operation and Development (OECD).² Because high marginal rates slow economic growth and hurt international competitiveness, many voters and policymakers consider lower tax rates a central priority of tax reform.

However, lower tax rates are expensive: even after accounting for economic feedback, tax rate cuts do not pay for themselves. One way to lower tax rates without increasing the federal deficit is to accompany tax rate cuts with equally large spending cuts. However, federal spending levels are unlikely to change significantly in the near future, and politicians considering tax rate cuts should not count on large spending cuts to make up for the lost revenue.

As a result, the only practical way to cut tax rates without increasing the deficit is by broadening the tax base – increasing the amount of economic activity subject to full taxation. Ideally, federal taxes would be levied on all consumption that occurs in the economy.³ In practice, significant portions of national consumption are not included in the tax base, through deductions, exclusions, and other preferential tax treatment. Broadening the tax base consists of ending tax preferences to raise revenue.

When enacted correctly, measures to broaden the tax base can have several positive effects. Broadening the tax base creates a simpler and more equitable tax code, by ending preferential tax treatment for certain economic activities. By eliminating distortionary provisions, base broadening can encourage a more efficient allocation of resources. Most importantly, broadening the tax base can raise the necessary revenue to cut federal tax rates without increasing the deficit.

³ Of course, a consumption tax need not be a national sales tax. There are several different ways of implementing a tax system with a consumption base, including various types of value-added taxes, an individual-level flat tax, or a hybrid of any of these frameworks. For an overview, see Curtis Dubay and David Burton, A Tax Reform Primer for the 2016 Presidential Candidates, Background #3009, The Heritage Foundation, Apr. 2015, http://www.heritage.org/research/reports/2015/04/a-tax-reform-primer-for-the-2016-presidential-candidates.
Several notable recent tax reform proposals have followed the template of “broader bases and lower rates,” but many have lacked imagination when it came to broadening the U.S. tax base. For instance, Congressman Dave Camp’s 2014 tax reform discussion draft contained dozens of small base-broadening measures, which would only have raised enough revenue for modest rate cuts.¹

Tax reform proposals from presidential candidates have also been short of base-broadening measures. In the 2016 presidential election, eight presidential candidates have released tax reform proposals that lower marginal tax rates significantly. Yet, each of these proposals is estimated to cost more than $500 billion over ten years, with some reducing federal revenues by over $10 trillion.² These high deficit figures indicate that candidates have not proposed sufficiently ambitious measures to broaden the U.S. tax base.

The goal of this paper is to offer policymakers more promising directions for broadening the U.S. tax base. Specifically, I consider three reforms that would make the U.S. tax base substantially broader: ending the exclusion of employer-sponsored health insurance, removing the cap on the Social Security payroll tax, and capping itemized deductions at a fixed dollar level.

All three reforms would end significant tax preferences for a large set of economic activities. Adopting these three base-broadening measures would allow the federal government to lower marginal tax rates significantly, without increasing the deficit.

This paper shows that the economic benefits from lower rates would far outweigh the economic costs of measures to broaden the tax base. Thus, broadening the tax base and lowering marginal rates would not only simplify the tax code and remove unfair preferences, but would also create substantial economic growth.

**Principles for Broadening the Tax Base**

The concept of broadening the tax base is often mischaracterized. For instance, some writers have claimed that longer depreciation schedules for capital investment would broaden the U.S. tax base.³ In fact, lengthening depreciation schedules would amount to little more than increasing the double taxation of investment in the current tax code.

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To correctly define whether a given proposal leads to a broader tax base, it is necessary to identify an ideal tax base, to which the current federal tax base can be compared. This paper treats a consumption tax base as the ideal federal tax base, following a long academic literature that identifies the consumption base as maximally economically efficient.\(^7\)

Deviations from a consumption base can be sorted into two categories: consumption that is left untaxed or taxed at a preferential rate, and consumption that is double-taxed or taxed at a higher rate. Broadening the tax base consists in removing preferential tax treatment and, by doing so, increasing tax revenue. In contrast, proposals that exacerbate disadvantageous tax treatment should not be considered base broadeners, even if they increase revenue.

Under this framework, there are several purported "base-broadening" measures that would, in fact, move the federal tax base further away from a consumption base. For instance, raising taxes on capital gains is sometimes characterized as a measure to broaden the U.S. tax base.\(^8\) However, taxes on capital gains and dividends place a higher burden on future consumption than present consumption, and a higher burden on corporate economic activity than pass-through economic activity.\(^9\) Thus, a tax increase on capital gains and dividends would move the tax base further from the ideal, and should not be considered a base broadening measure. Similarly, proposals to lengthen depreciation schedules would place a higher burden on future consumption than present consumption, by raising taxes on the costs of producing future consumption (i.e. capital investments).

Even when applying this precise definition of base broadening, the current U.S. tax code still offers dozens of opportunities for a broader tax base. The Office of Management and Budget lists over 150 "tax expenditures": credits, deductions, exclusions, and other preferential tax treatment that reduces the amount of income tax revenue the federal government is able to collect.\(^10\) Eliminating many of these provisions would broaden the U.S. tax base.\(^11\)

The three options for broadening the U.S. tax base that are presented in this paper were chosen deliberately, out of dozens of potential base broadening measures. All three are ambitious: each option would raise over $1.5 trillion in revenue over ten years, which could be used to cut rates significantly. All three cause minimal economic harm: no option would decrease long-term gross domestic product (GDP) by more than 1 percent. Finally, each option would end tax preferences that primarily benefit high-income Americans; all three would counteract the distributional effects of cuts to top marginal tax rates, making the resulting reform more politically palatable.


Three Options for Broadening the Tax Base

By themselves, all three of the base-broadening measures described below would harm the U.S. economy. However, combined with lower marginal rate cuts, each measure would lead to significant growth.

Ending the Exclusion of Employer-Sponsored Health Insurance

Since the inception of the federal income tax in 1913, individuals have not been required to report the value of employer-sponsored health plans as taxable income. This exclusion was formally established by a 1943 IRS ruling and codified in the Internal Revenue Code of 1954.12 In addition, employer-provided health insurance is excluded from federal payroll taxes.13 Finally, self-employed individuals are able to deduct the cost of health insurance for themselves, spouses, and dependents.14

Over time, this favorable tax treatment of employer-sponsored health insurance helped it become the predominant form of health insurance in the United States.15 Today, over half of Americans – 175 million individuals – are covered by employer-sponsored health insurance.16 In 2013, healthcare benefits for current employees cost private sector employers $408 billion and state and local governments $124 billion.17

There is little economic rationale for the exclusion of employer-sponsored health insurance from the tax code. Health economists have long argued that the exclusion has driven up health care demand and costs.18 Furthermore, it distorts the insurance market toward plans provided by employers, which are generally less portable and less subject to competitive pressures.19 Various attempts to equalize federal subsidies in the employer-provided market and the individual market, such as the Affordable Care Act, have been patchwork at best.20

The exclusion of employer-sponsored health insurance treats one class of consumption (medical expenditures) more favorably than other consumption. Thus, eliminating this exclusion would broaden the federal tax base and increase overall revenue.

13 26 U.S. Code §3121(a).
14 26 U.S. Code §126(l).
18 Nancy Greenspan and Ronald Vogel, Taxation and Its Effect Upon Public and Private Health Insurance and Medical Demand, HEALTH CARE FINANCING REVIEW 1: 29-45.
20 For a more extended discussion of the design and effects of this exclusion, see Tax Expenditures for Health Care, Joint Committee on Taxation, July 2008, http://www.jct.gov/x-66-08.pdf.
According to the Tax Foundation's Taxes and Growth Model, repealing the exclusion of employer-sponsored health insurance would lead to $4.40 trillion in additional federal revenue over ten years, on a static basis.\textsuperscript{21} By itself, this change would lead to a decline of 1.0 percent in long-run GDP, due to the increased tax burden on labor for individuals in all income groups.

However, the additional revenue from ending the exclusion could be used to cut the corporate tax rate to 25 percent and to enact an across-the-board cut of 3.3 percentage points on all individual income tax rates (which would lower the top rate on ordinary income to 36.5 percent and the top rate on capital gains to 20.7 percent).\textsuperscript{22} All together, these changes would create substantial economic growth: long-run GDP would rise by 3.3 percent, due to lower marginal rates on work and investment.

### Table 1.
**Economic and Revenue Effects of Ending the Exclusion of Employer-Sponsored Health Insurance**

<table>
<thead>
<tr>
<th></th>
<th>Ending the exclusion of employer-sponsored health insurance</th>
<th>Combined with 25% corporate rate and a 3.1% across-the-board individual rate cut (ordinary income and capital gains).</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>-1.0%</td>
<td>3.3%</td>
</tr>
<tr>
<td>Capital Investment</td>
<td>-1.2%</td>
<td>9.5%</td>
</tr>
<tr>
<td>Wage Rate</td>
<td>0.0%</td>
<td>2.6%</td>
</tr>
<tr>
<td>Full-time equivalent jobs (in thousands)</td>
<td>-1,067</td>
<td>774</td>
</tr>
<tr>
<td>10-year static revenue (billions)</td>
<td>$4,149</td>
<td>$10</td>
</tr>
<tr>
<td>10-year dynamic revenue (billions)</td>
<td>$3,824</td>
<td>$941</td>
</tr>
</tbody>
</table>


### Removing the Payroll Tax Cap

Since the enactment of Social Security in 1937, the program has been funded through payroll taxes, levied on wages and salaries. However, not all wages and salaries are subject to Social Security payroll taxes; the tax is capped at a set level of labor earnings. In 2015, only the first $118,500 of an individual’s labor earnings were subject to Social Security payroll taxes.

Over the last thirty years, the share of all wages and salaries falling under the cap has declined. In 1983, 90.0 percent of labor earnings were subject to Social Security payroll taxes. By 2013, this figure had fallen to 82.7 percent, or $5,913 billion out of the $7,147 in wages and salaries reported to the Social Security Administration.\textsuperscript{23}

The cap on the Social Security payroll tax treats one class of income (earnings over $118,500) more favorably than other income, thus deviating from an ideal consumption base. So, eliminating the cap on the Social Security payroll tax would broaden the federal tax base and increase overall revenue.

\textsuperscript{21} Taxes and Growth, Tax Foundation, accessed Nov. 12, 2015, \url{http://taxfoundation.org/taxes-and-growth}.

\textsuperscript{22} Because ending the exclusion of employer-sponsored health insurance would raise taxes on households in all income groups, it is combined with an across-the-board rate cut, to approximate a distributionally-neutral plan.

\textsuperscript{23} Table 4.B1, Annual Statistical Supplement, Social Security Administration, 2014.
Some writers point out that removing the payroll tax cap would “change the character” of Social Security, by asking the rich to pay much more in Social Security taxes than they receive in benefits. However, many Social Security reform proposals already include calls for additional “means-testing” of Social Security benefits; eliminating the payroll tax cap would be no different in kind from these proposals.

Removing the cap on the Social Security payroll tax would lead to $1.80 trillion in additional federal revenue over ten years, on a static basis. By itself, this change would lead to a decline of 0.6 percent in long-run GDP, due to the increased tax burden on the labor of individuals making over $118,500.

However, the additional revenue from removing the cap could be used to cut the corporate tax rate to 30 percent, to cut the top three brackets on ordinary income by 5 percent, and to cut the top rate on capital gains to 20 percent. All together, these changes would also create substantial growth, causing long-run GDP to grow by 2.2 percent.

<table>
<thead>
<tr>
<th>Table 2. Economic and Revenue Effects of Removing the Payroll Tax Cap</th>
</tr>
</thead>
<tbody>
<tr>
<td>Removing the payroll tax cap</td>
</tr>
<tr>
<td>GDP</td>
</tr>
<tr>
<td>Capital Investment</td>
</tr>
<tr>
<td>Wage Rate</td>
</tr>
<tr>
<td>Full-time equivalent jobs (in thousands)</td>
</tr>
<tr>
<td>10-year static revenue (billions)</td>
</tr>
<tr>
<td>10-year dynamic revenue (billions)</td>
</tr>
</tbody>
</table>


Capping Itemized Deductions

As long as the individual income tax has been around, taxpayers have been able to deduct specific items from their gross income. The Revenue Act of 1913 allowed individuals to itemize deductions for interest paid, state and local taxes, casualty losses, and several other categories. The Individual Income Tax Act of 1944 gave individuals the option to take a standard deduction, rather than itemizing, to mitigate taxpayer confusion and reduce the need for recordkeeping.

26 This analysis does not take into account the budgetary effects of increased Social Security payments that would result from removing the Social Security payroll tax cap, under the current benefits formula. It assumes that benefits for high-income Americans would be held constant, even as the structure of payroll taxes changes.
27 Because capping the payroll tax would primarily raise taxes on high-income households, it is combined with cuts to the top three income brackets, to approximate a distributionally-neutral plan.
28 P.L. 63-16.
Over the past century, itemized deductions have grown in size and scope. In 2013, taxpayers claimed $1.19 trillion in itemized deductions, up from $350 billion fifty years earlier. Itemized deductions largely benefit households with more than $100,000 in income, who accounted for 15 percent of returns in 2013 but claimed 61 percent of all itemized deductions.

There have been several attempts to reduce the value of itemized deductions. Notably, the Tax Reform Act of 1986 eliminated and limited the value of several deductions. Four years later, the Omnibus Budget Reconciliation Act of 1990 imposed a modest limitation on itemized deductions as a percentage of gross income.

Most itemized deductions deviate from an ideal tax base, giving preferences to certain forms of consumption, such as owner-occupied housing. Therefore, a general cap on itemized deductions would broaden the tax base and increase overall revenue.

A cap on itemized deductions could take several forms: a limitation on the tax benefit of itemized deductions; a limitation on the value of itemized deductions, as a percent of income; and a flat dollar cap on the value of itemized deductions. Without delving into the relative design merits of each of these proposals, this paper models a flat $25,000 cap on itemized deductions, a proposal associated with the 2012 Romney presidential campaign.

Capping itemized deductions at $25,000 would lead to $1.93 trillion in additional federal revenue over ten years, on a static basis. By itself, this change would lead to a decline of only 0.2 percent in long-run GDP. This is because itemized deductions have only a slight effect on the supply of labor and capital. Specifically, the availability of itemized deductions affects decisions about work and investment when cutting deductions would bump a taxpayer into a bracket with a higher marginal rate.

The additional revenue from capping itemized deductions could be used to cut the corporate tax rate to 30 percent, to cut the top three brackets on ordinary income by 5 percent, and to cut the top rate on capital gains to 20 percent. All together, these changes would create substantial growth, causing long-run GDP to rise by 2.7 percent.

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30 Historical Table 7, Statistics of Income, IRS, 2013. Figures adjusted for inflation, using CPI.
31 Table 1.4, Statistics of Income, IRS, 2013.
33 A few itemized deductions, such as some work-expense-related deductions and gambling loss deductions, represent the correct treatment of income. However, for simplicity, this paper models a cap on all itemized deductions.
36 Because capping itemized deductions would primarily raise taxes on high-income households, it is combined with cuts to the top three income brackets, to approximate a distributionally-neutral plan.
Table 3.
Economic and Revenue Effects of Capping Itemized Deductions at a Fixed Dollar Level

<table>
<thead>
<tr>
<th></th>
<th>Capping itemized deductions at $25,000</th>
<th>Combined with a 27% corporate rate, 5% cut to the top three ordinary income brackets, and a 20% top capital gains rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>-0.2%</td>
<td>2.7%</td>
</tr>
<tr>
<td>Capital Investment</td>
<td>-0.3%</td>
<td>7.7%</td>
</tr>
<tr>
<td>Wage Rate</td>
<td>-0.1%</td>
<td>2.2%</td>
</tr>
<tr>
<td>Full-time equivalent jobs</td>
<td>-132</td>
<td>644</td>
</tr>
<tr>
<td>(in thousands)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10-year static revenue (billions)</td>
<td>$1,930</td>
<td>-$14</td>
</tr>
<tr>
<td>10-year dynamic revenue (billions)</td>
<td>$1,880</td>
<td>$759</td>
</tr>
</tbody>
</table>


All Three Base-Broadening Measures

If all three of these base-broadening measures were enacted together, they would raise a substantial amount of revenue, increasing federal tax collections by 20.9 percent, or $8.12 trillion over ten years, on a static basis.37 Because these three changes would significantly increase the tax burden on labor, they would lead to a decline of 1.9 percent in long-run GDP.

However, the additional revenue from these measures could be used to cut marginal tax rates significantly. The corporate tax rate could be cut to 20 percent, five points lower than average in the OECD.38 Individual income tax rates could be cut by 10.5 percent for the top three ordinary brackets and 5.5 percent for the bottom four brackets, leading to a top rate of 29.1 percent. And the top rate on capital gains could be cut by over ten points, to 13 percent.

The combination of these three powerful base-broadening measures and these significant rate cuts would lead to a 6.0 percent increase in long-run GDP and 1.5 million new full-time equivalent jobs. Furthermore, while this plan would be revenue-neutral on a static basis, after economic feedback is taken into account, federal revenues would increase by $1.73 trillion over ten years.

Table 4.
Economic and Revenue Effects of Capping Itemized Deductions at a Fixed Dollar Level

<table>
<thead>
<tr>
<th></th>
<th>All three base broadeners, together</th>
<th>Combined with a 20% corporate rate, 10.5% cut to top three ordinary income brackets, 5.5% cut to bottom four ordinary income brackets, and a 13% top capital gains rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>-1.9%</td>
<td>6.0%</td>
</tr>
<tr>
<td>Capital Investment</td>
<td>-2.3%</td>
<td>17.5%</td>
</tr>
<tr>
<td>Wage Rate</td>
<td>0.0%</td>
<td>4.7%</td>
</tr>
<tr>
<td>Full-time equivalent jobs</td>
<td>-2.002</td>
<td>1,454</td>
</tr>
<tr>
<td>(in thousands)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10-year static revenue (billions)</td>
<td>$8,119</td>
<td>$24</td>
</tr>
</tbody>
</table>

37 This is a larger revenue figure than the previous three added together because of interaction effects; for instance, taxing employer-sponsored health insurance would raise even more revenue if it were not subject to a payroll tax cap.

Conclusion

The template of "broader bases and lower rates" is as close to a free lunch as policymakers get. It allows politicians to simplify the tax code, end unfair provisions, create economic growth, and sidestep messy questions about the overall level of federal revenue – all at once.

The three options presented above are ambitious, and deliberately so. They are intended to offer politicians promising directions for broadening the tax base, even if Congress is reluctant to enact them in full. For instance, while the exclusion of employer-sponsored health insurance may never be fully repealed, the exclusion could be capped, limited, converted to a deduction, or turned into a credit – each of which would lead to a broader tax base.

The more determined Congress is to broaden the U.S. tax base, the more it will be able to cut tax rates without increasing the deficit. The three options presented above would allow Congress to end narrow tax preferences and deliver broad economic growth.