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The Impact of Romney's Proposed $17,000 Deduction Cap

By
Stephen Entin

A recent Tax Foundation analysis of Governor Mitt Romney's tax proposals indicated they would add substantially to the GDP over time, raise after-tax incomes across the board, and cost the U.S. Treasury far less than what traditional "static" estimates (the cost before any economic gains are factored in) have reported.[1] Indeed, our model showed that the added income growth from that tax plan would generate sufficient tax revenue to cover about 60 percent of the "static" budget cost of the tax reductions.

Specifically, our model found that reducing individual tax rates would recover only a portion of the static revenue cost through economic growth, but that the proposed reduction in the corporate income tax rate, and lower taxes on capital gains, dividends, and estates would contribute to job growth and federal revenues, reducing the cost of the total tax package.

While the remaining revenue shortfall could certainly be closed by eliminating various tax expenditures (or so-called loopholes) on high-income taxpayers, our study also suggested that the budget shortfall could be closed through reasonable cuts in "corporate welfare" and obsolete and ineffective federal spending programs.[2]

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[1] Stephen Entin & Will McBride, *Simulating the Economic Effects of Romney's Tax Plan*, TAX FOUNDATION FISCAL FACT NO. 330 (Oct. 03, 2012), http://taxfoundation.org/article/simulating-economic-effects-romneys-tax-plan.

[2] In a follow up blog post, we also demonstrate that a natural byproduct of economic growth is reduced spending on recession induced transfer payments such as unemployment benefits, which further reduces the deficit. *See* William McBride, *More on How to Pay for Romney's Tax Cuts*, TAX FOUNDATION TAX POLICY BLOG, Oct. 5, 2012, http://taxfoundation.org/blog/more-how-pay-romneys-tax-cuts.

Recently, however, Governor Romney suggested that he might fund part of his proposed income tax reductions in a progressive manner by imposing a $17,000 cap on itemized deductions. Tax Foundation economists modeled this iteration of the Romney plan in order to see how well it closes any shortfall from cutting tax rates and how much it might lower the economic growth effects of the original plan. Our results are a rough approximation, in part because Romney has not provided details on which deductions would be subject to limit, and because taxpayers might avoid some of the limitations by changing their behavior.

Our earlier study showed that the original Romney tax plan would add about 7.8 percent to private sector GDP and incomes over time. Its "static" revenue cost, ignoring economic improvements and the resulting revenue reflow, would be about $338 billion (measured at a 2008 baseline level of GDP and income). After factoring in the growth of incomes and tax revenue, however, we found that only about 40 percent of the revenue gap remains (about $137 billion in 2008 dollars).

In this paper, we modeled the entire Romney plan including a $17,000 limit on all itemized deductions.[3] We found that this limitation on deductions would trim away about 0.4 percent from the 7.8 percent gains in private sector GDP and income, mainly by raising some marginal tax rates on labor and business income among people losing the deduction for state income taxes and some business expenses or whose augmented taxable income spills into a higher tax bracket. This lower economic growth would modestly reduce the pre-tax and after-tax income gains across the board, in all income classes. (See Tables 1 and 2.)

Nonetheless, the combination of the additional revenue from economic growth and the limitation on itemized deductions comes very close to making the plan revenue neutral at the end of the period. For example, the cap on deductions reduces the plan's static revenue losses from $338 billion to around $206 billion. Then, the economic growth generated by the plan further reduces the revenue losses to under $14 billion. By Washington standards, this is well within the margin of error.

The cap on deductions is not without cost. It would reduce the gain in GDP and incomes from the package by about $0.52 for each dollar of revenue that the cap saves for the treasury (lowering after-tax income by $1.52).

[3] For the 2008-based model run, we scaled back the $17,000 figure to the inflation adjusted 2008 amount of $15,950.

Table 1. Difference in GDP, Incomes, and Federal Budget Totals under Romney Tax Plan With and Without the Suggested $17,000 Cap on Itemized Deductions
(Dollar amounts in billions except as noted. Calculated at 2008 levels of income.)

Changes in:	With $17,000 Cap	Without Cap	Difference
GDP	6.9%	7.4%	-0.4%
Private business GDP	7.4%	7.8%	-0.5%
Capital stock	17.6%	18.6%	-1.1%
Wage rate	4.5%	4.7%	-0.2%
Hours worked	2.7%	3.0%	-0.3%
Federal revenue	-$13.8	-$137.4	$123.6
Federal expenditure	$32.3	$34.1	-$1.8
Federal deficit (- is larger def.)	-$46.1	-$171.4	$125.4
Static revenue	-$205.6	-$338.3	$132.7
Dynamic revenue	-$13.8	-$137.4	$123.6
% Rev. reflow	93.3%	59.4%	33.9%
GDP	$1,002.5	$1,066.7	-$64.3
$GDP/$tax rev. vs. baseline*	$72.78	$7.77	-$0.52

* Positive numbers indicate that the government would lose revenue with these tax cuts, but that economic output (GDP) and people's pretax incomes would rise by the indicated amount for each dollar of revenue lost. The negative number in the difference column indicates the smaller tax cut would cost the public $0.52 in lost income in addition to each $1 in tax saved by the government from the lower tax cut under the itemized deduction cap compared to no cap.

Effect on Progressivity

Compared to the Romney plan without the $17,000 cap on deduction, the new plan would make the tax code more progressive than his original plan. For example, while the plan cuts taxes across-the-board and boosts the after-tax incomes for all taxpayers, the cap on deductions claws back more of the gains from high-income taxpayers than from taxpayers at the lower and middle portions of the income scale.

Impact on the tax cuts. Looking first at how much the deduction cap reduces the static value of the tax cuts, we find that the limitation would take back over half the tax cut for people in the $150,000 to $500,000 AGI range and 60 percent to 80 percent of the tax cut for those earning over $500,000. By contrast, it would take back, on average, just 5 percent to 14 percent of the tax cut for people with AGI between $20,000 and $50,000. (Compare column 1 to column 3 on table 2.)

Impact on after-tax incomes. Similarly, when we look at the dynamic effect of the plan on after-tax incomes (columns 2 and 4 on table 2), we find that the deduction cap would lower the gains in after-tax income by about a third for people earning over $500,000 and by about a quarter for those earning between $150,000 and $500,000. By contrast, for those earning below $50,000 the cap would lower their after-tax gains by less than 8 percent.

In the end, the changes in after-tax incomes are nearly evenly distributed across the income spectrum.

The reason for the progressive effect of the limitation is obvious. A larger percent of upper income filers than lower income filers itemize. The latter rely more heavily on the standard deduction, which substitutes for itemization and generally exceeds their charitable giving, state and local taxes, and mortgage interest deductions and other deductible expenses.

Roughly 95 percent of the filers with more than $150,000 in adjusted gross income itemize their deductions. By contrast, about 65 percent of filers with AGI between $50,000 and $75,000 itemize; about 50 percent of filers with AGI between $40,000 and $50,000 itemize; 35 percent between $30,000 and $40,000; 20 percent between $20,000 and $30,000; and less than 10 percent for lower incomes.

Some caveats and issues for further study should be noted. The above numbers regarding the income distribution of the tax package with and without the $17,000 limitation on itemized deductions are averaged over all tax returns, whether the filers itemize or take the standard deduction. It should be noted that even those who do itemize in the income ranges from zero to $50,000 average between $14,000 and $17,000 in deductions. Therefore, some people in the lower income ranges could find their deductions limited by the $17,000 cap. Deductions average above the $17,000 cap at higher AGI ranges among those who itemize, exceeding $20,000 on average at $100,000 and above.[4]

Some of the revenue anticipated from the limitation could be lost to changes in taxpayer behavior. For example, there might be some impact on the amount or form of charitable giving, on the size of mortgages taken out to buy homes (affecting lenders' incomes), and on the prices of homes (affecting builders' incomes and sellers' capital gains). Some itemized deductions involve business expenses that must be accounted for to determine net income, such as fees for managing savings portfolios and unreimbursed business expenses. If these were moved to other tax forms, or if alternative billing arrangements were adopted, the projected federal revenue gains would be reduced. Finally, we note that Congress may be unwilling to restrict all categories of deductions. Medical expenses are already restricted to amounts that exceed 10 percent of AGI. Would Congress do more in that area or back away from limiting home-ownership-related items?

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[4] *See* Internal Revenue Service, *Individual Income Tax Returns 2012*, Publication 1304, Table 2.1, pp. 85-90, http://www.irs.gov/pub/irs-soi/10inalcr.pdf. *See also* William McBride, *Romney's Proposal to Cap Deductions at $17,000*, TAX FOUNDATION TAX POLICY BLOG, Oct. 3, 2012, http://taxfoundation.org/blog/romney%E2%80%99s-proposal-cap-deductions-17000.

Conclusion

Governor Romney has proposed to fund a portion of his tax package by limiting itemized deductions, suggesting a $17,000 cap as a talking point. This could reduce concerns (largely unfounded) that the tax plan is not sufficiently progressive, or that it would otherwise require raising taxes on the middle class.

Our model finds that the revised Romney plan would achieve the result of significantly reducing the tax cut for upper income taxpayers. It would reduce the growth effect of the tax package slightly and would affect some middle income filers with unusually large deductions. The proposal would fund most of the revenue gap not closed by the stronger economy, barring significant changes in taxpayer behavior. In other words, the plan is nearly revenue neutral.

It illustrates that the tax package can indeed be made to work without raising taxes on middle income families (except in rare cases). Nonetheless, this is a bit of a blunt instrument which does not address the merits or demerits of the different types of deductions. It is also not clear whether Congress will go along with major reductions in some types of the deductions involved. A series of spending reductions in the least valuable or most wasteful federal spending programs might be a better way to proceed.

Table 2. Comparison of Changes in After-tax Incomes under Romney Tax Plan With and Without the Suggested $17,000 Cap on Itemized Deductions

	Average Change in Dollars per Tax Return*				Average Percentage Change per Tax Return*			
	With $17,000 Limit		Without $17,000 Limit		With $17,000 Limit		Without $17,000 Limit	
AGI Class	Static (1) After-Tax AGI	Dynamic (2) After-Tax AGI	Static (3) After-Tax AGI	Dynamic (4) After-Tax AGI	Static After-Tax AGI	Dynamic After-Tax AGI	Static After-Tax AGI	Dynamic After-Tax AGI
< 0	131	-6,412	131	-6,845	-0.15%	7.25%	-0.15%	7.74%
0 - 5,000	0	178	0	190	0.02%	6.52%	0.02%	6.94%
5,000 - 10,000	7	518	7	551	0.09%	6.44%	0.09%	6.84%
10,000 - 20,000	54	1,046	54	1,110	0.35%	6.70%	0.35%	7.11%
20,000 - 30,000	165	1,780	174	1,897	0.67%	7.23%	0.71%	7.70%
30,000 - 40,000	304	2,535	349	2,730	0.91%	7.62%	1.05%	8.20%
40,000 - 50,000	456	3,263	531	3,526	1.08%	7.72%	1.26%	8.34%
50,000 - 75,000	669	4,522	855	4,969	1.16%	7.87%	1.49%	8.64%
75,000 - 100,000	894	6,283	1,277	7,045	1.11%	7.79%	1.58%	8.73%
100,000 - 150,000	1,363	8,695	2,471	10,310	1.24%	7.90%	2.25%	9.37%
150,000 - 200,000	3,053	12,690	6,267	16,644	2.07%	8.61%	4.25%	11.30%
200,000 - 250,000	5,370	17,237	10,583	23,586	2.89%	9.28%	5.70%	12.70%
250,000 - 500,000	8,800	26,578	18,734	37,784	3.26%	9.85%	6.94%	14.00%
500,000 - 1,000,000	12,296	48,488	33,119	71,765	2.34%	9.21%	6.29%	13.64%
> 1,000,000	24,590	208,436	121,859	318,331	0.96%	8.13%	4.76%	12.42%
TOTAL FOR ALL	677	3,994	1,375	4,923	1.36%	8.04%	2.77%	9.91%

*Change in after-tax income: Static column is initial change in tax; dynamic column adds change in income and income tax due to economic expansion. All dollars figures are in 2008 dollars, all changes are calculated relative to a 2008 GDP baseline.

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National Press Building
529 14th Street, N.W., Suite 420
Washington, DC 20045

202.464.6200
www.TaxFoundation.org

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