The Heritage Foundation
LEADERSHIP FOR AMERICA

BACKGROUNDER

No. 2704 | JUNE 25, 2012

The President's 2013 Budget: More Troubling Tax Increases in the Fine Print

Curtis S. Dubay

Abstract
Buried in the fine print of President Obama's FY 2013 budget proposal is an expansion of his cap on itemized tax deductions—to now include exemptions and exclusions. Applying the cap to exemptions and exclusions is yet another way the President has devised to increase the already sizeable tax burden shouldered by families and small businesses who earn $200,000 or more a year. This policy change so badly violates the basic tenets of sound taxation that it is little more than a move to further punish the most successful Americans with yet another confiscatory tax increase. Congress should reject the President's cap, like it has in the past, and focus on revenue-neutral fundamental tax reform that would lower tax rates and improve neutrality to encourage economic growth.

This paper, in its entirety, can be found at **http://report.heritage.org/bg2704**

Produced by the Thomas A. Roe Institute for Economic Policy Studies

The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

It is generally known that President Barack Obama's fiscal year (FY) 2013 budget calls for a massive $2 trillion tax increase. This amount is not explicitly in the budget because it hides several tax increases in the fine print.[1] Also buried deep in the fine print is the President's expansion of his cap on itemized deductions, which, unlike in previous years, now applies to tax exemptions and exclusions.

The devil really is in the details in this case. Applying the cap to exemptions and exclusions is yet another way the President has devised to increase the already sizeable tax burden shouldered by individuals and small businesses earning $200,000 a year or more ($250,000 for married couples). This makes it yet another growth-slowing tax increase in the long list of tax increases already proposed by the President.

President Obama's cap would slow growth even further because it would also move taxes further from neutrality. A proper tax code does not influence economic decisions of families, businesses, investors, and entrepreneurs. Neutrality is the standard against which tax policies are compared in order to determine if they influence decisions. A neutral policy is one that does not influence,

Key Points

- Buried deep in the fine print of President Obama's FY 2013 budget is the expansion of the President's cap on itemized deductions to income currently exempt or excluded from tax.
- The income exemptions or exclusions most affected would be state and local bond interest, employer-sponsored health insurance, and contributions to retirement savings plans.
- The policy would slow job growth by raising taxes for job creators, and would slow economic growth by moving taxes yet further from neutrality.
- The proper treatment of tax exemptions and exclusions is vital for instituting a neutral tax code. Changing their tax treatment should not be seen simply as an accounting exercise to raise more revenue for the government.
- This policy change so badly violates the basic tenets of sound taxation that it is little more than a move to punish the most successful Americans with another confiscatory tax increase.

neither in a positive nor negative way, economic choices. Policies that move in the opposite direction of neutrality, like President Obama's application of his cap to exemptions and exclusions, slow growth.

Congress has rightly rejected the President's cap in previous years. The inclusion of exemptions and exclusions should give it even more reason to do so again.

Capping Exemptions and Exclusions

In each of his three previous budgets, President Obama proposed a cap on the itemized tax deductions of individuals and businesses earning $200,000 or more a year. The cap served different purposes in previous budgets. In 2009, it was a way to raise revenue for the impending health care bill. In 2010, it was a way to raise more revenue for general spending. In 2011, the President wanted a cap as a misguided way to "pay for" patching the alternative minimum tax (AMT) for middle-income taxpayers. This year, the cap is back as an intended revenue raiser.

In its first three iterations, the cap restricted taxpayers' itemized deductions to the amount that those deductions would have reduced their tax bill had they paid the 28 percent marginal rate instead of the higher marginal rate they actually paid.[2] This year, the cap still limits deductions to their value at the 28 percent marginal tax rate, but now also applies to tax exemptions and exclusions as well.

President Obama provided no details in his budget about how the expansion of the cap would work, but the Treasury Department reports that, at a minimum, President Obama's cap would include the following exemptions or exclusions:

- State and local bond interest;
- Employer-sponsored health insurance paid for by employers or pre-tax employee dollars;
- Health insurance costs of self-employed individuals;
- Employee contributions to health savings accounts and Archer Medical savings accounts; and
- Contributions to defined-contribution retirement plans and individual retirement arrangements.[3]

Job-Destroying Revenue Grab

Expanding the cap to exemptions and exclusions greatly expands the policy's tax-hiking capacity. In President Obama's FY 2012 budget, when the cap only applied to itemized deductions, the Treasury Department estimated that it would raise $321 billion over 10 years.[4] Now that the cap includes exemptions and exclusions, the Treasury Department estimates that it would raise $584 billion over 10 years.[5] That is an increase of more than 80 percent.

The extension of the cap to exemptions and exclusions is another way to raise the taxes of job creators, such as businesses that pay their taxes through the individual income tax, as well as investors and entrepreneurs. The President already wanted to raise their marginal tax rates, their tax rates on capital gains and dividends rates, and revive old provisions that phased out their *personal* exemptions and deductions (PEP and Pease).

APPLYING THE CAP TO EXEMPTIONS AND EXCLUSIONS IS YET ANOTHER WAY TO INCREASE THE ALREADY SIZEABLE TAX BURDEN SHOULDERED BY FAMILIES AND SMALL BUSINESSES EARNING $200,000 A YEAR OR MORE.

By taking even more of these job creators' earnings, President Obama would further erode their already diminished ability to make the investments that are necessary to create the jobs the economy so desperately needs.

Step in Wrong Direction. Expanding the cap to exemptions and exclusions would slow economic growth not merely by taking resources from job creators, but also by moving taxes further from neutrality. It would also make repairing the broken health insurance market more difficult. The new cap would do these

1. Curtis S. Dubay, "Obama's Budget Badly Undercounts Tax Hikes," Heritage Foundation *Issue Brief* No. 3522, February 29, 2012, http://www.heritage.org/research/reports/2012/02/obamas-budget-undercounts-tax-increases.
2. Curtis S. Dubay, "Obama FY 2013 Budget Violates Basic Principles of Tax Reform," Heritage Foundation *Backgrounder* No. 2665, March 19, 2012, http://www.heritage.org/research/reports/2012/03/obama-fy-2013-budget-violates-basic-principles-of-tax-reform.
3. U.S. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals*, February 2012, p. 74, http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf (accessed June 20, 2012).
4. U.S. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals*, February 2011, p. 148, http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2012.pdf (accessed June 20, 2012).
5. U.S. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals*, p. 203.

things by levying tax on the following exemptions or exclusions:

- **Exemption of interest on state and local bonds.** Bonds issued by state and local governments generally pay a lower interest rate than bonds with similar risk characteristics and maturities because they are exempt from federal income tax. The exemption is justified by some as reflecting federal fiscal support for state and local governments. Others justify the exemption as recognizing the financing authority of another governmental entity.

  The tax policy justification is simply that state and local governments are federally tax exempt entities, thus they cannot deduct their interest expense, and thus no tax should be levied on interest paid. In short, the exemption preserves tax neutrality.

  A neutral tax, in order not to encourage or discourage borrowing and lending decisions, provides a deduction of interest for taxable borrowers and taxes interest earned to lenders. This is the case for bonds issued by most nongovernmental borrowers. In this arrangement, the investment decision is unaffected by tax because lenders demand a higher interest rate than they would if they paid no tax to meet the after-tax rate of return on the investment they require. But borrowers are willing to pay the higher rate because they receive a deduction for it. As a result, the same amount of investment occurs as would have without tax.

  A neutral tax can also be preserved by exempting interest paid to the lender from tax, yet disallowing a deduction for interest expense to the borrower. In this case, borrowers cannot deduct their interest costs, so they seek lower interest rates than if they could take the deduction. Lenders are willing to accept the lower rate because they do not pay tax on the interest they earn. As in the first example, the amount of investment remains the same—as if the tax never entered into the equation.

  State and local governments are sovereign, and so do not pay federal taxes. Since they do not pay tax they cannot deduct their interest costs. Therefore, to maintain neutrality, it is proper to provide an exemption for the interest earned by the investors that buy their bonds.

  Making state and local government bond interest taxable, as President Obama's cap would do for upper-income earners, would artificially reduce the amount of bonds issued by state and local governments because it would raise the interest rate required by bond buyers. This would shift the allocation of investment from its composition had taxes remained neutral. A tax-imposed shift of investment reduces efficiency and therefore economic growth.

  It is unclear whether the President's cap would apply to only state and local government bonds issued after implementation of the cap, or to previously purchased bonds as well. If it does apply to previously purchased bonds, the current owners of those bonds would see the value of their interest payments reduced by the amount of tax they would pay under the cap. Since these bond owners bought the bonds under the assumption that the interest would be tax-exempt, and therefore accepted a lower interest rate, the President's cap would impose a retroactive wealth tax on these holdings.

  Other tax increases on previous investments, for instance an increase in the dividends tax rate, are also retroactive taxes. However, with other investments, tax already applies to returns, and investors assume the risk that tax rates could climb in the future. When it comes to state and local bonds, as a matter of long-standing and widely supported practice, no tax has ever been levied on this form of interest income. As such, the expectation of risk regarding a tax hike on the interest from state and local bonds is essentially non-existent.

- **Exemption for contributions to retirement savings accounts.** A neutral tax code taxes income only once. That means that someone earns income, he pays tax on that income, and is then free to spend it or save it without paying any additional federal tax. Neutrality can also be maintained if the taxpayer saves a portion of his wages before paying tax on it, and then pays tax on the appreciated amount of that income when he later withdraws the savings.

  The current tax code falls well short of this standard by double-taxing savings, but for more than 30 years has been taking small steps towards neutrality with the growth of traditional 401(k) and individual retirement accounts

(IRAs). For the most part, taxpayers put pre-tax income into these retirement savings plans, where it builds up without any additional taxes on any investment income or interest the account earns. When they withdraw the money after retirement, they pay tax on the amount that they have withdrawn as they would under a neutral tax system.

President Obama's cap would turn back the progress these accounts represent. His cap would make contributions to these accounts deductible only at the 28 percent rate, instead of the 35 percent rate the saver should receive as he does under current law. This change would apply to taxpayers who earn $200,000 a year or more, and would not change how disbursements from the accounts are taxed after the savers retire. The cap would in essence make a retirement savings plan closer to a normal savings plan. It would reduce the incentive for taxpayers to save for retirement, and lower investment across the economy as taxpayers consumed more of their income rather than saving it for retirement. Lower investment slows job creation and economic growth.

- **Exclusion for employer-provided health insurance premiums.** Premiums for employer-provided health insurance, both the portion of the premium paid by employers and employees, is tax-exempt. Income used to pay premiums for non-employer based plans is fully taxable.

This tax bias is one of the fundamental flaws of the health insurance system and it is long overdue for Congress to fix it. President Obama's cap would make fixing it more difficult. Properly eliminating the bias would mean subjecting employer-paid premiums to income and payroll taxes. Congress would then use the resulting additional tax revenue to reduce taxes on income used to purchase health insurance on the open market. Many tax and health care reform plans would replace the open-ended exclusion with a tax credit that taxpayers could claim for premiums paid up to the value of the credit.

THE CAP WOULD REDUCE THE INCENTIVE FOR TAXPAYERS TO SAVE FOR RETIREMENT, AND LOWER INVESTMENT ACROSS THE ECONOMY AS TAXPAYERS CONSUMED MORE OF THEIR INCOME RATHER THAN SAVING IT FOR RETIREMENT.

An interim step would place a limit on the tax preference for employer-paid premiums, above which the premium payments would be included in taxable compensation for workers.[6] Although details are scarce, it appears that President Obama's cap would not function like a true limit on the tax exemption for employer-provided plans. Rather, it would simply limit the tax preference available to a taxpayer to the value that would exist if the entire premium were tax-exempt at the 28 percent tax bracket. That means that a taxpayer in the 35 percent bracket will still get a tax break, but it will be proportionally reduced so that the value is limited to what it would be in the 28 percent bracket. This would create a weaker disincentive for enrolling in expensive insurance plans than would a proper limit on the exclusion, because the higher the premium, the higher the tax break, even in the 28 percent bracket.

Another defect of the President's proposal is that the revenue raised would be spent on other programs, while leaving the tax bias against insurance plans not purchased through employers firmly in place. Without this revenue to offer tax relief for non-employer-based health plans, Congress will have a significantly tougher job finding the resources to alleviate the bias.

Focus on Tax Reform

Changing the tax treatment of exemptions and exclusions should not be seen simply as an accounting exercise to raise more revenue for the government to spend—as President Obama envisions it. The proper treatment of tax exemptions and exclusions is vital to instituting a neutral tax code. Congress should only change their tax treatment to improve neutrality, or, in cases like the exclusion for employer-provided health insurance, where reform is necessary to alleviate issues created by current exemptions and exclusions.

President Obama's cap would move taxes further from neutrality, which will harm economic growth. Just as troubling, there is no

6. Greg D'Angelo and Robert E. Moffit, "Health Care Reform: Changing the Tax Treatment of Health Insurance," Heritage Foundation *WebMemo* No. 2344, March 16, 2009, http://www.heritage.org/research/reports/2009/03/health-care-reform-changing-the-tax-treatment-of-health-insurance.

evidence that the President considered the serious consequences before deciding to expand his cap to exemptions and exclusions.

This policy change so badly violates the basic tenets of sound taxation that it is little more than a move to further punish the most successful American workers, investors, entrepreneurs, and businesses with yet another confiscatory tax increase.

For these reasons Congress should reject the President's cap, like it has in the past, and focus on revenue-neutral fundamental tax reform that would lower tax rates and improve neutrality to encourage economic growth.

—***Curtis S. Dubay*** *is a Senior Analyst in Tax Policy in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.*