The Bucket and Buffett Approaches to Raising Taxes on High-Income U.S. Individuals

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THE BUCKET AND BUFFETT APPROACHES
TO RAISING TAXES ON HIGH-INCOME U.S. INDIVIDUALS

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I. INTRODUCTION

In the 2012 U.S. presidential election, Democrats stood for the principle that taxes should increase only for the rich, while Republicans stood for the principle that they should increase for no one. Both positions were absurd, given the point (made elsewhere in this volume by Andrew Samwick1) that the U.S. will need more tax revenue in order to meet widely accepted spending commitments, but at least the Democrats’ position was marginally less absurd, since it did not wholly deny the need for additional revenue.

The Democrats’ election victory, along with the fact that the “Bush tax cuts” (i.e., temporary tax rate reductions first enacted in 2001) were scheduled to expire at the end of 2012 in any event, may enable them to win this dispute, at least on a one-time basis. However, the issue of whether high-income individuals’ taxes should distinctively increase is bound to arise again. If and when it does, there is likely to be a reprise of the 2012 U.S. tax policy debate regarding how to increase high-income individuals’ taxes.

The obvious way to increase their taxes would be through upper-bracket marginal tax rate increases. However, concerns of symbolism or perception, backed by claims about good tax policy, have led many to endorse instead an alternative approach, involving distributionally

* Wayne Perry Professor of Taxation, NYU Law School. I am grateful to Kevin Milligan for helpful comments on an earlier draft.
1 See Andrew Samwick, [forthcoming in Canadian Tax Journal].
selective base-broadening. Here the idea is to restrict or deny the benefit of various tax preferences in such a way as to target the impact of the base-broadening on high-income individuals who have such items. An inevitable byproduct of such an approach is that different individuals will in effect face different tax bases.

A leading example of distributionally selective base-broadening is the “bucket” approach to limiting the use of particular tax preferences, endorsed by the 2012 Romney campaign, and likely to be its only lasting legacy apart from the phrase “47 percent.” Under this approach, a ceiling – say, of $25,000 or $50,000 – would apply to the total amount of specified items that a given taxpayer could claim. The proposal’s impact would be directed to high-income individuals if and to the extent that only they potentially might exceed the ceiling in practice. It is called a “bucket” approach because it permits one to fill the “bucket” of allowable tax benefit items however one likes, as between the listed items (which I will call the “bucket list”).

While Republicans have recently been the main proponents of using a bucket approach as an alternative to tax rate increases, there is a prominent Democratic approach, endorsed by the Obama Administration, that I consider substantively similar, albeit differently motivated. This is the so-called “Buffett tax,” named after the billionaire Warren Buffett, who argued that it is unfair if he pays tax at a lower rate than, say, his secretary. Recent proposed legislation that would implement the Buffett tax helps to show that it resembles a bucket approach by reason of its effectively resulting in distributionally selective base-broadening.

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2 For example, the ceiling might apply to particular itemized deduction, such as the home mortgage interest and charitable deductions, and to particular exclusions from income, such as that for employer-provided health insurance.

3 Alternatively, the approach could be a percentage of the taxpayer’s adjusted gross income (AGI), although this would tend to reduce the degree to which it effectively targeted high-income taxpayers, as they would get higher ceiling amounts.

4 See S. 2059, 112th Cong., 2d Sess. (February 1, 2012), introduced by Senator Whitehouse, and providing for implementation of the “Paying a Fair Share Tax Act of 2012.”
What should we think of such approaches, and of their apparently increasing relative popularity? I will argue here that, while they may in some cases be better than the politically feasible alternatives, they have significant defects that should be kept in mind as well. Indeed, they bring to mind nothing so much as the decision, in the Tax Reform Act of 1986, to apply conceptually similar selectivity in the availability of tax preferences to different taxpayers, through the individual and corporate alternative minimum taxes (AMTs). In U.S. tax policy circles, this is not exactly a compliment, as the AMT is widely reviled for increasing the U.S. federal income tax system’s complexity while reducing its transparency.

II. THE BUCKET APPROACH

Governor Romney’s likely political rationale for proposing a bucket approach to tax preferences in the 2012 presidential campaign, to offset some of the revenue loss from his proposal to significantly reduce marginal tax rates, is easy to appreciate. It meant that he could target politically sensitive items, such as the deductions for home mortgage interest and perhaps charitable contributions, while both limiting the main impact to high-income individuals and throwing a veneer of taxpayer choice over the disallowance.

After the election, Republicans who were willing to increase high-income individuals’ taxes, but not their statutory tax rates, continued to support the use of a bucket approach or something similar, for reasons that were well-expressed by economist (and former Romney campaign advisor) Glenn Hubbard. He emphasizes that, from the standpoint of efficiency, making the tax system more progressive is only a problem if it raises high-earners’ marginal tax

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7 See U.S. Code section 163(h)(3).
8 See U.S. Code section 170.
rates, as opposed to their average tax rates. A bucket approach ostensibly navigates this distinction successfully. In addition, by denying the use of tax preferences in certain settings, it effectively results in base-broadening, which one might hope will yield further efficiency gains.

Such arguments are not entirely wrong – although they may equally apply to using an AMT in lieu of increasing marginal tax rates and/or not addressing tax preferences at all. However, their weaknesses, limitations, and clear lack of anything approaching “first-bestness” should be understood as well.

Marginal Versus Average Tax Rate Increase – Hubbard is most clearly on thin ice intellectually when he suggests that distinctively targeting high-earners’ tax preferences only increases their average tax rates, as distinct from marginal tax rates. He is correct in the scenario where a given high-income individual, who either has already reached the limit for allowable tax preferences or else would not consider increasing them even if he had more income, is deciding whether to earn an additional dollar. In other scenarios, however, the two cannot be separated so neatly. Suppose, for example, that one is deciding whether to earn additional income, part of which one would spend on tax-favored items that the bucket approach would disallow. Then one’s true marginal tax rate with respect to the choice is raised by a bucket approach.

This is not just an abstract conceptual point, but one that is potentially very important in practice. Consider the recent debate over work by Peter Diamond and Emmanuel Saez, arguing that marginal tax rates for high-income individuals should exceed 70 percent, partly due to evidence that high earners have low labor supply elasticity. Some of those who disagree have

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argued that the long-run behavioral response to high marginal tax rates at the top is both greater and more important than the short-term response. For example, “[i]magine a high school student who graduates in a world where the top marginal income tax rate is [high rather than low] ….. He may decide not to pursue his dream of becoming a college-educated engineer because the government will take a large share of the returns to his college investment.”12 Such an assessment presumably will reflect how high-earners actually end up doing under the existing federal income tax system, and it may make no difference whether their tax burdens are raised by explicit tax rate increases or indirect means.13

Efficiency Versus Distributional Concerns – Suppose we nonetheless agree with Hubbard that selectively applying tax preference denial to high-earners does less than explicitly raising the top tax rates to reduce incentives to earn income. This only addresses efficiency (and incompletely, as I discuss next), as distinct from distributional concerns. If efficiency were all that we cared about, a lump sum tax, such as a uniform head tax, would be better still. Tax system design, however, involves tradeoffs between efficiency and distribution.

One clear potential distributional problem with bucket-type approaches concerns their incidence within the group of high-income taxpayers. Depending on one’s reasons for favoring greater progressivity in the tax system, increasing taxes for those at the very top – the super-rich, as opposed to the merely rich – may be especially important. For example, one might posit that their marginal utility of dollar is especially close to zero (or should count least in the social welfare metric), or one might believe that extreme wealth concentration at the very top has especially large adverse social effects.

12 Aparna Mathur, Sita Slavov, and Michael R. Strain, Should the Top Marginal Tax Rate Be 73 Percent?, 137 Tax Notes 905, 909 (2012).
13 Similarly, if one has tax planning opportunities to reduce one’s taxable income substantially without actually earning less economically, one will presumably take into account the benefit from escaping the reach of bucket-type rules, in measuring the expected benefit from such opportunities.
Marginal rate increases are well-designed to avoid having a diminishing relative impact as high-end income increases. A bucket approach, by contrast, can easily end up having a declining percentage effect on after-tax income as one moves from being rich to being super-rich. Many of the items that potentially might appear on a “bucket list” tend on average to fall as a percentage of income as such income rises at the top end.\(^\text{14}\) And if a bucket approach is designed so that the relative tax hit does indeed stay constant or even increase, as pre-tax income rises at the top of the scale, then apparently it is operating like a marginal rate increase, and the claimed efficiency advantages may be lost.

**Efficient subsidy design** – A frequently overlooked issue in discussions of distributionally selective base-broadening is how it might affect the incentive structure for remaining tax benefits. One way of framing the underlying problem is as follows. When the tax system provides a benefit, such as a credit, exclusion, or deduction, that is unrelated to measuring relative wellbeing (such as via the income definition), the resulting tax saving can (as emphasized by the literature on tax expenditures) be thought of as a subsidy. Where the tax saving is based a given outlay by the taxpayer (including the implicit outlay represented by receiving in-kind benefits in lieu of cash), one can compute a marginal reimbursement rate (MRR) for the outlay. For example, if I am in the 35 percent marginal tax bracket, a one-dollar special deduction or exclusion gives rise to an MRR of 35 percent, whereas if I am in the 20 percent bracket, my MRR for the same item is only 20 percent.

This point is well-known in the tax expenditure literature. Stanley Surrey, for example, decried special deductions and exclusions as “upside-down subsidies” that implicitly, and in his

\(^{14}\) Consider, for example, home mortgage interest deductions and the exclusion for employer-provided health insurance. One generally would not expect individuals earning, say, $10 million per year to make ten times as much use of these provisions as those earning $1 million per year. There are, however, potential “bucket list” items, such as state and local income tax deductions and charitable contributions, that do not necessarily exhibit such relative decline.
view for no good reason, offered higher MRRs (in my terminology) to high-income taxpayers than to those in lower tax brackets.15 Lily Batchelder, Fred Goldberg, and Peter Orszag have recently argued that, absent specific reasons for having MRRs vary as between taxpayers, the optimal approach is likely to be setting them at the same level for everyone, such as through the use of fixed-percentage, refundable tax credits in lieu of exclusions and deductions.16

While this way of thinking about tax subsidy design is well-known, it often is overlooked in analyses of distributionally selective base-broadening, such as through the use of a bucket approach, that could have significant and varying effects on individuals’ MRRs for particular items. In this setting, there are several reasons why the effects on MRRs may matter:

(1) Suppose initially that taxpayers respond to subsidies separately – rather than, say, bidding against each other for tax-favored assets. For example, I may determine my charitable gifts largely separately from what everyone else does. In this setting, while there may be reasons for differentiating people’s subsidy levels, for example, by offering higher charitable MRRs to individuals who are more price-responsive – Batchelder, Goldberg, and Orszag argue that it is generally most efficient to offer uniform MRRs if we have no such differentiating information.17

In practice, with respect to charitable contributions it is plausible that price-responsiveness rises with income, at least in certain ranges.18 Thus, while it would be remarkably fortuitous if present U.S. law got it exactly right by offering an MRR that equals the taxpayer’s marginal tax rate, at least the rising marginal rate structure may lean in the right direction. For other items, however, such as the home mortgage interest deduction and the

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15 See, e.g., Stanley S. Surrey, PATHWAYS TO TAX REFORM 136 (1973) (arguing that tax benefits such as the medical expense deduction are inequitable upside-down subsidies).
17 See id.
exclusion for the value of employer-provided health insurance, one might argue for declining MRRs, on the view that high-income individuals are likely to own homes and carry adequate health insurance even if they are not offered subsidies.

Now suppose we take the view that a given subsidy is wholly inefficient and should not be offered at all. In conditions where we lack relevant differentiating information as between taxpayers, the Batchelder-Goldberg-Orszag uniformity prescription may apply even though we no longer want taxpayers to respond to the incentive. Here the idea is that the deadweight loss from distortive subsidies, like that from distortive taxes, would generally be expected to rise at a faster than linear rate (for example, by quadrupling if the subsidy rate doubles). Thus, equalizing people’s MRRs, by cutting the higher ones in exchange for raising the lower ones, may tend to reduce overall deadweight loss.

(2) A further reason for preferring uniform MRRs as between taxpayers may arise when the underlying tax preferences are tied to tradable assets. Uneven MRRs may lead to inefficient clientele effects, with the tax-favored assets being held by taxpayers with high MRRs, rather than those who would have valued the assets the most on a pre-tax basis. A common example in the literature is accelerated depreciation if, due to loss nonrefundability, it disfavors ownership of depreciable property by companies that lack positive taxable income to offset. Home ownership can pose the same problem if competing purchasers face different MRRs with respect to such tax benefits for home ownership as the home mortgage interest deduction.

(3) A final MRR issue worth noting here pertains to the optimal subsidy rate as the amount that a given individual spends in a particular way keeps rising. Consider again home

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19 See U.S. Code section 105(a).
21 Admittedly, the analysis may be complicated by the fact that tax subsidies may to a degree offset the underlying distortions that result from taxing income.
ownership, which arguably has positive externalities, such as inducing people to pay greater
attention to local amenities that also affect their neighbors. It is very hard to argue, however, that
the decision to have a costlier home, rather than a cheaper one, generates further positive
externalities.\textsuperscript{23} Thus, limiting or capping the tax benefits from home ownership, so that they
operate more at the extensive and less at the intensive margin, may be desirable.\textsuperscript{24} A similar
argument can be made with respect to employer-provided health insurance. While inducing
people to have health insurance may be socially desirable,\textsuperscript{25} the same does not hold, say, for
inducing the purchase of insurance that is costlier than otherwise due to its coverage of routine
expenditures.\textsuperscript{26}

For charitable contributions, a common and plausible argument runs in the opposite
direction. Where taxpayers are likely to give at least some minimum amount to charity in any
event, establishing a deduction floor, under which only further giving is deductible, may make
sense. Optimal MRRs might therefore rise, rather than fall.

The broader point is as follows. Differential MRRs for rising outlays by the same
taxpayer may make sense even if one also favors applying the same MRR schedule to different
taxpayers. However, optimal MRR design may require looking at each item separately, rather
than aggregating them in an overall “bucket list.”

\textsuperscript{23} Indeed, the reverse may be true. Robert Frank argues that people who build large homes impose a cost on others,
by shifting their frame of reference about an acceptably-sized home, thus requiring them to have larger homes than
previously just to remain equally satisfied. See Robert H. Frank, Are Positional Externalities Different From Other
\textsuperscript{24} Present U.S. federal income tax law does this, to a slight degree, by capping the home mortgage loan principal
that can generate allowable interest deductions at $1.1 million. See U.S. Code section 163(h)(3).
\textsuperscript{25} The argument for encouraging people to hold health insurance may rest on the hope that it will ease risk pooling,
thus mitigating adverse selection problems in health insurance, and that ensuring people’s ability to pay for their
own vital care generates positive fiscal externalities, insofar as others would otherwise have paid for the care. See,
e.g., Daniel Shaviro, Should Social Security and Medicare Be More Market-Based? (2012).
\textsuperscript{26} U.S. tax law attempts to limit indirectly the tax benefit from excluding costly employer-provided health insurance
plans that extensively cover routine care, through the so-called “Cadillac tax,” which will apply to high-end plans
beginning in 2018.
Implications for the bucket approach – The complexity of optimal MRR design issues, which I have only briefly touched on here, impedes definitively evaluating a bucket approach to distributionally selective base-broadening. Clearly, however, such approaches create odd MRR patterns, characterized by the sudden emergence of a zero MRR at an artificially determined point that seems unlikely to reflect sound design. In addition, slopping together a bucket list of disparate items that pose divergent design issues seems unlikely to reflect best practice.

Obviously, the core argument for a bucket approach is that it may be more politically feasible than either directly raising high-end tax rates or engaging in more straightforward and generally applicable base-broadening. However, while political feasibility clearly matters, we should keep in mind the downside of sacrificing directness and transparency at this altar.

III. THE BUFFETT TAX

The Buffett tax is not just like an alternative minimum tax; it actually is one. The current legislative version requires an individual with adjusted gross income (AGI)\(^\text{27}\) sufficiently in excess of $1 million to pay federal income plus payroll taxes that total, in the aggregate, at least 30 percent of AGI minus charitable contribution deductions. Thus, the Buffett tax only applies insofar as one would otherwise have paid less than 30 percent in U.S. federal income plus payroll taxes.\(^\text{28}\) For example, if one has AGI, minus charitable contributions, totaling $10 million, and one would otherwise have paid only $1.8 million in such taxes, the Buffett rule would require one to pay an additional $1.2 million, bringing the total paid to $3 million (the requisite 30 percent of $10 million).

\(\text{AGI differs from taxable income in that it has not been reduced by personal exemptions, or by the taxpayer’s choice between a standard deduction and certain items that are classified as itemized deductions. See U.S. Code section 62. In general, although not in all cases, the itemized deductions are “personal” rather than business-related items – for example, home mortgage interest deductions. However, certain items – for example, investment expenses (see U.S. Code section 212) are classified as itemized deductions even though they may clearly pertain to calculating net economic income.}\)

\(\text{\textsuperscript{28} See S. 2059, supra. The Buffett tax is phased in as AGI rises above $1 million, so that there will not be too large a “cliff” effect at the moment when AGI first reaches that level.}\)
Here the rationale is based more on a view about equity than about efficiency. Ostensibly, it is unfair if a very rich individual’s effective tax rate is less than that of a middle class or poor individual. For this purpose, the effective tax rate is defined as a fraction, the numerator of which is U.S. federal income plus payroll taxes, and the denominator of which is AGI minus charitable contributions.

On its face, this equity rationale for the Buffett rule makes very little sense. An initial question is why one should take a nonlinear view of the use of tax preferences by high income individuals. If using them to lower one’s effective tax rate from, say, 35 percent to 30 percent is fine, then why is further lowering it particularly objectionable? And why should a purely annual measure of both income and tax liability govern here?

However, even if one takes a nonlinear view of tax reduction by high-income individuals, such a view arguably requires casting one’s net more broadly. For example, what about implicit taxes, or reduced pre-tax returns by reason of market responses to a given tax preference? And in the case of capital gain or dividend income derived by a corporate shareholder, what about the entity-level corporate taxes?

Even if one accepts all that, however, the rule’s reliance on AGI as the denominator makes it almost comically selective as an implementation of the underlying principle. AGI can be extremely remote from economic income. For example, it does not include unrealized asset appreciation. Nearly all aggressive tax shelters that U.S. individuals employ will, if legally successful, reduce AGI, rather than just taxable income. Thus, almost the only tax benefits for high-income individuals that the Buffett rule would actually target, apart from itemized deductions other than the charitable deduction, are the capital gains preference and the special
tax rate for dividends. These items would be affected because they are fully included in AGI, and are expressly given a lower tax rate, rather than (to similar effect) being made partly excludable.

The Buffett rule therefore basically amounts to distributionally selective targeting of non-charitable itemized deductions, the capital gains preference, and the low tax rate for dividends – period. Even for individuals who earn primarily capital gains – for example, hedge fund managers who exploit the notorious “carried interest” rule to effectively convert labor income into capital gains – it only works insofar as they are unable to use “strategic trading” opportunities in their overall investment portfolios to realize offsetting capital losses disproportionately to gains.

Surely one can argue for such a rule, such as by reason of its raising revenues entirely from high-income individuals in a manner that may sound good to the general public. However, the argument would almost certainly have to rely on the Buffett rule’s greater political appeal than that of various alternatives that might have much stronger rationales. One downside of adopting it is that it might misleadingly create the impression that all people with high economic incomes, not just those with high AGI, were within its reach. This might conceivably reduce politically achievable high-end progressivity in the long run, by encouraging a mistaken verdict of “mission accomplished.”

IV. CONCLUSION

29 As of 2012, the U.S. tax rate on long term capital gains, as well as on qualified dividends, generally was 15 percent. See U.S. Code section 1(h).
31 See U.S. Code section 1211 (limiting capital loss deductions for individuals to the amount of capital gains plus $3,000).
Tax politics in the U.S. has been convoluted and socially irrational for decades, and if anything has generally been getting worse over the last twenty or more years. The pivot in the 2012 U.S. presidential election towards recognizing that at least someone’s taxes must increase is surely a welcome development, if still far short of what the U.S. needs, either to place itself on a fiscally sustainable long-term course or, in my view, to address adequately rising high-end inequality. To my mind it is on balance unfortunate, however, that rate and base issues are getting tangled up together via the appeal of convoluted, distributionally selective base-broadening.