canadian tax journal / revue fiscale canadienne (2013) 61:2, 425-34

The Bucket and Buffett Approaches to Raising Taxes on High-Income US Individuals

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KEYWORDS: FISCAL POLICY ■ TAX INCREASES ■ TAX BENEFITS ■ TAX BASE ■ ALTERNATIVE MINIMUM TAX ■ UNITED STATES

CONTENTS

Introduction 425
The Bucket Approach 427
Marginal Versus Average Tax Rate Increase 427
Efficiency Versus Distributional Concerns 428
Efficient Subsidy Design 429
Implications for the Bucket Approach 432
The Buffett Tax 432
Conclusion 434

INTRODUCTION

In the 2012 US presidential election, Democrats stood for the principle that taxes should increase only for the rich, while Republicans stood for the principle that taxes should increase for no one. Both positions were absurd, given that the United States will need more tax revenue in order to meet widely accepted spending commitments,[1] though the Democrats' position was marginally less so, since it did not wholly deny the need for additional revenue.

The Democrats' election victory, along with the fact that the Bush tax cuts (temporary tax rate reductions first enacted in 2001) were expiring at the end of 2012, enabled them to win this dispute, at least on a one-time basis. However, the issue of

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1 See the preceding Policy Forum article by Andrew A. Samwick for further discussion of this issue.

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 US tax policy debate on how such increases should be implemented.

The obvious approach would be to raise upper-bracket marginal tax rates. However, concerns of symbolism or perception, backed by claims about good tax policy, have led many to endorse an alternative approach, involving distributionally 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 by-product 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 so-called 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—of, say, \$25,000 or \$50,000—would apply to the total amount of specified items that a given taxpayer could claim.[2] The impact of this proposal would be directed to high-income individuals if and to the extent that only they might exceed the ceiling in practice.[3] This is called a bucket approach because it permits the taxpayer to fill the bucket of allowable tax benefit items however he or she 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 has 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[4] helps to show that it resembles a bucket approach by reason of its effectively resulting in distributionally selective base broadening.

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,[5] to apply conceptually similar selectivity in the availability

2 For example, the ceiling might apply to particular itemized deductions, 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, since they would get higher ceiling amounts. See infra note 27 for further discussion of AGI.

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 Act of 2012.

5 Pub. L. no. 99-514, enacted on October 22, 1986.

of tax preferences to different taxpayers, through the individual and corporate alternative minimum taxes (AMTs).[6] In US tax policy circles, this is not exactly a compliment, since the AMT is widely reviled for increasing the complexity of the US federal income tax system while reducing its transparency.

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[7] and perhaps charitable contributions,[8] 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 the economist (and former Romney campaign adviser) Glenn Hubbard. He emphasized that, from the standpoint of efficiency, making the tax system more progressive is a problem only if it raises high earners' marginal tax rates, as opposed to their average tax rates.[9] 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.[10] 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 their marginal rates. He is correct in the scenario where a given high-income

6 See the Internal Revenue Code of 1986, as amended (herein referred to as "the Code"), sections 53 through 59.

7 See Code section 163(h)(3).

8 See Code section 170.

9 See Glenn Hubbard, "How the US Can Avoid Falling off the Fiscal Cliff," *Financial Times*, November 12, 2012 (www.ft.com/intl/cms/s/2/66564c38-2cbd-11e2-9211-00144feabdc0 .html#axzz2E7fuvsNU).

10 For early analyses of how to think about provisions such as the AMT, see Daniel Shaviro, "Perception, Reality and Strategy: The New Alternative Minimum Tax" (1988) 66:1 *Taxes: The Tax Magazine* 91-113; and Daniel Shaviro, "Selective Limitations on Tax Benefits" (1989) 56:4 *University of Chicago Law Review* 1189-1260.

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 the individual is deciding whether to earn additional income, part of which he would spend on tax-favoured items that the bucket approach would disallow. In this situation, the individual's true marginal tax rate with respect to the choice is increased 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 Diamond and Saez arguing that marginal tax rates for high-income individuals should exceed 70 percent, partly on the basis of evidence that high earners have low labour supply elasticity.[11] Some of those who disagree have argued that the long-run behavioural 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 has less impact on incentives to earn income than does the alternative approach of explicitly raising the top tax rates. This only addresses efficiency (and does so 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

11 Peter Diamond and Emmanuel Saez, "The Case for a Progressive Tax: From Basic Research to Policy Recommendations" (2011) 25:4 *Journal of Economic Perspectives* 165-90.

12 Aparna Mathur, Sita Slavov, and Michael R. Strain, "Should the Top Marginal Tax Rate Be 73 Percent?" (2012) 137:8 *Tax Notes* 905-15, at 909.

13 Similarly, if a taxpayer has tax-planning opportunities to reduce her taxable income substantially without actually earning less economically, she will presumably take into account the benefit from escaping the reach of bucket-type rules, in measuring the expected benefit from such opportunities.

one's reasons for favouring 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.

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.[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 well-being (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 on 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 39.6 percent marginal tax bracket, a one-dollar special deduction or exclusion gives rise to an MRR of 39.6 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. Surrey, for example, decried special deductions and exclusions as "upside-down subsidies" that implicitly, and in his view for no good reason, offer higher MRRs (in my terminology) to high-income taxpayers than to those in lower tax brackets.[15] Batchelder, Goldberg, and

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 10 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.

15 See, for example, Stanley S. Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (Cambridge, MA: Harvard University Press, 1973), at 136 (arguing that tax benefits such as the medical expense deduction are inequitable upside-down subsidies).

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 context, 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-favoured assets. For example, I may determine my charitable gifts, for the most part, independently from other people's choices. 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 et al. argue that if we have no such differentiating information, it is generally most efficient to offer uniform MRRs.[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 US law got it exactly right by offering an MRR that equalled the taxpayer's marginal tax rate, at least the rising marginal rate structure might lean in the right direction. For other items, however, such as the home mortgage interest deduction and the exclusion for the value of employer-provided health insurance,[19] 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 et al. 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

16 See Lily L. Batchelder, Fred T. Goldberg Jr., and Peter R. Orszag, "Efficiency and Tax Incentives: The Case for Refundable Tax Credits" (2006) 59:1 *Stanford Law Review* 23-73.

17 Ibid.

18 See, for example, Jon Bakija and Bradley Heim, *How Does Charitable Giving Respond to Incentives and Income? Dynamic Panel Estimates Accounting for Predictable Changes in Taxation*, NBER Working Paper no. 14237 (Cambridge, MA: National Bureau of Economic Research, August 2008), at 7.

19 See Code section 105(a).

at a faster than linear rate (for example, by quadrupling if the subsidy rate doubles).[20] Thus, equalizing people's MRRs, by cutting the higher ones in exchange for raising the lower ones, may tend to reduce overall deadweight loss.[21]

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-favoured assets being held by taxpayers with high MRRs rather than taxpayers who would have valued the assets the most on a pre-tax basis. A common example in the literature is accelerated depreciation if, owing to loss non-refundability, it disfavours ownership of depreciable property by companies that lack positive taxable income to offset.[22] 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 ownership, which arguably has positive externalities, such as inducing people to pay greater attention to local amenities that also affect their neighbours. It is very hard to argue, however, that the decision to have a costlier home, rather than a cheaper one, generates further positive externalities.[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.[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,[25] the same does not hold, say, for inducing

20 Compare Harvey S. Rosen and Ted Gayer, *Public Finance*, 8th ed. (Boston: McGraw-Hill, 2008), at 340.

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.

22 Compare Surrey, supra note 15, at 135-36.

23 Indeed, the reverse may be true. 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, "Should Public Policy Respond to Positional Externalities?" (2008) 92:8-9 *Journal of Public Economics* 1777-86.

24 Present US 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 Code section 163(h)(3).

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, for example, Daniel Shaviro, *Should Social Security and Medicare Be More Market-Based?* NYU Law and Economics Research Paper no. 12-41 (New York: New York University School of Law, December 2012).

the purchase of insurance that is costlier than it would otherwise be, owing to its coverage of routine expenditures.[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 giving above the assumed minimum level gives rise to deductions, 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 be good policy even if one also favours applying the same MRR schedule to different taxpayers. However, optimal MRR design may require looking at each item separately, rather than aggregating items in an overall bucket list.

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.

THE BUFFETT TAX

The Buffett tax is not just like an AMT; it actually is one. The current legislative version requires an individual with adjusted gross income (AGI)[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

26 US 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.

27 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 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 Code section 212)—are classified as itemized deductions even though they may clearly pertain to calculating net economic income.

tax applies only insofar as an individual would otherwise have paid less than 30 percent in US federal income plus payroll taxes.[28] For example, if an individual had AGI, minus charitable contributions, totalling $10 million, and he would otherwise have paid only $1.8 million in income plus payroll taxes, the Buffett rule would require him to pay an additional $1.2 million, bringing the total paid to $3 million (the requisite 30 percent of $10 million).

Here the rationale is based more on equity than on efficiency. Ostensibly, it is unfair if the effective tax rate of a very rich individual 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 US 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 non-linear view of the use of tax preferences by high-income individuals. If using them to lower one's effective tax rate from, say, 39.6 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 non-linear 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 US 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.[29] 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

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28 See S 2059, supra note 4. 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.

29 Even without the Buffett rule, starting in 2013 the United States has mildly graduated tax rates on long-term capital gains and qualified dividends. These rates are generally 15 percent, but 20 percent for individuals with AGI in excess of $400,000 ($450,000 for married couples).

to effectively convert labour income into capital gains[30]—it works only insofar as they are unable to use strategic trading opportunities in their overall investment portfolios to realize offsetting capital losses disproportionately to gains.[31]

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, compared to various alternatives that might have much stronger rationales. One downside of adopting the Buffett tax is that it might misleadingly create the impression that all people with high economic incomes, not just those with high AGI, are within its reach. This might conceivably reduce politically achievable high-end progressivity in the long run, by encouraging a mistaken verdict of "mission accomplished."

CONCLUSION

Tax politics in the United States has been convoluted and socially irrational for decades, and if anything has generally been getting worse over the last 20 years or more. The pivot in the 2012 US presidential election toward recognizing that at least *someone's* taxes must increase is surely a welcome development, if still far short of what the United States needs, either to place itself on a fiscally sustainable long-term course or, in my view, adequately to address rising high-end inequality. I consider it on balance unfortunate, however, that rate and base issues are getting tangled up together via the appeal of convoluted, distributionally selective base broadening.

30 On the carried interest issue, see, for example, Victor Fleischer, "Two and Twenty: Taxing Partnership Profits in Private Equity Funds" (2008) 83:1 *New York University Law Review* 1-59.

31 See Code section 1211 (limiting capital loss deductions for individuals to the amount of capital gains plus $3,000).