

The Takeaway

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Trade, Economics, and Public Policy

Are There Benefits to a Higher Standard?

The Effects of Raising the Standard Tax Deduction

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The US personal income tax code is an attractive target for reformers. It is complicated, confusing, and riddled with loopholes and deductions that distort taxpayer behavior. Increasing the standard deduction would simplify the code and benefit most taxpayers, but have consequences for fairness and for the public, private, and nonprofit sectors.

HOW DOES THE FEDERAL INCOME TAX WORK?

Individuals and married couples pay the US personal income tax according to their “taxable income.” Those with higher taxable incomes pay higher tax rates (i.e. are in a higher tax bracket) than

those with lower taxable incomes.

Taxable incomes are calculated as adjusted gross incomes minus the appropriate number of personal exemptions and tax deductions. Each eligible member of the household represents one



WHAT'S THE TAKEAWAY?

Tax reform proposals that increase the standard deduction would reduce administrative burdens, but also have other consequences.

With a higher standard deduction, only a fraction of US taxpayers—those in specific states and higher tax brackets—would enjoy the tax advantages associated with itemized deductions.

Getting rid of itemized deductions altogether would be cleaner and fairer.

exemption, and therefore reduces taxable incomes by \$4,050.

Each taxpayer can further reduce their taxable income by claiming either the standard or the itemized deduction, whichever is greater.

- The standard deduction for 2017 is between \$6,350 (for taxpayers who are single or married filing separately) and \$12,700 (for married filing jointly).¹
- The itemized deduction is the sum of eligible expenditures on:
 - medical and dental expenses,
 - taxes paid at the state and local level,
 - mortgage interest,
 - gifts to charity, and
 - miscellaneous other expenses.

As a result, a married couple with two kids could claim at least \$28,900 ($\$4,050 \times 4 + \$12,700$) in exemptions and deductions.

Under current law, most US taxpayers choose the standard deduction. Only 30% of US taxpayers took the itemized deduction in 2016 (when filing their 2015 taxes). Of course, the proportions weren't the same in all states. As the map illustrates, taxpayers were more than 2.5 times as likely to itemize in Maryland than in South Dakota or West Virginia. As a general rule, taxpayers were more likely to itemize in states with state-level income taxes or higher housing costs. Also, taxpayers in higher income brackets were more likely to itemize than taxpayers in lower income brackets. Nearly all taxpayers with incomes above \$200,000 itemized while less than 10% of taxpayers with incomes below \$25,000 itemized in 2015.

WHAT DOES IT MEAN TO INCREASE THE STANDARD DEDUCTION?

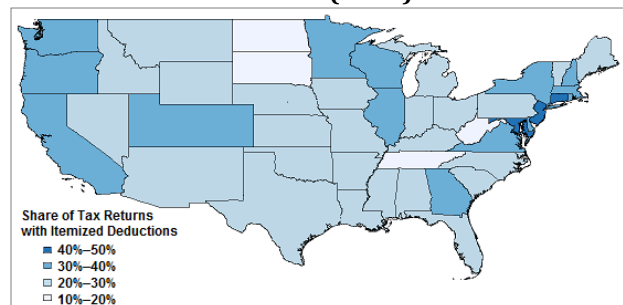
Naturally, increasing the standard deduction will further reduce the number of itemizers. The Tax Policy Center estimates that 84% of taxpayers who currently itemize would take the standard deduction if it were doubled and the available deductions were limited to mortgage interest and charitable donations (as in one of the prominent proposals).² If the standard deduction were increased without changing what can and cannot be deducted, then the decrease in the number of itemizers would not be as dramatic, but it could easily be 33% of current itemizers.³

As a stand-alone proposal, doubling the standard deduction would cut taxable income (and therefore taxes) for everyone who chose not to itemize after the reform. That's ballpark 80% of US taxpayers.

UNINTENDED CONSEQUENCES

When itemization is an option, taxpayers are incentivized to behave in specific ways so that they can maximize their deductions. Removing those tax advantages will undoubtedly alter consumer behavior.

Figure 1: Share of Tax Returns with Itemized Deductions in Each State (2015)



Source: IRS, Statistics of Income Division, Individual Income and Tax Data by State, August 2017. <https://www.irs.gov/statistics/soi-tax-stats-historic-table-2>

There will be less of a tax advantage to owning a home. Under current law, itemizers can deduct not only their mortgage interest but also their property taxes. Raising the standard deduction means that buying a moderately priced home may no longer generate any tax savings for a married couple. Either way—buyers or renters—these taxpayers will be taking the standard deduction. The loss of those tax savings will undoubtedly affect what buyers are willing to pay for moderately priced homes, even though it may have no effect on willingness to pay for more expensive residences.

On the other hand, the income tax advantage to owning a moderately priced home wasn't all that large to begin with. Because everyone can take the standard deduction, itemizers only benefit from the difference between their itemized deductions and the standard one. Many lower-income homeowners in states with no state income tax—like Texas or Tennessee—don't have enough eligible deductions to bother with itemizing under current law.

Furthermore, the tax savings is a function of the tax bracket. Each dollar of extra itemized deductions (above the standard deduction) saves a taxpayer in the 10% bracket one dime, but saves a taxpayer in the top tax bracket 39.6 cents.

In other words, the primary beneficiaries of the itemized deductions for mortgage interest and property taxes already tend to be higher income taxpayers with expensive homes, especially those in states with lots of state and local taxes. Raising the standard deduction will only exacerbate this effect.

There will be less of a subsidy for charitable donations. In tax year 2015 more than 82% of itemizers claimed a deduction for charitable donations. Those itemized donations totaled more than \$222 billion. Most of the donations were made by high income people who are likely to continue itemizing. However, taxpayers with incomes below \$100,000 claimed nearly \$56 billion in deductions for charitable donations, and their giving may be affected.

Of course, changing the tax treatment of donations will not completely deter most donors. Faithful people will still donate to religious organizations. Passionate supporters will still give to universities. Compassionate people will still give to hurricane relief efforts. But research has found that the tax deduction induces people to give more than they would otherwise,⁴ so limiting the number of people who itemize would undoubtedly impact the nonprofit sector.

The federal subsidy for state and local taxes will shrink. Property taxes aren't the only deductible state and local taxes. Itemizers can also deduct either their income or their sales taxes. (They can't deduct both.)

Deductibility means that taxpayers in one state are able to shift some of their tax burden onto taxpayers in another state. For example, consider Maryland, where nearly 46% of taxpayers itemize. A \$1 increase in deductible taxes in Maryland generates between 10 cents and 39.6 cents in federal income tax savings for Maryland residents who itemize. So, the net cost of that \$1 Maryland tax increase is actually between 61 and 90 cents for nearly half of Maryland taxpay-

ers. And federal taxpayers in all other states must pay slightly higher taxes to pay for it.

Increasing the standard deduction will increase the number of taxpayers who bear the full burden of any state and local taxes. That should increase voter scrutiny of state and local government decision-making and make voters less likely to approve state and local tax increases...which might be an unintended consequence after all.

CONCLUSIONS

Simplifying the US personal income tax code is a worthy goal, and increasing the standard deduction is one way to get there. With a higher standard deduction, only a relatively small fraction of US taxpayers would enjoy the tax advantages associated with itemization. The rest of us would enjoy lower taxes and less burdensome tax compliance.

Those privileged few who still itemize will receive subsidies for their health care, housing costs, state and local taxes, and charitable donations that the rest of us will not receive. They will be highly concentrated in

specific states and higher tax brackets. This begs the question: why not simplify even farther, and get rid of itemized deductions altogether? We'd have to find replacement support for the nonprofit sector—maybe through a system of tax credits rather than tax deductions—but that isn't hard. The US income tax code would be cleaner and fairer as a result.

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Notes:

¹ For those filing as heads of households—mostly unmarried individuals with dependent children—the standard deduction for 2017 is \$9,350.

² Burman, L.E., Nunns, J.R., Page, B.R., Rohaly, J., and Rosenberg, J. (2017). An Analysis of the House GOP Tax Plan. *Columbia Journal of Tax Law*, 8(2), 257-294.

³ More than half of itemizing taxpayers have taxable incomes below \$100,000, and the average amount of itemized deductions among those taxpayers is less than \$20,000.

⁴ Brooks, A.C. (2007). Income Tax Policy and Charitable Giving. *Journal of Policy Analysis and Management*, 26(3), 599-612.

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