REVAMPING ITEMIZED AND STANDARD DEDUCTIONS:
EXPLICIT AND IMPLICT BASE BROADENING IN THE TCJA

PRELIMINARY – DO NOT CITE OR QUOTE

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The author thanks Derrick Choe and Erin Melly for excellent research assistance. In this paper, Viard analyzes the changes that the Tax Cuts and Jobs Act made to itemized deductions and the standard deduction. The views expressed are solely those of the author and do not necessarily reflect the views of any other person or institution.

The non-business provisions of the Tax Cuts and Jobs Act (TCJA)[1] made relatively few changes to exclusions, above-the-line deductions, and credits under the individual income tax. However, the TCJA curtailed several itemized deductions, including capping the state and local tax deduction.

However, the curtailment of itemized deductions was not the only major type of individual income tax base broadening done by the TCJA. Another major provision is the implicit base broadening associated with a large-scale switch from itemized deductions to the standard deduction. That switch was partly due to the curtailment of itemized deductions, but was primarily due to a near-doubling of the standard deduction. Switching to the standard deduction is a form of base broadening because it effectively scales back all of the tax preferences provided by itemized deductions. The economic effects of the implicit base broadening are similar to those of explicit base broadening.

I compute a revenue-based measure of the size of the implicit base broadening. The implicit base broadening due to the increase in the standard deduction was comparable to explicit base broadening that repealed $376 billion of deductions and raised $71 billion of revenue.

The economic effects of the TCJA's changes to itemized and standard deductions are mixed. The reduction in the number of itemizers reduced compliance costs, but only to a modest extent. The tax incentive for charitable contributions was curtailed, which may reduce giving by 4 to 5 percent. The tax preference for owner-occupied housing was curtailed, which corrects overinvestment in that sector and may boost labor supply (if housing is a complement to leisure). The state and local tax deduction's potential incentive for expansion of state and local government activity was almost completely eliminated, as very few taxpayers now experience marginal federal tax savings from an increase in state and local tax payments. The repeal of the deduction for employee business expenses may have undesirable effects on labor supply.

The reduced extent of itemization calls into question the role of itemized deductions. The incentive for charitable giving is now confined to a relatively small group of largely affluent taxpayers, raising the question of whether an above-the-line deduction or tax credit would be a superior way to promote giving by all income groups. Similarly, the tax preferences for owner-occupied housing, while smaller, are now even more ill-suited to encouraging homeownership, as they are even more focused on high-income groups that would be unlikely to rent in any case. Apart from the normative implications of this shift, it remains to be seen whether the narrower applicability of itemized deductions will diminish their political support.

I. TCJA'S CHANGES TO ITEMIZED AND STANDARD DEDUCTIONS

[1] Public Law 115-97 (enacted December 22, 2017). The law is widely referred to as the Tax Cuts and Jobs Act, although the provision giving it that name was stricken from the bill during Senate consideration.

The non-business provisions of the TCJA made very few changes to exclusions, above-the-line deductions, and credits under the individual income tax. BRIEF DISCUSSION WILL BE ADDED

However, the TCJA made some significant changes to itemized deductions and it dramatically increased the standard deduction.

A. Background

Section 62(a) provides that an individual's adjusted gross income (AGI) equals her gross income minus the deductions listed in section 62, which are commonly referred to as "above-the-line" deductions. Section 63(d) classifies all other deductions as "itemized deductions" and section 63(e) provides that those deductions are allowable only for taxpayers who elect to itemize. Section 63(b) provides that taxpayers who do not elect to itemize may claim a standard deduction, in the amount set forth in section 63(c). In general, therefore, taxpayers choose between the standard deduction and itemized deductions.[2]

Section 67(b) classifies all itemized deductions other than 12 enumerated deductions as "miscellaneous itemized deductions." Section 67(a) provides that miscellaneous itemized deductions are allowable only to the extent that their aggregate value exceeds 2 percent of AGI.

Under section 56(b)(1)(E), no standard deduction is allowed under the individual alternative minimum tax (AMT). Some itemized deductions are also disallowed under the individual AMT.[3]

B. Changes to Itemized Deductions

The TCJA adopted the following provisions narrowing or removing itemized deductions:

- The section 164 deduction for non-business state and local income, property, and sales taxes was capped at $10,000 for 2018 through 2025.[4]
- The section 163(h) deduction for mortgage interest was denied for interest on home equity loans paid in 2018 through 2025. The cap on the deduction for acquisition interest was lowered from interest on $1,000,000 of debt to interest on $750,000 of debt, for interest paid in 2018 through 2025. However, transition relief was provided for interest on mortgage debt that was outstanding on December 15, 2017 or on debt incurred pursuant to certain contracts signed before that date.[5]
- The section 165(h) deduction for theft and casualty losses was suspended for 2018 through 2025, except for casualty losses due to federally declared disasters. As under pre-

[2] However, section 63(c)(6) requires nonresident aliens and taxpayers with short tax years due to a change in accounting period to itemize deductions and also requires itemization by a married taxpayer filing separately whose spouse chooses to itemize deductions. Under section 63(e)(3) and Treasury regulation section 1.63-1(a), taxpayers may switch between itemizing and claiming the standard deduction on amended returns.

[3] For example, section 56(b)(1)(A) disallows miscellaneous itemized deductions and the deduction for non-business state and local taxes under the individual AMT.

[4] TCJA section 11042 enacted new section 164(b)(6), setting forth the cap.

[5] TCJA section 11043 enacted new section 163(h)(3)(F), setting forth the temporary restrictions.

TCJA law, taxpayers (including those who claim the standard deduction) may use casualty losses to offset casualty gains.[6]

- Miscellaneous itemized deductions, as defined in section 67, which had been subject to the 2-percent-of-AGI floor as discussed above, were suspended for 2018 through 2025.[7]
- The limit on the section 165(d) deduction for gambling losses was reduced from gross gambling winnings to gambling winnings net of associated expenses, for 2018 through 2025.[8]

Two TCJA provisions liberalized itemized deductions:

- The limit on the section 170 deduction for certain cash contributions to charities was increased from 50 percent of AGI to 60 percent of AGI, for contributions made in 2018 through 2025.[9]
- The section 213 medical expense deduction was liberalized by allowing a deduction for expenses exceeding 7.5, rather than 10, percent of AGI, for 2017 and 2018.[10]

The two liberalizing provisions are of limited importance. The increase in the charitable limit affects very few taxpayers and the lower medical-deduction floor was in effect for only two years before expiring at the end of 2018. The TCJA's liberalization of the medical deduction was consistent with health care legislation that previously passed the Republican-controlled House of Representatives, but was a sharp about-face from House Republicans' initial tax blueprint, which called for the deduction to be repealed.[11]

C. Changes to the Standard Deduction

Increase in 2018 Through 2025

Prior to the enactment of the TCJA, section 63(c)(2) provided a basic standard deduction in 1993 equal to $3,000 for single taxpayers, $4,400 for heads of households, and $6,000 for married couples filing joint tax returns. Section 63(c)(4) provided for inflation indexation of those values in years after 1993 based on the Consumer Price Index for all Urban Consumers (CPI-U). Reflecting 25 years of inflation indexation, the 2018 basic standard deduction under pre-TCJA law would have been $6,500 for single taxpayers, $9,550 for heads of household, and $13,000 for married couples.[12]

Sections 63(c)(3) and (f) provide an additional standard deduction in 1993 for blind and elderly taxpayers, equal to $750 for each unmarried taxpayer and $600 for each married taxpayer, with

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[6] TCJA section 11044 enacted new section 165(h)(5), setting forth the suspension.
[7] TCJA section 11045 enacted new section 67(g), setting forth the suspension.
[8] TCJA section 11050 amended section 165(d) to set forth the temporary limitation.
[9] TCJA section 11023 enacted new section 170(b)(1)(G), setting for the temporary increase in the limit.
[10] TCJA section 11027 amended section 213(f) to set forth the temporary changes to the floor.
[11] For further discussion of House Republicans' ambivalent attitudes toward the deduction, see Cody Kallen, "Republicans Need to Get Their Story Straight on the Medical Expense Deduction," Inside Sources, April 3, 2017, https://www.insidesources.com/republicans-need-get-story-straight-medical-expense-deduction/.
[12] Revenue Procedure 2017-58, 2017-45 *Internal Revenue Bulletin* 489 (November 6, 2017).

inflation indexation based on the CPI-U.[13] A taxpayer who is both blind and elderly may claim two additional standard deductions. The 2018 additional standard deduction for the blind and elderly was $1,600 for each unmarried taxpayer and $1,300 for each married taxpayer.[14]

The TCJA prescribes dramatically larger standard deductions for 2018 through 2025. Under new section 63(c)(7), the basic standard deduction for 2018 is $12,000 for singles, $18,000 for heads of household, and $24,000 for married couples.[15] The TCJA therefore increases the 2018 basic standard deduction by a factor of 1.85 for single taxpayers and married couples and by a factor of 1.88 for heads of household. The TCJA made no change to the 2018 additional standard deduction for the blind and elderly.

Permanently Slower Inflation Indexation

Under the TCJA, the basic and additional standard deductions are inflation-indexed based on the chained CPI-U rather than the CPI-U, starting in 2019.[16] The chained CPI-U generally rises more slowly than the CPI-U because it better accounts for consumers' ability to shift their buying patterns in response to relative price changes.[17]

The chained CPI-U rose at an average rate of 1.90 percent per year, compounded annually, from December 1999 (when the index was introduced) to November 2018, compared to a corresponding rate of 2.16 percent for the CPI-U.[18] The Congressional Budget Office expects a difference of approximately 0.25 percentage points per year to persist.[19]

In 2019 through 2025, the slower inflation indexation slightly blunts the boost in the basic standard deduction. The 2025 basic standard deduction for married couples under the TCJA will be approximately 1.82 times higher under the TCJA than it would have been under pre-TCJA law, down from a ratio of 1.85 in 2018. Moreover, the slower inflation indexation slightly reduces the otherwise-unchanged additional standard deduction for the blind and elderly. The 2025 additional standard deduction will be approximately 2 percent lower under the TCJA than it would have been under pre-TCJA law.[20]

Although the TCJA's boost in the basic standard deduction and its curtailment of various itemized deductions expire at the end of 2025, the indexation change is permanent. In years after

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[13] Under section 63(f), the additional standard deduction is available if, at the close of the tax year, the taxpayer is 65 or older, or the taxpayer's central vision acuity does not exceed 20/200 in the better eye with corrective lenses or the widest diameter of the taxpayer's visual field subtends an angle no greater than 20 degrees.

[14] Revenue Procedure 2017-58, *supra* note 12.

[15] Section 11021 of the TCJA sets forth the larger values, which are also listed in Revenue Procedure 2018-18, 2018-10 *Internal Revenue Bulletin* 392 (March 10, 2018).

[16] Section 11002 of the TCJA amended section 1(f) to base indexation on the C-CPI-U.

[17] For further discussion of the chained CPI-U, see Alan D. Viard, "The Chained CPI: A Path to Bipartisan Deficit Reduction," *Tax Notes*, September 26, 2011, pp. 1427-1434.

[18] Bureau of Labor Statistics data show that, from December 1999 to November 2018, the chained CPI-U rose from 100 to 142.470 and the CPI-U rose from 168.3 to 252.038.

[19] Congressional Budget Office, *Options for Reducing the Deficit: 2019-2028*, December 2018, p. 125.

[20] The 2019 basic standard deduction is $12,200 for single taxpayers, $18,350 for heads of household, and $24,400 for married couples and the 2019 additional standard deduction is $1,650 for each unmarried taxpayer and $1,300 for each married taxpayer, Revenue Procedure 2018-57, 2018-49 *Internal Revenue Bulletin* 827 (December 3, 2018).

2025, therefore, the basic and additional standard deductions will be smaller than they would have been under pre-TCJA law, with the shortfall steadily growing over time as each year's inflation adjustment is based on a more slowly rising price index. For example, the 2043 standard deductions will be approximately 6 percent lower under the TCJA than they would have been under pre-TCJA law.

In years after 2025, the TCJA will prompt taxpayers to switch from the standard deduction to itemized deductions, a form of implicit base narrowing. Of course, those effects would not occur if the TCJA's changes to itemized deductions and the standard deduction are extended beyond 2025. (The House of Representatives passed a bill to permanently extend those provisions in September 2018, but the Senate took no action on the bill.)[21] In any event, this article focuses on the TCJA's effects in 2018 through 2025.

II. SWITCHING TO THE STANDARD DEDUCTION: IMPLICIT BASE BROADENING

When tax changes cause a taxpayer to switch from itemizing deductions to claiming the standard deduction, the switch can be considered a form of implicit base broadening. The switch constitutes base broadening in the economic sense because it eliminates, for the switching taxpayer, the preferential tax treatment of those activities that qualify for itemized deductions.

To be sure, the taxpayer who switches and thereby loses itemized deductions gains a standard deduction. Unlike itemized deductions, however, the standard deduction does not confer favorable tax treatment on some activities relative to other activities. Instead, the standard deduction is merely a zero-bracket amount and is effectively part of the rate structure. Joel Slemrod recently commented that the TCJA "broadened the individual tax base a bit, although not as extensively as did the Tax Reform Act of 1986. Much of this happened indirectly, via the near doubling of the standard deduction, which reduces the value of claiming itemized deductions relative to claiming the standard deduction."[22]

As Slemrod notes, implicit base broadening occurs when taxpayers switch to the standard deduction because its value has been increased. As discussed below, that is the source of most of the implicit base broadening accomplished by the TCJA. However, implicit base broadening also occurs when taxpayers switch to the standard deduction because itemized deductions have been curtailed. That implicit base broadening is distinct from the explicit base broadening that directly results from the curtailment of itemized deductions. A modest portion of the implicit base broadening accomplished by the TCJA arises from the curtailment of itemized deductions.

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[21] On September 28, 2018, the House passed H.R. 6760, the proposed "Protecting Family and Small Business Tax Cuts Act," on a 220-191 vote, with Republicans supporting the bill 217-10 and Democrats opposing it 181-3. The bill would have permanently extended, with a few minor modifications, the increase in the standard deduction, the various provisions curtailing itemized deductions, and the liberalization of the charitable deduction. The bill would also have extended the liberalization of the medical expense deduction through 2020.

[22] Joel Slemrod, "Is This Tax Reform, or Just Confusion?" *Journal of Economic Perspectives*, 32(4), Fall 2018, pp. 73-96, at p. 81.

It is useful to examine each type of implicit base broadening.

A. Implicit Base Broadening from Curtailment of Itemized Deductions

Consider a taxpayer who has $14,000 of potential itemized deductions when the standard deduction is $13,000. Suppose that a curtailment of itemized deductions reduces the potential itemized deductions to $12,000, prompting the taxpayer to switch to the standard deduction.

The revenue estimate for the change would show that the taxpayer loses only $1,000 of deductions. The revenue estimate does not, however, accurately measure the extent of base broadening from the change.

The change causes the taxpayer to lose $14,000 of itemized deductions and to gain $13,000 of standard deduction. As explained above, the standard deduction is a zero-bracket amount that does not narrow the tax base. The amount of base broadening from the change is therefore the loss of $14,000 of itemized deductions, just as it would be if all of the taxpayer's itemized deductions had been repealed. The base-broadening equivalence of the two cases is clear; in each case, the taxpayer is left with no marginal tax incentive to engage in any of the deductible activities.

The amount of explicit base broadening from the change is $2,000, but the total base broadening is $14,000, reflecting $12,000 of implicit base broadening from the switch to the standard deduction. Because the revenue gain reflects a net loss of $1,000 of deductions, it fails to capture all of the explicit base broadening, let alone the much larger implicit base broadening.

The switch to the standard deduction *lowers* the revenue gain by giving the taxpayer a larger zero-bracket amount. However, it *increases* the amount of base broadening because it prompts the taxpayer to give up other base-narrowing deductions, including deductions that have not been explicitly curtailed, in exchange for the larger zero-bracket amount.

In this example, the tax change can be decomposed into three components (1) the loss of the $2,000 of itemized deductions that were curtailed (2) the loss of the remaining $12,000 of itemized deductions due to the switch to the standard deduction (3) the allowance of the $13,000 standard deduction due to the switch. The revenue gain from the first component measures the effect of the explicit base broadening. The revenue gain from the second component measures the effect of the implicit base broadening associated with the switch. The revenue loss from the third component measures the effects of the larger zero-bracket amount that replaces the itemized deductions. As discussed in Part III.A, below, the revenue decomposition depends on the stacking order.

Of course, a curtailment of itemized deductions would typically cause only a small fraction of taxpayers to switch to the standard deduction. Only those taxpayers experience implicit base broadening. The curtailment has no effect on taxpayers who claim the standard deduction both with and without the change. For taxpayers who itemize deductions both with and without the change, the curtailment results only in explicit base broadening, which is accurately measured by the static revenue change.

In principle, the effects of switching should be considered in an analysis of changes to any itemized deduction. For example, because a curtailment of the mortgage interest deduction would prompt some taxpayers to switch to the standard deduction, it would reduce charitable contributions as the switching taxpayers would no longer deduct contributions and would therefore face a higher price of giving. Part of the incidence of the change to the mortgage deduction would therefore fall upon recipients of charitable contributions. Conversely, if the mortgage interest deduction raises home prices by boosting demand for owner-occupied housing, then a curtailment of the charitable deduction would lower home prices by inducing some taxpayers to switch to the standard deduction and thereby give up their mortgage interest deductions. Part of the incidence of the change to the charitable deduction would therefore fall on homeowners. The macroeconomic, efficiency, and equity effects of changing any itemized deduction depend, to some extent, on the macroeconomic, efficiency, and equity properties of all itemized deductions.

B. Implicit Base Broadening from Increase in Standard Deduction

Consider a taxpayer with $20,000 of potential itemized deductions. Suppose that the standard deduction is increased from $13,000 to $24,000, prompting the taxpayer to switch to the standard deduction.[23] The revenue estimate for the change would reflects a $4,000 increase in deductions. The revenue estimate does not, however, accurately measure the base broadening implications of the change.

The change causes the taxpayer to lose $20,000 of itemized deductions and to gain $24,000 of standard deduction. The loss of $20,000 of itemized deductions constitutes implicit base broadening. Once again, the switch to the standard deduction *lowers* the revenue gain by giving the taxpayer a larger zero-bracket amount, but expands the tax base by prompting the taxpayer to give up base-narrowing deductions in exchange for a larger zero-bracket amount. As discussed in Part III.B, below, the revenue decomposition depends on the stacking order.

Note that the $13,000 old-law value of the standard deduction does not directly affect the size of the implicit base broadening. However, implicit base broadening occurs only for taxpayers who switch from itemized deductions to the standard deduction, and the old-law value of the standard deduction determines which taxpayers make that switch. The enlargement of the standard deduction has no effect on taxpayers who itemize both with and without the change. For taxpayers who claim the standard deduction both with and without the change, the enlargement is merely an increase in their zero-bracket amounts.

[23] The level of itemized activities actually should be higher when the taxpayer is itemizing than when the taxpayer is not itemizing. (It is simplest to abstract from income effects and focus only on substitution effects). If the level of activities done when itemizing is larger than the standard deduction, but the level done when not itemizing is smaller than the standard deduction, then the optimal choice is ambiguous because two points both satisfy the first-order condition. Note that the budget set is non-convex because the price of the activity declines as more of it is consumed. In contrast, the Heckman problem with labor supply under graduated tax rates has a convex budget set, so the solution then involves locating at a kink.

III. QUANTIFYING TCJA'S IMPLICIT BASE BROADENING

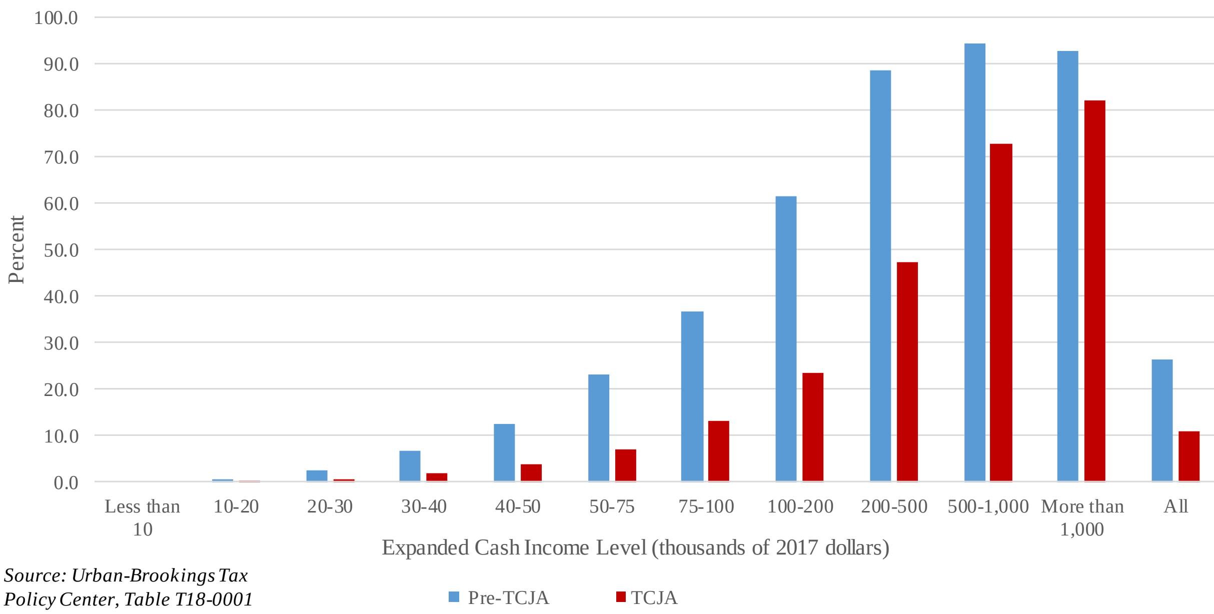
A. Large-Scale Switch to Standard Deduction

The changes made by the TCJA will cause a large number of taxpayers to switch to the standard deduction. Several studies place the number of switchers at 26 to 28 million, approximately three-fifths of those who would otherwise have itemized.

In April 2018, the staff of the Joint Committee on Taxation (JCT) estimated that the number of itemizers would drop from 46.5 million in 2017 to 18 million in 2018.[24] A June 2018 study by my AEI colleagues Alex Brill and Derrick Choe estimated that the TCJA would reduce the number of 2018 itemizers from 47.2 million to 19.9 million.[25] The IRS estimated that the TCJA would reduce the number of 2018 itemizers from 46 million to 20 million.[26]

The Urban-Brookings Tax Policy Center (TPC) has provided particularly complete information, including a detailed breakdown by income level and filing status. TPC estimated that the TCJA would reduce the number of 2018 itemizers from 46.3 million (26.4 percent of tax units) to 19.3 million (10.9 percent of tax units).[27] Figure 1 shows the fraction of tax units at each income level that itemize in 2018, under pre-TCJA law and under the TCJA.

Figure 1: Percent of Tax Units That Itemize

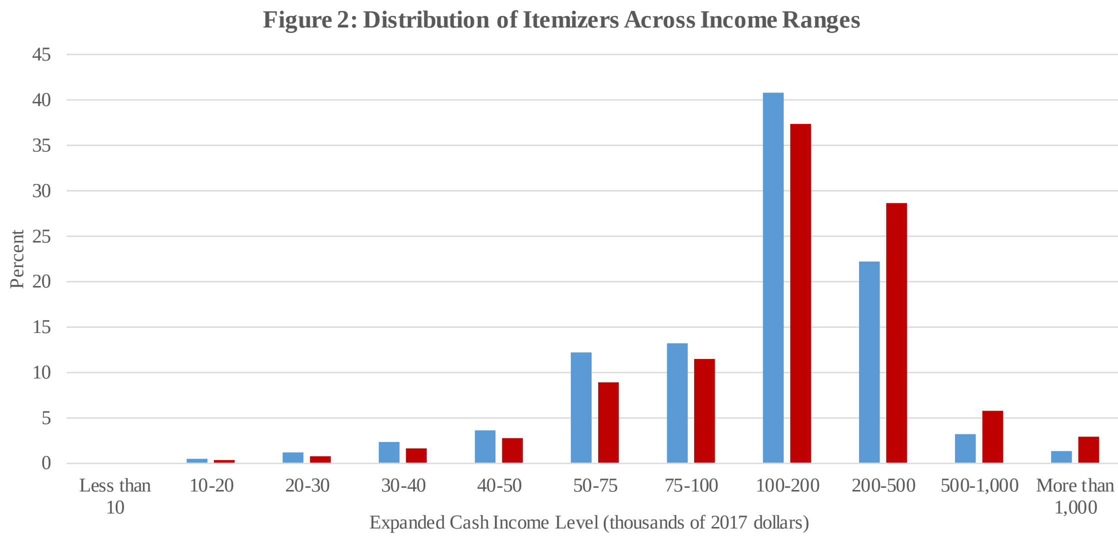


Source: Urban-Brookings Tax Policy Center, Table T18-0001

[24] Joint Committee on Taxation, "Tables Related to the Federal Tax System as in Effect 2017 Through 2026," JCX-32R-18, April 24, 2018, p. 5.
[25] Alex Brill and Derrick Choe, "Charitable Giving and the Tax Cuts and Jobs Act," *AEI Economic Perspectives*, June 2018.
[26] 83 *Federal Register* 34698. 34700 (July 20, 2018).
[27] Urban-Brookings Tax Policy Center, Table T18-001, January 11, 2018.

The TPC estimates reveal that the largest fractions of tax units switch in the $200,000-$500,000 income range, where the itemization rate falls by 41 percentage points, from 89 to 47 percent, and in the $100,000-$200,000 income range, where the itemization rate falls by 38 percentage points, from 61 to 23 percent. There is less switching at the very top, where most tax units continue to itemize, and at the bottom, where almost no tax units itemize under either law.

Due to the differential switching rates, the TCJA alters the income composition of itemizers. Figure 2 shows the fraction of the itemizing population who are in each income group in the TPC estimates.



Source: Author's calculations based on Urban-Brookings Tax Policy Center, Table T18-0001

According to the TPC estimates, a larger fraction of itemizers have incomes above $200,000 under the TCJA. Itemizers are a smaller and richer group of people. As discussed in Part IV, below, the change in the income composition of itemizers has significant implications for the role of itemized deductions.

B. Implicit Base Broadening from TCJA's Changes to Itemized Deductions

I estimate the revenue effects of the explicit and implicit base broadening arising from the TCJA's curtailment of itemized deductions, using the Open Source Policy Center Tax Calculator. The Tax Calculator estimates the potential 2018 itemized deductions of taxpayers that itemized in 2017. The data have a few limitations. The Tax Calculator assumes that casualty loss deductions are zero under the TCJA, although casualty losses due to federally declared disasters are still deductible. The Tax Calculator also assume that all itemized deductions other than medical expenses, state and local taxes, mortgage and investment interest expense, and charitable contributions are zero under the TCJA, although eight other small itemized deductions actually remain available.[28] Also, the Tax Calculator does not distinguish investment interest expense from mortgage interest expense.

As usual, the revenue estimates are sensitive to stacking order. In this case, a few dimensions of stacking order need to be considered.

I stack the TCJA's changes to the itemized deductions, which are considered in this subpart, before the TCJA's enlargement of the standard deduction, which will be considered in subpart C, below. In this subpart, therefore, the policy change being considered is the TCJA's change to itemized deductions, while keeping the standard deduction at its value under pre-TCJA law. All other TCJA provisions are in effect.

The analysis in this subpart is limited to the taxpayers who switch from itemizing to the standard deduction as a result of the curtailment of itemized deductions, with the standard deduction fixed at its pre-TCJA level. Those switchers are the taxpayers who experience implicit base broadening from the TCJA's curtailment of itemized deductions (when that curtailment is stacked before the TCJA's enlargement of the standard deduction). The estimates indicate that 23.8 million taxpayers are in this group.

As discussed in Part II.A, above, the impact of the curtailment on each switcher can be decomposed into three components; the loss of the curtailed deductions, the loss of the other itemized deductions due to the switch, and the allowance of the standard deduction due to the switch. I stack the three components in that order.

For each switcher, I first compute the revenue gain from the curtailment of the itemized deductions, while forcing the switcher to continue itemizing. Then, for each switcher, I compute the revenue gain from removing the remaining itemized deductions, leaving the switcher with no deductions at all. That quantity is the revenue gain from the implicit base broadening, which is the focus of the inquiry. Finally, for each switcher, I compute the revenue loss from allowing the switcher to claim the pre-TCJA standard deduction.

CALCULATIONS TO BE ADDED

C. Implicit Base Broadening from TCJA's Increase in Standard Deduction

The change considered in this subpart is the TCJA's enlargement of the standard deduction. Because the enlargement is stacked after the TCJA's changes to itemized deductions, which were analyzed in subpart B, above, all TCJA provisions other than the increase in the standard deduction are in effect.

The analysis in this subpart is limited to the taxpayers who switch from itemizing to the standard deduction as a result of the increase in the standard deduction. Those switchers are the taxpayers

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[28] As set forth in section 67(b), the other deductions are gambling losses, amortizable bond premiums, impairment-related work expenses, estate taxes in cases of income in respect of a decedent, deductions connected to personal property used in short sales, deductions for repayments of substantial amounts received under claim of right, deductions related to cessations of annuity payments before recovery of investment, and deductions connected to cooperative housing associations.

who experience implicit base broadening from the TCJA's increase in the standard deduction (when that increase is stacked after the TCJA's curtailment of itemized deductions).

As discussed in Part II.A, above, the impact of the increase in the standard deduction on each switcher can be decomposed into two components; the loss of itemized deductions due to the switch and the allowance of the TCJA standard deduction due to the switch. I stack the two components in that order.

For each switcher, I first compute the revenue gain from removing itemized deductions, leaving the switcher with no deductions at all. That quantity is the revenue gain from the implicit base broadening, which is the focus of the inquiry. Then, for each switcher, I compute the revenue loss from allowing the switcher to claim the TCJA standard deduction. CALCULATIONS ARE PRELIMINARY – MINOR DISCREPANCIES ARE STILL BEING RESOLVED

As shown in Table 1, the 2018 switchers gave up $376 billion of itemized deductions in order to obtain $489 billion of standard deductions, reflecting a net $113 billion increase in deductions and generating a $21 billion net tax reduction. The revenue gain from the switchers' loss of itemized deductions (stacked before the allowance of the standard deduction) was $71 billion and the revenue loss from the allowance of the standard deduction to the switchers (stacked after the loss of itemized deductions) was $92 billion. The revenue gain from the implicit base broadening due to the TCJA's increase in the standard deduction was therefore $71 billion.

Table 1 also shows the portion of the revenue gain due to the switchers' loss of each type of itemized deduction, where the deductions were removed in the order listed in the table. The largest revenue gains are due to the switcher's loss of deductions for interest expense and state and local taxes.

Table 1: Impact of Larger Standard Deduction on Switchers, 2018

Type of Deduction	**Change in Deductions ($ billions)**	**Revenue Change ($ billions)**
Charitable Contributions	-56.7	11.0
Interest Expense (Investment and Mortgage)	-129.4	24.5
State and Local Taxes	-159.7	32.5
Medical and Dental Expenses	-30.1	3.3
Total Itemized Deductions	**-375.9**	**71.3**
Standard Deduction	**489.0**	**-92.4**
Net Effect	**113.1**	**-21.0**

In each row of the table, the ratio of the revenue change to the change in deductions is equal to the algebraic opposite of the weighted average of the switchers' marginal tax rates, where the weights are given by the amounts claimed by the switchers for the deduction listed in that row. The ratio is generally in the vicinity of negative .2, indicating that the switchers face an average marginal tax rate around 20 percent. However, the ratio for the medical deduction is negative .11, indicating that switchers who claimed large medical deductions tended to be in lower tax brackets, as one might expect.

The $71 billion of implicit base broadening is significant, representing an increase of more than 4 percent in individual income tax revenue. NEED TO ADD IN IMPLICT BASE BROADENING FROM CURTAILMENT OF ITEMIZED DEDUCTIONS.

I now provide a tentative economic evaluation of the TCJA's curtailment of itemized deductions and its enlargement of the standard deduction.

IV. ECONOMIC EFFECTS OF TCJA'S CHANGES TO ITEMIZED AND STANDARD DEDUCTIONS

A. Itemization and Tax Complexity

The reduction in the number of itemizers reduces compliance costs. Taxpayers who switch to the standard deduction not only can avoid completing Schedule A, but also need not track and document their charitable contributions, mortgage interest payments, state and local tax payments, and other deductible expenditures. However, some taxpayers who end up claiming the standard deduction may devote some effort to tracking and documentation during the year if they believed that they could have ended up itemizing.

The $10,000 cap on the state and local tax deduction is also a simplification as it makes it unnecessary for many itemizers to determine the exact value of their state and local tax payments. The repeal of miscellaneous itemized deductions and the near-repeal of the theft and casualty loss deduction also make it unnecessary for taxpayers to track those expenses. Those repeals offer limited simplification gains, though, because those deductions were claimed by relatively few taxpayers, partly due to income-based floors (that had been adopted in order to reduce the number of taxpayers who needed to track those expenses).

In general, the simplification gains of the TCJA's changes to itemized deductions and the standard deduction are modest. The computation of itemized deductions is far from the source of the greatest tax complexity in the tax system; the computation of business income and expenses, or perhaps even the proliferation of tax-preferred savings accounts and educational tax preferences, poses greater complexity.

The IRS estimates that the TCJA's changes to itemized and standard deductions, its changes to the individual AMT, and its creation of the section 199A above-the-line deduction for qualified business income will, in combination, reduce the average time to complete an individual income tax return by 4 to 7 percent and reduce average out-of-pocket costs by 1 to 3 percent, where the time and cost estimates include tax planning and recordkeeping.[29] A Tax Foundation study finds the annual economic value of the time savings estimated by the IRS to be $3 to $5 billion.[30] Those costs are trivial in comparison to the more than $1.6 trillion of annual revenue raised by the individual income tax system. The IRS may have underestimated the gains and the gains might be larger if computed for the changes to the itemized and standard deductions alone (without netting out the increased costs due to section 199A), but it seems clear that the costs are small relative to revenue.

As discussed below, the TCJA's changes to itemized and standard deductions significantly alter incentives for charitable giving, owner-occupied housing, and state and local governments' activities. Those changes have important equity and efficiency implications that outweigh their effects on compliance costs and the changes should be judged based on those implications. It would be quite sensible for an observer who views the mortgage interest deduction as inequitable and inefficient to oppose it. But, it would be peculiar for an observer who views the deduction as equitable and efficient to oppose it merely because it requires taxpayers to spend a little time tabulating their mortgage payments as they file their tax returns.

Interestingly, the cap on the state and local tax deduction has generated auxiliary complexity that may offset some of its simplicity gains. Some states have adopted laws that allow taxpayers to make charitable contributions to state and local governments in lieu of tax payments, in an attempt to exploit the fact that charitable contributions, including contributions to state and local governments,[31] are not subject to the cap. Treasury has issued proposed regulations that would generally disallow charitable deductions in that context.[32] Other states are replacing taxes on employees' wages with employer payroll taxes that employers may be able to deduct against their business income without regard to the cap (and without regard to whether the employee itemizes), a strategy that may prompt regulatory or legislative responses. Similarly, the repeal of miscellaneous itemized deductions has created uncertainty concerning the treatment of certain expenses incurred by estates and trusts,[33] which Treasury has attempted to address.[34]

B. Economics of Base Broadening

The appropriate purpose of base broadening is to move toward neutral tax treatment of alternative economic activities, so that the tax system does not distort the efficient allocation of resources. The celebrated Atkinson-Stiglitz result[35] provides a rigorous justification of neutral

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[29] 83 *Federal Register* 34698 (July 20, 2018).
[30] Erica York and Alex Muresianu, "The Tax Cuts and Jobs Act Simplified the Tax Filing Process for Millions of Households," *State Tax Notes*, December 10, 2018, pp. 965-970, at p. 970.
[31] Section 170(c)(1) provides that gifts to state and local governments qualify for the charitable deduction.
[32] 83 *Federal Register* 43563 (August 27, 2018).
[33] Jonathan Curry, "Practitioners Fret Over Deductibility of Executor, Trustee Fees," *Tax Notes*, April 30, 2018, pp. 716-717.
[34] Notice 2018-61, "Clarification Concerning the Effect of Section 67(g) on Trusts and Estates," 2018-31 *Internal Revenue Bulletin* 278 (July 30, 2018), describes proposed regulations that Treasury intends to issue on this topic.
[35] Anthony B. Atkinson and Joseph E. Stiglitz, "The Design of Tax Structure: Direct Versus Indirect Taxation," *Journal of Public Economics*, 6(1), 1976, pp. 55-75.

tax treatment of consumer purchases, albeit under restrictive assumptions. Atkinson and Stiglitz showed that in a single-period framework, in which all individuals have identical preferences that are separable between consumer purchases and leisure and there are no exernalities, it is optimal for the government to rely on a (generally nonlinear) income tax system for redistribution while taxing all consumer purchases at the same rate. As Louis Kaplow has emphasized, the result can be extended to settings in which the income tax schedule is not optimal but can be flexibly adjusted; Kaplow shows that (under the maintained assumption of identical separable preferences and no externalities) any policy that taxes consumer purchases non-uniformly is Pareto-dominated by a reform that restores uniformity while making distribution-neutral perturbations to the income tax schedule.[36]

In those settings, nonlinear income taxation (which is equivalent to nonlinear consumption taxation in the single-period framework) offers a better redistribution-efficiency tradeoff than differential taxation of consumer purchases. Although the government could expand the scope of redistribution (while increasing work disincentives) by taxing luxuries at a higher rate than necessities, an appropriate increase in the income tax rate schedule could achieve the same increase in redistribution with the same work disincentives, but without the distortion of consumer choice between luxuries and necessities. Conversely, although the government could reduce work disincentives (while reducing redistribution) by taxing necessities at a higher rate than luxuries, an appropriate decrease in the income tax rate schedule could achieve the same improvement in work incentives with the same reduction of redistribution, but without the distortion of consumer choice between luxuries and necessities.

Under the maintained assumptions of identical separable preferences and no externalities, then, uniform taxation of all consumer purchases is desirable. There should be no special preferences or special penalties for buying some items rather than others. Explicit or implicit base broadening that removes special preferences is therefore likely to be desirable.[37]

Departures from uniformity can be desirable if those maintained assumptions do not hold. Items that have positive externalities should receive tax preferences or other subsidies, and items that have negative externalities should receive tax penalties. For example, tax preferences for charitable giving and homeownership may be desirable if those activities have positive externalities. Taxes on pollution are likely to be desirable due to the negative externalities of pollution.

If preferences are not separable between consumer purchases and leisure, departures from uniform taxation can be desirable. Tax penalties should be imposed on items that are complementary to leisure and tax preferences should be given to items that are leisure substitutes. Base broadening is therefore likely to be beneficial when tax preferences for leisure

[36] Louis F. Kaplow, *The Theory of Taxation and Public Economics* (Princeton University Press, 2008), pp. 127-135.
[37] However, if tax preferences have been given to two items are close substitutes for each other, removing one preference while leaving the other intact may be undesirable, even though it would be desirable to remove both preferences.

complements are curtailed, but it is likely to be harmful when tax preferences for leisure substitutes are curtailed.

A good is a leisure substitute if a compensated reduction in its relative price causes households to consume less leisure by working more. For example, abundant statistical evidence (and common sense) demonstrate that child care satisfies this condition.[38] Thanks to a property of consumer demand functions called Slutsky symmetry, the condition can be restated in an alternative equivalent form: a good is a leisure substitute if a compensated reduction in the wage rate (the price of leisure), which causes the household to work less, also causes households to buy less of the good. Purchases of leisure substitutes can be viewed as work-related costs.

The analysis indicates that a good's status as a luxury or a necessity does not justify a tax penalty or preference. Instead, the relevant factors are the good's externalities and its impact on the labor-leisure choice. Kaplow argues that the analysis of base broadening should be done in a distribution-neutral manner. Whether base broadening falls on the rich or the poor should be disregarded if the income tax rate schedule can be flexibly adjusted.[39]

In general, one might question that focus because it is not always clear that the income tax rate schedule can or will be adjusted. For example, an observer who believes that the current level of redistribution is too low and who thinks the income tax rate schedule cannot be adjusted might support tax preferences for necessities and tax penalties on luxuries.

In the case of the implicit base broadening from the increase in the standard deduction, however, those concerns need not detain us. Distributional adjustments have automatically been made.

For what it is worth, Figure 3 shows the distribution of the burden posed by that implicit base broadening. In other words, it shows the incidence of the $73 billion revenue gain, computed in Part III.C, above, that arises from the switchers' loss of itemized deductions, before the standard deduction is allowed. The chart shows the ratio of each income quantile's share of the total burden to that quantile's share of total income, thereby indicating relative burdens as shares of income. (The income measure is AGI). The heaviest relative burdens fall on tax units between the 60th and 95th percentiles). Because relatively low burdens are imposed at the top and at the bottom of the income distribution, this change is progressive at the low end and regressive at the high end.[40]

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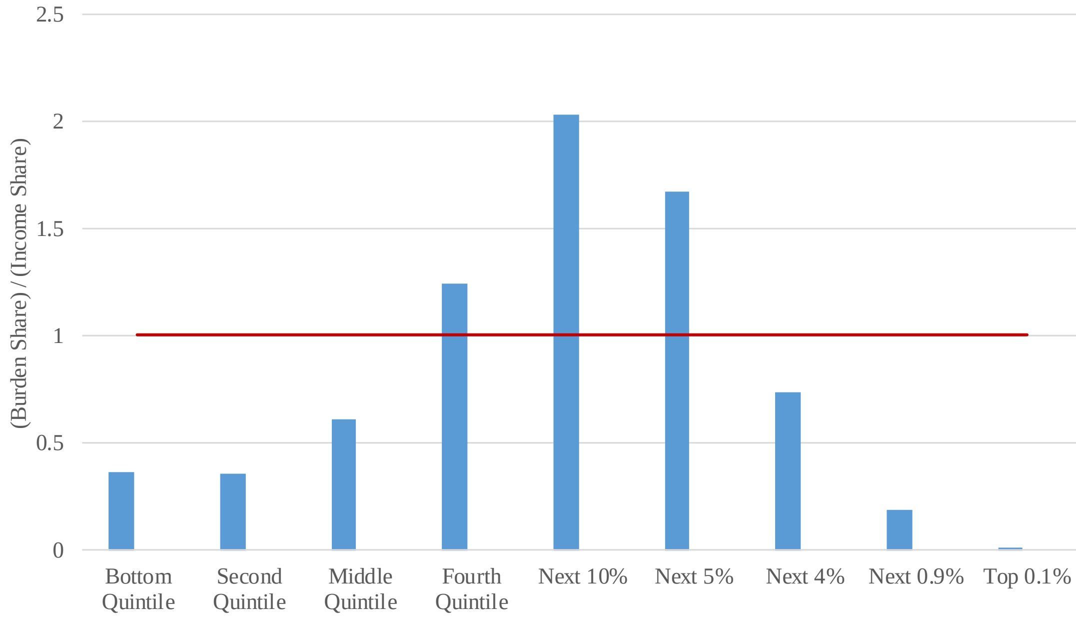
[38] For further discussion, see Alan D. Viard, "The Child Care Tax Credit: Not Just Another Middle-Income Tax Break," *Tax Notes*, September 27, 2010, pp. 1397-1403, at pp. 1399-1400.

[39] Kaplow, *supra* note 36; Louis F. Kaplow, "A Distribution-Neutral Perspective on Tax Expenditure Limitations," *Tax Policy and the Economy*, 2017, pp. 161-188.

[40] For further discussion of policies that are progressive at the low end and regressive at the high end, see Sita N. Slavov and Alan D. Viard, "Taxes, Transfers, Progressivity, and Redistribution: Part 3," *Tax Notes*, November 26, 2018, pp. 1109-1121.

Figure 3: Distribution of Burden Implicit Base-Broadening due to TCJA's Increase in Standard Deduction



Source: Author's Calculations using Open Source Policy Center (OSPC) Tax-Calculator release 0.24.0

Even if that distributional pattern might seem problematic, however, there is no need for concern. Recall that the loss of itemized deductions for the switchers occurs because they voluntarily elect the standard deduction. All of the switchers experience a net tax reduction from the increase in the standard deduction. The burdens of the implicit base broadening are (more than) offset by an increase in zero-bracket amounts.

No such automatic adjustment occurs for the explicit base broadening achieved by the curtailment of itemized deductions, including the cap on the state and local tax deduction. Nevertheless, Kaplow's point about the ability to adjust tax rate schedules remains valid. I therefore set distributional concerns aside and focus on whether the base broadening narrows tax disparities across alternative economic activities and whether any such disparities can be justified by externalities or interactions with the labor-leisure decision.

C. Charitable Contributions

Table 1 indicates that the implicit narrowing of the charitable deduction accounts for 15 percent of the implicit base broadening from the enlargement of the standard deduction. For taxpayers who switch to the standard deduction, their price of giving rises from 1 minus their statutory tax rate to 1. The increased price of giving is likely to reduce the amount they give.

A June 2018 study by my AEI colleagues Alex Brill and Derrick Choe estimated that the TCJA would reduce 2018 contributions by $17 billion, or about 4 percent. The impact was primarily due to the reduction in itemization, but it was reinforced by a decline in statutory tax rates.[41]

A November 2018 study by Joseph Rosenberg and Eugene Steuerle at the Urban-Brookings Tax Policy Center estimated that the TCJA would reduce giving by 5 percent in 2018.[42] The study finds that the number of taxpayers claiming the charitable deduction would fall from 36 million in 2017 to 15 million in 2018. The fraction of contributions that are deducted would fall from 81 percent in 2017 to 60 percent in 2018. The decline in the deductible fraction would be particularly strong in the middle of the income distribution.

There is broad support for a tax incentive for charitable giving, based on a belief that giving has positive externalities. The reduction in incentives for giving may therefore be problematic if the remaining incentive falls short of the incentive warranted by the externalities.

BUNCHING, DONOR-ADVISED FUNDS

A separate, but related, concern is the uneven nature of the remaining incentive. Although the deduction has never provided giving incentives to non-itemizes, that feature is more problematic under the TCJA because itemizers are a smaller share of the population. Note that this is an efficiency concern rather than a distributional concern. The problem is not that taxpayers claiming the standard deduction are paying too much tax; the problem is that their contributions receive no marginal tax subsidy even though they (presumably) generate the same externalities as itemizers' contributions.

This outcome has rightly drawn widespread criticism, as normatively undesirable and as politically unsustainable. One commentator argues that confining the charitable incentive to a smaller group challenges the concept of "shared sacrifice by private citizens to complement a limited government" and "tears" at the national fabric by denying many citizens an "important incentive to engage and give more to their communities."[43] Roger Colinvaux argues that "broad-based participation in the giving incentive is central to its integrity and provides a base for dynamic and worthy charitable sector."[44] Howard Gleckman of the Tax Policy Center notes that "gifts will come from fewer–and richer–givers."[45] Steuerle aptly states, "A deduction that is only available to the most affluent donors cannot pass the laugh test for political sustainability."[46]

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[41] Brill and Choe, *supra* note 25.

[42] Joseph Rosenberg and Eugene Steuerle, "Reforming Charitable Tax Incentives: Assessing Evidence and Policy Options," Urban-Brookings Tax Policy Center, November 15, 2018. For previous coverage of the report, see Fred Stokeld, "Policy Center Predicts Major Drop in Charitable Giving from TCJA," *Tax Notes*, November 26, 2018, p. 1145.

[43] David Rogers, "GOP Tax Law a One-Two Punch to Charities–and American Giving," *Politico*, January 13, 2018.

[44] Roger Colinvaux, "The Importance of a Participatory Charitable Giving Incentive," *Tax Notes*, January 30, 2017, pp. 605-614, at p. 605 (discussing the potential impact of the House Republican blueprint, which was similar to the final form of the TCJA in the relevant respect).

[45] Howard Gleckman, "21 Million Taxpayers Will Stop Taking the Charitable Deduction Under TCJA," Tax Vox, January 8, 2018.

[46] Eugene Steuerle, "Charities Have Plenty of Opportunities to Advance Giving Despite Tax Law Losses," *The Chronicle of Philanthropy*, February 8, 2018.

Different types of charities may experience disparate impacts, depending on the extent to which they draw contributions from the income groups in which itemization is likely to decline the most. There is not complete agreement on which charities would be most affected. Rosenberg and Steuerle cite concerns that religious and social service charities might be disadvantaged relative to colleges, hospitals, and other cultural organizations.[47] A recent media report notes that "very high-income people will still itemize and the charities they disproportionately support–including universities and arts groups–should see minimal effects. Most households didn't itemize under the old law, either, so religious congregations and other groups that bank on lower-income donors shouldn't experience much change. Any pinch will be felt most acutely in the upper-middle class, affecting food banks and social-services groups and others in ways and amounts as yet unknown."[48]

A partial solution would be to make charitable contributions an above-the-line deduction available to all taxpayers, including those who claim the standard deduction. It is not a novel idea. That treatment was provided for all contributions in 1986 and for some contributions in 1982 through 1985. Under section 408(d)(8), up to $100,000 per year of distributions from individual retirement accounts that are donated to charities can be excluded from gross income, if the account holder is at least 70 years 6 months old. That provision effectively provides an above-the-line deduction for those contributions.[49] I have called for an above-the-line deduction.[50]

On May 10, 2018, Rep. Christopher H. Smith (R-New Jersey) and Rep. Henry Cuellar (D-Texas) introduced H.R. 5771, which would have provided an above-the-line charitable deduction. The bill won support from many charitable organizations,[51] but the House did not vote on it. Some proposals, although not H.R. 5771, would allow the deduction only for contributions above an annual floor, so that the IRS need not verify small contributions. Rosenberg, Steuerle, and two other researchers endorsed that approach in a recent report.[52]

Brill and Choe estimated that an above-the-line deduction with no floor would have boosted 2018 giving by $21.5 billion, more than reversing the $17.2 billion decline caused by the TCJA. An above-the-line deduction with a floor of $500 for singles and heads of household and $1,000 for married couples would have increased 2018 giving by $19.1 billion.[53]

Under an above-the-line deduction, the marginal rate of the charitable incentive would be based on the taxpayer's bracket, a factor that presumably has little or no relationship to the externalities

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[47] Rosenberg and Steuerle, *supra* note 42, p. 4.
[48] Richard Rubin, "Charities Brace for Tax-Driven Drop in Year-End Giving," *Wall Street Journal*, November 27, 2018.
[49] For further discussion, see Jonathan Curry, "Non-Itemizers Can Still Reap Charitable Tax Benefits through IRA Rollovers," *Tax Notes*, July 2, 2018, pp. 121-122.
[50] Alan D. Viard, "We Should Allow All Taxpayers to Deduct Charitable Contributions," The Hill, June 19, 2018.
[51] For coverage of the bill, see David van den Berg, "Nonprofit Groups Welcome New Charitable Giving Tax Bill," *Tax Notes*, May 21, 2018, p. 1213.
[52] Joseph Rosenberg, C. Eugene Steuerle, Joycelyn Ovalle, and Philip Stallworth, "The New Debate Over a Charitable Deduction for Nonitemizers," Urban Institute, October 2016.
[53] Brill and Choe, *supra* note 25, p. 7.

generated by the giving. Moreover, there would be no giving incentive for households too poor to owe individual income tax. A nonrefundable flat-rate credit would provide a uniform subsidy for all giving by households that owe individual income tax and a refundable flat-rate credit would provide a uniform incentive for all households. Brian Jenn has noted that refundable flat-rate credits are the correct type of tax incentive for an activity when the positive externality generated by the activity does not depend on the identity of the person engaging in it.[54] It is possible, however, that the provision of a refundable tax credit for contributions to religious organizations could be deemed to violate the Establishment Clause of the First Amendment to the U.S. Constitution, because the provision of such a credit could be seen as similar to direct government spending to support religion.[55]

Colinveaux endorsed a credit, but did not spell out the details of how it would work.[56] Brill and Choe estimated that replacing the deduction with a 25 percent nonrefundable credit would have boosted 2018 giving by $23.3 billion if the credit had no floor or by $20 billion if the credit had a $500/$1,000 floor.[57]

The need for a broader charitable incentive of some sort seems clear.

D. Owner-Occupied Housing

The individual income tax system has long provided a major tax preference for owner-occupied housing by excluding imputed rent from taxable income.[58] Despite the exclusion for imputed rent, itemizers are allowed to deduct mortgage interest and property taxes, although maintenance expenditures are not deductible.

The tax preference for owner-occupied housing is often defended on the grounds that homeownership generates positive externalities because homeowners have a stronger stake in their communities than renters and because homeownership promotes social stability. The merits of these arguments are far from clear. In any event, economists have steadfastly criticized the existing tax preferences for owner-occupied housing because they are not well targeted to increase the homeownership rate. Instead, the tax preferences are more likely to encourage taxpayers who would own homes anyway to own larger and more expensive homes. Even if there is a positive externality from homeownership, it is hard to imagine that there is a positive externality from the ownership of larger and more expensive homes once a minimum level of habitability has been attained.

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[54] Brian H. Jenn, "The Case for Tax Credits," Tax Lawyer, 61(2), Winter 2008, pp. 549-597. Also see Laurence Seidman, "How to Clean Up Tax Expenditures: Terminate or 'Credify'," *Tax Notes*, October 10, 2011, pp. 217-219.

[55] This problem was noted by Robert Carroll and Alan D. Viard, *Progressive Consumption Taxation: The X Tax Revisited* (AEI Press, 2012), pp. 181-182 n.8. The Establishment Clause states, "Congress shall make no law respecting an establishment of religion." Carroll and Viard opined that a refundable tax credit for religious contributions would likely withstand an Establishment Clause challenge, but they do not appear to have any expertise in constitutional law.

[56] Colinveaux, *supra* note 44, pp. 611-612.

[57] Brill and Choe, *supra* note 25, p. 7.

[58] It appears to be well settled that imputed rent is not a form of "income" within the meaning of section 61. No specific provision is therefore needed to exclude it.

To be sure, repeal of the imputed rent exclusion would pose severe challenges of measurement and administration. Proposals to curtail the tax preference therefore normally take an indirect route by proposing to make mortgage interest partially nondeductible, which is a second-best approach.

Denial of an interest deduction effectively negates the benefits of the imputed rent exclusion for debt-financed home purchases while leaving the exclusion intact for equity-financed home purchases. That policy therefore creates a favoritism toward equity-financed purchases over debt-financed purchases even as it reduces the overall favoritism toward owner-occupied housing. Studies typically find, therefore, that a curtailment of the mortgage interest deduction reduces the demand for owner-occupied housing, but also induces a portfolio distortion that prompts taxpayers to reduce their holdings of financial assets in order to take out smaller mortgages and hold more home equity. That distortionary portfolio change would reduce the revenue gain from denial of the mortgage deduction.[59] A prominent analysis by James Poterba and Todd Sinai concludes, however, that the portfolio response would undo less than one-quarter of the revenue gain from interest deduction repeal and would only slightly diminish the effectiveness of the repeal in curtailing the tax advantage of owner-occupied housing.[60]

The TCJA explicitly curtailed the mortgage deduction by denying it for home equity loans and lowering the cap from $1,000,000 of debt to $750,000 of debt. It also implicitly curtailed the deduction through the switch to the standard deductions.

Another way to curb the tax preference for owner-occupied housing is to limit the deduction for property taxes on homes. The TCJA explicitly curtailed that deduction by capping the deduction for state and local income (or sales) and property taxes at $10,000 and implicitly curtailed it through the switch to the standard deduction. As discussed in subpart E, below, relatively few taxpayers now obtain marginal federal tax savings from an increase in state and local tax payments.

The TCJA therefore significantly curbed the tax preference for owner-occupied housing. Because there appears to be little externality along the relevant margin, that would be a desirable change under the assumption of identical separable preferences, as discussed in subpart B, above. That assumption may, however, understate the gains from raising taxes on owner-occupied housing.

David Albouy argues that housing is likely to be a leisure complement, which would warrant heavier taxation under the optimal-tax framework.[61] Albouy cites evidence from the American Time Use Survey establishing that much time spent in the home is devoted to leisure. Although hardly conclusive, that finding suggests that housing and leisure may well be complements; a rise in the cost of housing may prompt taxpayers to buy smaller homes with fewer amenities,

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[59] For further discussion, see Alan D. Viard, "Proposal 8: Replacing the Home Mortgage Interest Deduction," in *15 Ways to Rethink the Federal Budget*, Hamilton Project, Brookings Institution, February 2013.
[60] James M. Poterba and Todd Sinai, "Revenue Costs and Incentive Effects of the Mortgage Interest Deduction for Owner-Occupied Housing." *National Tax Journal*, 64 (2), part 2, June 2011, pp. 531–564.
[61] David Albouy, "Should We Be Taxed Out of Our Homes? The Optimal Taxation of Housing Consumption," University of Illinois, unpublished manuscript, http://davidalbouy.net/housingleisure.pdf.

making leisure time in the home less appealing and boosting labor supply. Albouy also cites more direct evidence from a cross-sectional analysis of metropolitan areas that finds higher labor supply in areas with higher housing costs, after controlling for an array of other relevant variables. If housing is a leisure complement, then curtailing tax preferences for housing is even more beneficial.

One paradoxical feature deserves further discussion. The preferences removed by the TCJA were ill-suited to encouraging homeownership. However, the vestige of the preferences that have survived the TCJA are even more ill-suited than those that were removed; recall that the remaining itemizers are richer than those who switched to the standard deduction, suggesting that they are even less likely to be making marginal decisions between home ownership and renting.

The economic case for changing the tax preference to a form that is better suited to encouraging homeownership is therefore stronger than ever. Moreover, it may be more politically feasible than before to make such a change. With fewer taxpayers claiming the mortgage interest and property tax deductions, those deductions may have fewer supporters. However, the real estate industry is likely to still support the deductions, as might homeowners concerned that changes would lower the market value of their homes.

Jordan Weissman recently noted, “Going forward, [the mortgage deduction] will be a smaller giveaway but an even more regressive one ... if Democrats ever get a chance to kill off the vestigial remains of the mortgage interest deduction down the line, they might as well.”[62] Steuerle argues that “the TCJA has left the nation with an upside-down tax incentive that applies to only about one-tenth of all households–nearly all of them with high incomes. Such a design doesn’t pass the laugh test for political sustainability.” He urged lawmakers to instead adopt tax benefits and direct spending programs that benefit both homeowners and renters.[63]

The TCJA’s curtailment of the tax preference for owner-occupied housing is a major tax policy improvement and it may pave the way for further reform.

E. State and Local Governments

The case for curtailing the state and local tax deduction is the argument that the federal tax system should not provide an incentive for general expansion of state and local governments. That case seems reasonable, although contestable. Undoubtedly, many specific state and local programs promote national priorities and deserve encouragement from the federal government. However, that encouragement can be provided through matching grants. Indeed, the federal government provides matching grants to an array of programs, with particularly large grants for Medicaid.

In any event, the TCJA largely achieves the no-subsidy goal with respect to non-business state and local income, sales, and property taxes. The deduction for those taxes was explicitly

[62] Jordan Weissman, “Republicans Gutted the Mortgage Interest Deduction. Democrats Should Finish It Off,” Slate, April 27, 2018.
[63] C. Eugene Steuerle, “How Recent Tax Reform Sounds a Clarion Call for Real Reform of Homeownership Policy,” Tax Vox, May 9, 2018.

curtailed through a $10,000 cap and it was implicitly curtailed through the switch to the standard deduction. Under the TCJA, a taxpayer receives marginal federal tax savings from additional state and local tax payments only if all three of the following conditions hold; (1) the taxpayer itemizes (2) the taxpayer's state and local tax payments are less than $10,000, so that a marginal increase in tax payments can still yield additional deductions (3) the taxpayer is not on the AMT, which disallows the deduction for state and local taxes.

Calculations using the OSPC Tax Calculator reveal that, in 2018, only 9.5 million taxpayers, 5.5 percent of all taxpayers, satisfy these criteria. Their total state and local tax deductions are $53.6 billion, an average of $5,651 per taxpayer. Those taxes – the only ones that receive a marginal federal tax incentive – are a small fraction of total state and local tax payments.

One crucial difference between the TCJA's charitable deduction and its state and local tax deduction deserves emphasis. Although the charitable incentive remains for only a small group of taxpayers, those tend to be the taxpayers who make the largest contributions because they have enough contributions to itemize. In contrast, taxpayers who make the largest state and local tax payments do *not* receive a marginal incentive to pay more state and local taxes because the $10,000 cap is binding and additional payments do not increase their deductions.

F. Employee Business Expenses

One aspect of the TCJA's changes to itemized deductions appears to be undesirable. Employee business expenses were a large part of miscellaneous deductions that were subject to the 2-percent-of-AGI floor under pre-TCJA law and have now been suspended by the TCJA.[64] Because employee business expenses are defined as the ordinary and necessary expenses of carrying on the trade of business of being an employee, they are likely to be work-related.

Examples of employee business expenses include union dues, the costs of buying uniforms or other clothing for work if the clothing would not be suitable to wear away from work, the costs of commuting from one job to another job (but not between home and a job), the costs of lodging and (50 percent of) meals when working at a temporary job away from the taxpayer's tax home, and the costs of a home office. It seems plausible that raising the cost of some of these expenditures would reduce labor supply to some extent, although the effect may be questionable for some of these costs. While there may have been a case for narrowing some aspects of the definition of employee business expenses, it is hard to see a plausible argument for complete repeal of the deduction.[65] However, the impact is likely to be minor because few taxpayers claimed the deduction.

G. Saving

[64] Section 162 allows a deduction for the ordinary and necessary costs of carrying on any trade or business, but section 62(a)(1) provides that the deduction is above-the-line only if the trade or business does not consist of being an employee; the costs are therefore itemized deductions for employees. Section 67 does not exempt them from the 2-percent floor.

[65] A similar objection applies to the TCJA's suspension of the above-the-line section 217 moving expense deduction, which applied to the costs of moving to a new location at which the taxpayer works full-time. However, above-the-line deductions are outside the scope of this article.

As discussed above, the TCJA greatly curtails the state and local tax deduction. Many savers therefore cannot deduct state and local income taxes paid on interest income and other returns to saving.

The TCJA implicitly curtails the section 163(d) investment interest expense deduction through the switch to the standard deduction. That curtailment reduces the incentives for saving and also artificially discourages taxpayers to avoid offsetting long and short positions in financial assets.

One small provision should also be mentioned. The TCJA repeals miscellaneous itemized deductions that were subject to the 2-perent-of-AGI floor, including the section 212(1) deduction for costs for the production of income and the section 212(2) deduction for costs for the management, conservation, or maintenance of property held for the production of income Treasury regulation section 1.212-1(g) provides that the following investment-related costs qualify for those deductions:

> "Fees for services of investment counsel, custodial fees, clerical help, office rent, and similar expenses paid or incurred by a taxpayer in connection with investments held by him are deductible under section 212 only if (1) they are paid or incurred by the taxpayer for the production or collection of income or for the management, conservation, or maintenance of investments held by him for the production of income; and (2) they are ordinary and necessary under all the circumstances, having regard to the type of investment and to the relation of the taxpayer to such investment."

It is unclear what impact, if any, the loss of those deductions will have on taxpayers' saving or portfolio behavior.

VI. CONCLUSIONS AND POLICY IMPLICATIONS

There is little logic to having the availability of a deduction depend on the size of other deductions claimed by the taxpayer. It would therefore make more sense for deductions to be above the line, with the standard deduction providing a zero-bracket amount for all taxpayers. By limiting itemized deductions to a smaller group of taxpayers, the TCJA has highlighted the problems posed by allowing taxpayers to claim deductions only if their aggregate value exceeds a standard deduction. As discussed above, the problems are particularly severe for charitable and owner-occupied housing provisions. The TCJA may pave the way for a reexamination of the role of itemized deductions.