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“A Distribution-Neutral Perspective on Tax Expenditure Limitations”

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A DISTRIBUTION-NEUTRAL PERSPECTIVE ON
TAX EXPENDITURE LIMITATIONS

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Abstract

A recent wave of literature, partly motivated by Presidential campaign tax reform plans, advances and analyzes the effects of proposals to limit tax expenditures. In addition to reducing distortions caused by favoritism for some types of expenditures over others, many of these reforms are advanced on distributive grounds and because the resulting broader base enables lower marginal tax rates and hence less distortion of labor effort and other margins associated with the income tax. More sophisticated analyses recognize that the results are heavily dependent on what sorts of rate adjustments are used to return the proceeds to taxpayers in achieving revenue neutrality. This article advances a complementary, distribution-neutral perspective on the analysis of tax expenditure limitations. Distribution-neutral implementation provides an illuminating benchmark against which to understand prior analysts’ large number of results and also clarifies the analysis, particularly of the distribution-distortion tradeoff. A central lesson is to challenge the common belief that one can have less distortion of labor supply through supposedly lower marginal tax rates while also maintaining or enhancing progressivity.

Keywords: tax expenditures, distribution-neutral, progressivity, marginal tax rates, optimal taxation, tax reform, distribution

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Proposals to limit tax expenditures\textsuperscript{1} are favored by many for a familiar microeconomic reason: they generate efficiency gains from the reduction in distortions induced by the relative preference for some types of expenditures over others. Nevertheless, much of the impetus for limiting tax expenditures derives from what are thought to be a number of other sources of benefit: efficiency gains from enabling lower marginal tax rates on account of the broader tax base; improvements in the distribution of income on account of overturning the “upside down” effect of deductions and exclusions caused by their being more valuable to higher-income individuals who are in higher tax brackets and more likely to itemize their deductions; and enhanced revenue.

Most analysis of tax expenditure limitations, however, is not grounded in the well-developed optimal taxation framework. This article explains how substantial illumination of both positive and normative effects of tax expenditure limitation proposals can be provided by modern extensions of this framework that employ a distribution-neutral methodology for assessing tax reform.

Section 1 develops the methodology. It begins with the Mirrlees (1971) optimal taxation model as extended by Atkinson and Stiglitz (1976) to incorporate commodity taxation. Tax expenditures provide subsidies to different commodities and hence are incorporated in this methodology. Most of the discussion is devoted to the extensions developed in my own prior work (e.g., Kaplow 1996, 2004, 2008, 2012) that employ a distribution-neutral framework. As a normative matter, this approach enables the analysis of the welfare consequences of all manner of tax reforms, without requiring either that the initial income tax be optimal or that the reform moves all the way to an optimum with regard to the income tax or tax expenditures.

\textsuperscript{1} For tax expenditure limitation proposals and related analyses, see, for example, Burman, Toder, Berger, and Rohaly’s (forthcoming), Feldstein (2015), Schizer (2015), and Toder, Rosenberg, and Eng (2013).
In particular, this distribution-neutral approach enables one to disentangle the distinctive efficiency consequences due to the reform of tax expenditures themselves from the efficiency, distribution, and revenue consequences of changing overall features of the tax system – changes that can be made independently of whether tax expenditure reform is contemplated. This mode of analysis clarifies the positive effects of tax expenditure reduction proposals as well. It is understood that it is difficult to discern distributive and distortionary effects of such proposals because there are so many ways to disburse the revenue raised as a result of tax expenditure limitations, including an infinite variety of ways to adjust the income tax schedule to rebate some or all of the proceeds. The distribution-neutral approach sharpens the analysis of different overall reforms by providing a simple decomposition that distinguishes their core features.

In the course of providing clearer positive and normative analysis of tax expenditure reform, the analysis reveals a number of commonly held views to be misleading. Prominent analysts argue that eliminating tax expenditures enables one to enjoy important forms of a free lunch, including: raising revenue without raising tax rates, reducing the distortion due to high marginal tax rates, and enabling enhanced progressivity without raising the distortion ordinarily associated with redistributive taxation. Unfortunately, these lunches are not free and, as often served, are not even available at a discount. The first-mentioned efficiency gain – the reduction in distortion across different categories of expenditure – is present, and the distribution-neutral framework enables this aspect to be better understood, including in cases in which there may be positive externalities (or internality corrections) that some tax expenditures may address.

The distribution-neutral framework elaborated in this article is quite general. It is subject to all manner of qualifications, many of which are familiar from the literature on optimal taxation and various extensions in prior work; in that respect, changing a tax expenditure is no different
from adjusting a differential commodity tax or subsidy rate. Because this article aims to apply a broad framework, these issues will largely be set to the side. It should be emphasized, however, that the approach is fully encompassing in two senses. First, although simple examples will often be employed for ease of exposition (such as use of a linear income tax and a uniform proportional reduction in tax expenditures), the framework readily encompasses a highly complex income tax and transfer scheme and a range of even fairly idiosyncratic proposals for tax expenditure limitations. Second, the refinements that would be required to incorporate qualifications are fairly generic.

1. Framework

1.1. Optimal Income and Commodity Taxation

Mirrlees (1971) launched the modern study of optimal income taxation, and his approach has provided the backbone for much subsequent work in public economics that seeks to ground policy analysis in first principles. In the standard formulation of the problem, the government seeks to raise revenue for public goods and, in the process, maximize a social welfare function that may embody concerns for the distribution of income. This optimization is subject not only to the technological feasibility constraints of the economy itself but also, centrally, to the information constraint that the government can observe only individuals’ incomes and not their varying productivities and labor efforts that generate those incomes. As a consequence, income taxation (rather than a tax based directly on individuals’ productivities) must be employed, which is the source of the distortion of labor effort. (For those unfamiliar with Mirrlees, it is important to mention further that his income taxation may be negative, and optimally would be for the poor if there were nontrivial distributive concerns. In that sense, his “income tax,” and that to be
discussed below, is a shorthand for the aggregate of both income and related taxes and also transfer programs.)

Atkinson and Stiglitz (1976) offered an important extension that combines the Mirrlees optimal income tax problem with commodity taxation. In particular, their interest was in the optimality of differential commodity taxation. Note that differential commodity taxation includes the case of relative subsidies (the commodity taxes may be negative, or one may contemplate systems such as a VAT that provides preferential rates or exclusions). Moreover, the notion of “commodities” is understood broadly as including all forms of expenditure and hence, combined with the first point, readily incorporates tax expenditures. Indeed, this application is not an extension of the commodity tax framework but just a recognition that tax expenditures are in fact a pure form of differential commodity taxation.²

Atkinson and Stiglitz’s central result was that, when individuals’ (taken to be common) utility function was weakly separable in labor – which is to say, utility can be written as a function of labor and a composite subutility function of all commodities – then it is optimal to employ uniform commodity taxation. (As an accounting identify, this is equivalent to no commodity taxation and a normalizing shift in the income tax schedule). The basic intuition comes from principles of second best analysis. Although sometimes sloppily taken to mean that, once there is at least one distortion in the economy, “anything goes,” in fact the logic is that, when there is a preexisting distortion, introducing a second one can be helpful if and only if it helps to offset the initial distortion. Here, the preexisting distortion is of the labor-leisure choice.

² Much of the literature on commodity taxation taxes such taxes to be a linear function of expenditures that is imposed at a common rate for all individuals. This would correspond to a refundable income tax credit. The preference resulting from deduction and exclusion depends on an individual’s tax bracket and hence varies across individuals, and for a given individual the rate need not be linear because one’s tax bracket is endogenous to the level of expenditure (and other choices). Matters like itemization and phase-outs further complicate the picture. Nevertheless, the conceptual framework remains applicable, and the lessons to be presented here are robust to these complications, although further effort may be required with regard to implementation of a distribution-neutral approach.
Hence, with weak separability – meaning that relative changes in an individual’s consumption bundle do not affect labor supply directly – there is nothing to be gained by any distortion of consumption allocations. Hence, all that remains is the simple efficiency cost of consumption distortion from any differential commodity taxation.\(^3\)

A simple example helps to explain the nature of this separability assumption. Suppose instead that consumption of dishwashers was a leisure substitute, reducing the marginal value of leisure and hence the marginal disutility of labor supply. In that case, a relative subsidy on dishwashers, although introducing a consumption distortion, would help encourage labor supply and thereby reduce the preexisting distortion of the labor-leisure choice. Some such subsidy would be efficient. For the remainder of this article, this and other qualifications (except for externalities) are set to the side. For an informal catalogue of many of the more important qualifications, see Kaplow (2008, ch. 6.C).

As a matter of intellectual history, it should be noted that both Mirrlees’s analysis of the income tax and Atkinson and Stiglitz’s extension to incorporate commodity taxation are about characterizing the second-best optimum. Their techniques involve standard optimization, and their results make use of first-order conditions. Accordingly, the results, strictly speaking, apply only at an optimum, and what Atkinson and Stiglitz teach us about optimal commodity taxation applies only regarding the optimum itself (and thus not partial reforms of nonuniform taxation) and only if the income tax is optimized as well. However, starting with an important (and underappreciated) paper by Hylland and Zeckhauser (1979), there now exists substantial work that extends many of the results to cases of partial reforms of all manner of government policies.

\(^3\) Readers familiar with Ramsey principles of commodity taxation should appreciate that Atkinson and Stiglitz’s analysis displaces those results, which shift can be attributed to the introduction of an income tax, in particular, the feasibility of a uniform lump-sum grant component. For further discussion, see Kaplow (2008, ch. 6.D).
and that does not require the assumption that the income tax is optimized. This is accomplished using a distribution-neutral framework, one that also pays other dividends.

1.2. Distribution-Neutral Approach

There is a longstanding tradition in public economics of employing a revenue-neutral approach when assessing reform proposals (other than those aimed at raising or reducing revenue). The motivation is that, if revenue is not held constant, revenue effects themselves become entangled with the distinctive features of the reform under consideration. This complicates the analysis and confounds the interpretation of the results. Much more work would be necessary if every analysis of every policy had to determine how to assess changes in revenue, including such matters as to how different levels of debt would ultimately be paid, how the financing of deficits would influence interest rates and investment, and so forth – much of which would require the introduction of additional, controversial assumptions that were unrelated to the reform under consideration. Moreover, it would be difficult to compare the conclusions from different analyses of the same reform because differences in analyses of the distinctive effects of the reform would be entangled with different assumptions and methodologies in assessing the revenue consequences. Accordingly, economists have often insisted on revenue-neutral analysis.

In a similar spirit, some work – and much of my own writing over the past two decades – has advanced a complementary, distribution-neutral approach. See, for example, Kaplow (1996, 2004, 2008). This subsection briefly describes its core features, and the remainder of this article applies a distribution-neutral approach to the analysis of tax expenditure limitations, illustrating the benefits of the methodology in this important setting.
In a nutshell, the distribution-neutral approach combines a reform proposal with an adjustment to the income tax that is designed to be distributively offsetting at all income levels. As will be explained, this framework (unsurprisingly) eliminates distributive effects and also (in a benchmark case) has the effect of holding labor supply constant and thereby eliminating the need to consider the other half of the familiar distribution-distortion tradeoff. What remains are what may be viewed as the distinctive, efficiency-related consequences of the reform.

Moreover, when two different studies evaluate the same reform employing this methodology, any differences in conclusions will correspondingly reflect differences in the assessment of these distinctive features of the core reform, rather than different choices in how to balance the budget. Distributive and distortionary consequences of a given tax expenditure limitation proposal depend on how the revenue is rebated. (Likewise for environmental reforms and many other policies considered in this conference volume.) Moreover, even with revenue-neutrality, there are an infinite variety of ways to balance the budget, with all manner of consequences for distribution and distortion (although, as will be explained, the two are tightly related). Hence, the gains from disentangling the analysis of particular reforms from broader fiscal issues are immense.

Consider the implementation of any reform. As stated, distribution-neutral implementation involves adjustment of the income tax schedule so as to offset the reform’s distributive effects for all levels of before-tax income. More precisely, the tax schedule adjustment at each level of income is calibrated to leave unchanged individuals’ level of utility under the assumption that their labor supply remains the same. (Whether individuals would choose to do so is considered momentarily.)
This income tax adjustment can better be understood by decomposing it into two components. First, one can wash out any effects on taxes paid (or transfers received) as a mechanical consequence of the reform. For a tax expenditure limitation, one simply computes how much taxes paid rise at each level of income and adjusts (reduces) income tax rates accordingly.\textsuperscript{4} Second, because the income tax adjustment is, in principle, designed to hold individuals’ utility constant, the full income tax adjustment must also offset any effects of the core reform on utility. Suppose, for example, that a tax expenditure proposal reduces only inefficient subsidies on certain forms of consumption. In that case, the utility consequence of reducing consumption distortion is to raise utility.\textsuperscript{5} Hence, the complete adjustment would involve somewhat higher income tax rates than those described in step one. As a practical matter, for some purposes one might employ approximations for this second step or even omit it.\textsuperscript{6} The discussion to follow, however, will assume that the full utility-based distributive offsets are made.

\textsuperscript{4} The exposition throughout ignores heterogeneity at a given income level. Hence, distribution neutrality only holds on average for individuals earning each amount of income. See Ng (1984). Of course, in reporting distributive effects of reforms, it is common to aggregate – usually, at a much higher level. For example, Burman, Toder, Berger, and Rohaly (forthcoming) display distributive effects by quintile, with further disaggregation at the top. To compute the requisite offsetting income tax adjustment for this component, one could start with the bottom bracket and adjust it to generate a zero effect in the first quintile, and proceed up the tax brackets to hit this target for each subsequent group. If the number of groups being considered is more refined than the number of tax brackets, including if breaks in groups are at different points than breaks in tax brackets, one could introduce further brackets for this income tax schedule adjustment. Keep in mind that the distribution-neutral approach is primarily a thought experiment to aid analysis, not an actual proposal, so there is no reason to avoid such a mechanical adjustment for purposes of displaying results (as discussed further in subsection 2.6). If one instead is actually implementing a distribution-neutral reform, such as with TRA 1986, one would tweak the tax brackets accordingly.

\textsuperscript{5} To elaborate, after some tax expenditures are curtailed, as a consequence of the first component of the income tax adjustment, an individual can continue to consume the same consumption bundle as before. However, because relative prices are changed, the individual will prefer to adjust expenditures, spending less on those items that are now subject to a reduced preference and more on others. It is the increase in utility from this consumption reallocation that constitutes the efficiency gain and determines the amount of the second component of the income tax adjustment, in this instance, a rate increase to absorb the utility benefit, leaving individuals at their pre-reform utility levels.

\textsuperscript{6} If one did omit this second component of the adjustment to the income tax schedule, then the result would be equivalent to preforming the complete distribution-neutral experiment and followed by a rebate the proceeds, as discussed below, in a pattern that matched these efficiency benefits from the reform. If, for example, everyone benefitted somewhat from the distortion reduction, there still would be a Pareto improvement, but the gains would
Having described what the distribution-neutral experiment is, let us now consider its consequences. Regarding distribution, it is obvious that there is no effect, by construction.

Next, consider labor-supply, which is usually taken to be a first-order factor for many policies, including significant reforms of tax expenditures. Under a distribution-neutral approach, however, labor supply effects recede. More precisely, if one assumes that labor effort is weakly separable in individuals’ utility functions, as in Atkinson and Stiglitz’s (1976) demonstration of when uniform commodity taxation is optimal, then labor supply effects are nil. The explanation is straightforward. Individuals, when choosing labor effort, trade off the disutility of labor with the utility of consumption. The distribution-neutral implementation, recall, holds utility constant for each level of earnings and hence for every level of labor effort that individuals might choose. Hence, whatever level of labor effort maximized utility before the reform, that same level will be optimal afterward. For further exposition, see Kaplow (2004, 2006, 2008).

Finally, what is the effect of the reform on revenue? Note that the distribution-neutral reform is constructed to be distribution neutral rather than revenue neutral. The revenue effect of this manner of implementation is immediate from examination of the two components of the distribution-offsetting adjustment to the income tax schedule. The first component is a wash: at each level of income, we adjust income tax rates to offset the mechanical effects of the core reform on taxes paid. For proposals that reduce the availability of tax expenditures, revenues rise as a direct consequence, so income tax rates are accordingly reduced to, in essence, return the proceeds.

be distributed in accord with initial incidence of the gains from the distortion reduction rather than, say, pro rata. More broadly, all aspects of the incidence of any reform are taken account in the distribution-neutral experiment because it absorbs (offsets) all effects of the reform on the utility of taxpayers at each income level. In practice, when the actual incidence is uncertain, one attempting distribution-neutral implementation would need to base the second component of the income tax schedule adjustment on estimated incidence.
The second component of the income tax adjustment absorbs the utility consequences of the reform (aside from the aforementioned mechanical effect of the change in tax payments). As explained, for a tax expenditure limitation that reduces consumption distortion, utility rises. Hence, the second component of the income tax adjustment is to raise income tax rates to absorb this utility gain at each level of income. Combining these two components, for this case we have an unambiguous increase in revenue.

Observe that this revenue gain under the distribution-neutral package corresponds to a dollar measure of the efficiency gain from the reform. Had we instead considered a reform that increased consumption distortion, the second component of the income tax adjustment would have been a tax rate reduction, to make taxpayers at each income level whole for the utility cost of that distortion. In that event, this hypothetical reform package would be a revenue loser.

In sum, the net revenue effect of the distribution-neutral reform package is the only effect of the overall reform, and it corresponds to the efficiency gain or loss produced. How this revenue change is dealt with is, strictly speaking, outside the distribution-neutral experiment. For reforms that raise revenue, for example, one might choose to distribute the surplus pro rata, generating a Pareto improvement. If the reform is inefficient, we could make up the deficit by raising taxes somewhat at every income level, making everyone worse off. Obviously, reversing such a reform – or moving incrementally in the opposite direction, in most instances – would produce a revenue gain that could finance a Pareto improvement.
2. Application

2.1. Different Types of Tax Expenditures

*Income measurement:* At the risk of oversimplification, this article will distinguish three categories of tax expenditures. First are those income tax provisions that are best understood not as tax expenditures but rather as refinements to income measurement. Classification is controversial, most notably because of disagreement about the proper normative baseline. In particular, many tax expenditures under a Haig-Simons income tax are proper under a cash-flow consumption tax, and indeed they may not go far enough in excluding capital income. On a different dimension, provisions such as the EITC may be taken as part of the tax rate schedule, and personal exemptions, child credits, and some other preferences may best be thought of as an attempt to define a different tax schedule for different family configurations. Given the purpose of this article, such questions will be set to the side, and the analysis to follow will suppose that the tax expenditures that are to be limited are deviations from whatever baseline is thought to be normatively appropriate.\(^7\)

*Junk:* Second are those provisions that provide inefficient subsidies to certain forms of consumption. The existence of such provisions is usually explained on political grounds (perhaps lobbying by special interest groups or optics that make unwise provisions seem appealing to voters). From a normative perspective, these preferences may be regarded as junk.

\(^7\) The text briefly presents a conventional view of the subject. Under a more rigorous optimal income tax analysis, such taxonomic questions have no direct role, and instead optimal treatment of any item is whatever comes out of the mechanism design exercise. Nevertheless, the familiar categories are useful even in that setting. Moreover, the analysis to follow holds under standard simplifying assumptions that are implicitly incorporated here for ease of exposition: weak separability of labor, common utility functions, and the entailed supposition that the utility of various forms of consumption does not directly depend on unobservable ability. There is also a substantial literature on optimal capital taxation in the presence of an income tax that takes into account uncertainty in a dynamic formulation of the problem. Because most work analyzing global tax expenditure limitations largely sets capital taxation matters to the side, the proper way to incorporate that subject is less important for this article. Note, however, can undertake a simple extension of the distribution-neutral framework to consider the further requirement that one also holds fixed the overall burden on capital income, which allows one to focus on how to achieve a given effective tax rate on capital income most efficiently. See Kaplow (2008, ch. 9)
Because it may be politically difficult simply to repeal them, one by one or even altogether, many have proposed various across-the-board tax expenditure limitations that would impose some sort of common reduction to groups of these provisions.

This article is primarily interested in this second category, so the reader should assume that any limitations under discussion are limitations on such junk, unless otherwise stated. Application of section 1’s framework to such reforms is straightforward. As explained, the distribution-neutral approach involves an adjustment to the income tax schedule that has two components. First, tax rates are reduced sufficiently at each income level to leave taxpayers with as much disposable income as before their tax expenditures were limited. Second, tax rates are increased sufficiently at each income level to absorb the utility gain from eliminating the distortion to individuals’ expenditure decisions. Distribution-neutrality holds by construction. With regard to revenue, the first component alone entails revenue neutrality, and the second component results in a revenue gain that equals (in dollars) individuals’ aggregate utility gains from the reduction in expenditure distortion. As mentioned, how these proceeds are used is outside the distribution-neutral framework itself, but it is helpful to suppose that they are returned in some fashion to individuals at all income levels, generating a Pareto improvement.

Externalities and internalities: The third category of tax expenditures, which will be considered briefly here and then set to the side, involves those that correct otherwise distorted behavior. The core case is externality correction. For example, the charitable contribution deduction may be envisioned as a Pigouvian subsidy on a class of expenditures that generates positive externalities.

Analysis of this case involves a modest extension of section 1’s basic framework. See Kaplow (2004, 2012). The distribution-neutral framework is an all-purpose tool that can be
applied to all manner of policies that are advanced for a variety of reasons. As always, one combines the policy – the introduction of a charitable contribution deduction, or, of interest here, a proposal to limit it in some fashion – with an income tax rate schedule adjustment that holds utility constant at every level of income. The first component, which absorbs the mechanical revenue effect of the policy, is the same as before. The second component, which absorbs the utility effect, is the same at a high level of abstraction but the specifics differ qualitatively. Here, changes in individuals’ expenditure decisions affect not only their own utility but also the utility of others. This is just the definition of an externality. As a consequence, this component of the tax schedule adjustment would in principle include the impact of the change in the level of the externality on all individuals. Not that, once again, this means that the overall distribution-neutral package is truly distribution-neutral, in that it takes into account the distribution of costs and benefits from changes in the level of externalities.

As before, there will be a revenue gain from the package as a whole if and only if the change in the tax expenditures that involve externalities moves the level of the subsidy closer to the optimal Pigouvian subsidy.8 If the charitable deduction provided too much of a benefit, then

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8 Note also that, contrary to a commonly held view, this is optimal without regard to the fact that many individuals’ contributions are inframarginal (amounts that would be given without regard to the subsidy). Under distribution-neutral implementation, the revenue, distribution, and efficiency effects would be washed out in any event. Suppose, for example, that literally everyone’s contributions to charity strictly exceeded 1% of AGI under a common subsidy rate of 25%. A 1% floor might seem “efficient” because these funds are “wasted” on donors that would have given those amounts anyhow. But imposing a 1% AGI floor in this case is identical in its consequences to raising everyone’s marginal tax rate by 0.25%. Indeed, if this reform – introduction of the floor – was introduced in a distribution-neutral manner, the offsetting income tax adjustment would be just that. (Because expenditures do not, by assumption, change, the second component of the income tax adjustment would be nil.) The package would be distribution-neutral, revenue-neutral, and externality-neutral. That is, it would do nothing. See Kaplow (1994). (However, if some individuals gave less than 1% of AGI, and the subsidy rate were at the efficient level, imposition of this floor would forgo efficient contributions from those individuals because the floor eliminates their marginal subsidy. In that case, eliminating such a floor could be implemented in a distribution-neutral fashion so as to generate a Pareto improvement.)
limiting it would produce a gain, whereas if the deduction provided too little benefit, then further limitation would generate a loss.⁹

One might also consider in this third category those tax expenditure provisions that are designed to correct internalities, i.e., individuals’ decision infirmities, such as the tendency to be myopic or to underestimate certain types of harm to oneself. See, for example, Gruber and Koszegi (2001). Similar corrective principles apply, although there are some notable differences. Most important for thinking about tax expenditures are that many internalities impose nonlinear harm, so that the more an individual is induced to adjust consumption toward the true optimum, the less the marginal benefit from further adjustments. Also, heterogeneity is likely to be substantial: many individuals may not be misoptimizing, so taxing or subsidizing them may create new distortions. As a result, the optimal design of corrective policies is more challenging, but these matters are set to the side here, as the main focus is on the second category, junk tax expenditures.¹⁰

2.2. Non-Distribution-Neutral Reforms

To many, one of the most apparent and disturbing features of tax expenditures is what Surrey (1973) referred to as their “upside-down” effect. As is familiar, exclusions and deductions have a value given by individuals’ marginal tax rates and hence are more valuable to higher-income individuals under a graduated income tax. For this and other reasons, many tax expenditures are significantly more favorable to the upper-middle-class and the rich, often in

⁹ As an aside, for what environmental economists refer to as an atmospheric externality – one that depends on aggregate activity and not any particular individuals’ contribution thereto – the optimal Pigouvian tax or subsidy equals the marginal external harm or benefit, as the case may be. As a consequence, the optimal rate is the same for every individual, so if a Pigouvian subsidy for this sort of externality is administered through the income tax system, it would optimally take the form of a refundable credit.
¹⁰ See also Schizer (2015) on the distinction between corrections of aggregate externalities and those pertaining to the well-being of individual taxpayers.
terms of the dollar benefit of tax reduction and sometimes as a percentage of income or taxes owed.

Because of this feature, many have favored tax expenditure limitations because they augment the progressivity of the income tax. As emphasized by Griffith (1989), however, this perspective is overly simplistic. After all, the existing regime did not take some tax rate schedule from Plato or Pluto, set in stone, and then have someone else (Congress) superimpose tax expenditures. Rather, the political process jointly generated the existing regime. Moreover, this regime is reformed from time to time: sometimes the tax rate schedule, sometimes various of the tax expenditures, and sometimes a combination. An example of particular note is TRA 1986, which (speaking roughly) broadened the base by reducing tax expenditures and simultaneously lowered rates, and in a manner that linked the two together, specifically, to achieve distribution neutrality (as well as revenue neutrality).\(^{11}\) In such a case, there is by construction no relationship between the level of tax expenditures and progressivity.

Suppose, however, that one does wish to understand and assess non-distribution-neutral reform packages, perhaps of the sort that some reformers envision under which tax expenditures would be significantly limited but the tax rate adjustments would result in an overall greater degree of redistribution. As will now be explained, the distribution-neutral framework remains a very useful lens for analysis. See Kaplow (1996, 2004, 2008).

The pertinent extension of the distribution-neutral methodology employs a simple two-step decomposition. Begin with any reform package – such as one of the many combinations of tax expenditure limitations and income tax reductions analyzed in recent work. Any such non-distribution-neutral reform can be decomposed as follows:

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\(^{11}\) It is familiar that this is an oversimplification, among other reasons because the reform in part shifted taxes from the personal income tax to the corporate income tax, and also because many of the changes (a nonrandom subset) eroded at various points subsequently, some of which may well have been anticipated by those enacting the reform.
1. Distribution-neutral implementation: Combine the tax expenditure limitation component with a distribution-neutral income tax schedule adjustment of the sort examined throughout. Then, an instant after this is to be enacted, and with the same effective date, do the following:

2. Pure redistribution: Implement an adjustment to the income tax schedule that moves from the distribution-neutral schedule to the actual schedule in the overall proposal under consideration.

To analyze any non-distribution-neutral reform, one can simply combine the analysis of these two steps.

Analysis of the first step is straightforward from the previous discussion. It is distribution neutral by construction. It does not affect labor supply. Its only consequence is the pure efficiency effect of the tax expenditure limitation with regard to reducing individuals’ consumption distortions. (Keep in mind that we are focusing on junk tax expenditures.)

Analysis of the second step is readily understood once one appreciates what it is: step two constitutes a purely redistributive change to an income tax system. In the motivating example, this would be an increase in redistribution, but in other settings, it may be a decrease. In any event, because this step is purely redistributive, the correct analysis is generic: it is that appropriate for the standard optimal income tax problem. We know that if step two involves an increase in redistribution, for example, we have whatever social gains are deemed to be associated with that change and the social cost of increased distortion. A related point, to be elaborated in subsection 2.4, is that if effective marginal tax rates (MTRs) fall and hence distortion falls, then we know we have less redistribution.

12 And in many, there may be no simple classification. For example, the middle class might gain at the expense of the rich and the poor.
In emphasizing that this second step is generic, involving a pure change in redistribution, note as well that it could be achieved in a variety of ways, including without regard to limiting tax expenditures. That is, step two – some particular reform to the income tax schedule that involves purely a change in redistribution – could be implemented all by itself. Or packaged with a change in the military budget, spending on highways, or the regulation of greenhouse gas emissions.

A further implication is that the distribution-neutral framework, even when not examining an actually distribution-neutral reform package, facilitates specialization and clarifies communication. If a single study aims to analyze the total effects of a non-distribution-neutral package – whether of tax expenditure limitations, road construction, or a gasoline tax – it must take on all the burdens of those who analyze optimal income taxation: making assumptions about elasticities, choosing a social welfare function, and so forth. If it instead analyzes the distribution-neutral version, it can focus on the distinctive features of the subject at hand. (Further distributive effects of the overall package might be displayed, but left for others to analyze.)

Closely related, it can be very difficult to compare two studies of the same subject if distribution-neutral implementation is not employed. First, the studies may differ in what they actually suppose step two will be. There are many (indeed an infinite number of) ways to achieve revenue neutrality. Distribution-neutral implementation is a common metric enables apples-to-apples comparisons. Studies that do differ in the extent of assumed redistribution can generate different evaluations that are hard to compare. Perhaps the first study is favorable and the second unfavorable in its bottom line, but the first may actually have found the distinctive features of the reform to be less desirable than did the second, but come to its positive conclusion
because of desirable aspects of the redistribution involved. Second, even if the two studies make the same assumption about redistribution (they are analyzing the same overall package), it may be difficult to disentangle whether, say, the first study’s more favorable bottom line is due to its more positive assessment of the distinctive features of the reform or perhaps a more negative assessment of those but a more positive view of the resulting change in redistribution. If different studies fail to disaggregate – that is, if they neither impose distribution-neutrality nor employ the suggested two-step decomposition – it is very difficult to compare the results and, accordingly, for our understanding of each element to advance over time.

2.3. The Relationship between Tax Expenditure Limitations and Lower MTRs

Whereas the previous subsection elaborated on distribution, this one will focus on the distortion side of the familiar distribution-distortion tradeoff in redistributive taxation. The two-step decomposition makes clear that changes in both distribution and labor supply distortion will be located in the second, purely redistributive step of a reform. Unfortunately, this tight linkage is often insufficiently appreciated. In particular, many proponents of tax expenditure limitations believe that they can have their cake and eat it too – in economists’ parlance, that there exists a free lunch (rather than dessert). Upon more careful analysis, we should not be surprised to discover that such is not the case.

Consider a simple illustration. First, assume that the tax system begins with a linear income tax with a marginal tax rate $t$ and a lump-sum grant $g$. Furthermore, there are deductions or exclusions for expenditures (that is, tax expenditures) that in aggregate are the fraction $\alpha$ of individuals’ gross labor earnings $y$ (linear Engel curves). Tax due, $T(y)$, may be expressed as follows:
Next, let us consider a global limitation on these tax expenditures. Specifically, the reform allows individuals to deduct or exclude only the fraction $\theta$ of their tax expenditures. That is, gross income of $y$ is now offset by deductions and exclusions worth only $\theta \alpha y$ rather than $\alpha y$. Suppose further that the resulting revenue is used entirely to fund a reduction in the tax rate $t$. And assume as well – for ease of exposition – that individuals’ expenditures on the tax-preferred items are unchanged. (That is, we are setting aside the core efficiency gain from reducing consumption distortions.) The new, lower tax rate is therefore $\frac{1-\alpha}{1-\theta \alpha} t$. Tax due is now:

$$ T(y) = \frac{1-\alpha}{1-\theta \alpha} t(1-\theta \alpha) y - g = t(1-\alpha)y - g. $$

After this tax expenditure limitation reform plan, the following are true: First, individuals at all income levels pay the same amount of tax that they did before. An implication is that the proposal is revenue-neutral. Second, note that this way of rebating the revenue gained from the tax expenditure reduction also happens to be distribution-neutral. Third, and the present focus, we have to further consequences regarding the MTR: (A) the statutory MTR falls (from $t$ to $\frac{1-\alpha}{1-\theta \alpha} t$, which is a lower rate because we are assuming that $\theta < 1$), but also (B) the effective MTR stays the same.

This latter point is key. Note that the statutory MTR of $t$ was not the effective MTR to begin with, and it still is not the effective MTR afterwards. From our initial expression for $T(y)$, it is apparent that the effective MTR was not the statutory MTR of $t$, but rather was $(1 - \alpha) t$. 

$$ T(y) = t(1-\alpha)y - g. $$
After the reform, the effective MTR is unchanged: the new statutory MTR is \( \frac{1-a}{1-\theta} t \), which is applied to the fraction of income \( 1 - \theta \alpha \), giving the same effective MTR of \( (1 - \alpha) t \).\(^{13}\)

Hence, suggestions that broadening the tax base through tax expenditure reform enables lower MTRs are either misleading or incorrect. If interpreted as reductions of the statutory MTR, they are accurate but convey the misleading impression that the effective MTR and hence the distortion of the labor-leisure margin are lower. If interpreted as reductions in the effective MTR, they are incorrect.

This illustration is extremely simple: a linear income tax, tax expenditures on forms of consumption with linear Engel curves, reform consisting of a proportional reduction in tax expenditures, and no response in consumption allocation. Regarding all but the last assumption, the analysis can readily be generalized. (And, indeed, prior work examining tax reforms using the distribution-neutral framework is entirely general. See, for example, Kaplow (2006, 2008).) The final assumption – regarding the improvement in consumption allocation – is suggested by the preceding analysis to indeed be the distinctive benefit of tax expenditure limitations. The analysis in this subsection focuses instead on the argument that the base-broadening that results from tax expenditure limitations enables lower MTRs.

The other key assumption in this illustration is that the proceeds from the reduction in tax expenditures were used to fund a reduction in statutory MTR. This construction is employed to assess directly the purported benefit of these proposals in lowering the MTR. And, as mentioned, in this example, such a manner of rebating the proceeds is also distribution-neutral.

\(^{13}\) Consider a numerical example in the spirit of proposals to cap tax expenditures as a percentage of AGI. Focusing on those in the top bracket, suppose that their statutory MTR is 40% and that actual tax expenditures are 10% of AGI. Then, their current effective MTR on labor earnings is 40% \( \times \) 90% = 36%. Next, consider a cap that limits tax expenditures to 5% of AGI (which, note, limits the tax-reduction benefit of the tax expenditures to those in the 40% bracket to 2% of AGI). Their effective MTR rises to 40% \( \times \) 95% = 38%. Likewise, if one wished now to lower the statutory rate to restore the original, lower effective MTR, one could reduce it from 40% to approximately 37.9%. Then we would have a lower statutory MTR but no reduction in the effective MTR.
which the prior analysis suggested is highly illuminating. We will now consider further arguments about increases in progressivity and how they relate to the current discussion of effective MTRs.

2.4. Progressivity and Distortion

A recurring theme of this article is that neither black magic nor tax expenditure limitations enable us readily to escape the distribution-distortion tradeoff inherent in redistributive taxation.\(^{14}\) Distribution-neutral implementation leaves both distribution and labor supply distortion unchanged, features shared by the example in the preceding subsection. The two-step decomposition makes clear how deviations from distribution-neutrality can be isolated, leaving (as step two) a purely redistributive change to the tax system. And that is where our familiar distribution-distortion tradeoff resides. Because some proponents of tax expenditure limitations present a rosier picture of the possibilities – suggesting that one can enhance progressivity, for example, without raising or even by lowering the core distortion of the income tax – some elaboration is useful.

For concreteness, let us employ a common definition of progressivity (PROG): rising average tax rates (ATRs).\(^{15}\) That is, \(\text{PROG}(y) = \frac{d\text{ATR}(y)}{dy}\). Taking that simple derivative, we have \(\text{PROG}(y) = \frac{\left[\text{MTR}(y) - \text{ATR}(y)\right]}{y}\). In the present discussion, MTR\((y)\) and ATR\((y)\) are both taken to be effective rates, in the spirit of the preceding subsection’s discussion.

\(^{14}\) Prior work on other types of reforms (involving, notably, public goods and corrective taxation) often obscures this point, which can readily happen if one uses representative agent models and thus focuses only on the how changing effective MTRs influences distortion, without noticing that, say, lower effective MTRs imply a less redistributive fiscal system in a world in which individuals’ productivities vary. See, for example, the discussion of previous studies of environmental policies in Kaplow (2012).

\(^{15}\) Many refer instead to rising marginal tax rates and hence a graduated rate system. I find this approach confusing if the concern is not with curvature but the degree of redistribution. For example, a very generous grant for the poor with a high phase-out rate would be deemed regressive, by comparison to providing nothing. And the most redistributive tax system possible – in a world with no incentive effects – is a flat tax of 100%, with all the proceeds rebated pro rata. But that is not progressive at all under the marginal rate interpretation.
This expression teaches a straightforward lesson: the only way to increase the level of progressivity at a given income level – which is to say, to increase $\text{ATR}(y)$ faster than before – is to push $\text{MTR}(y)$ higher than before. Hence, the suggestion that we can increase progressivity while maintaining or reducing MTRs is clearly mistaken. As subsection 2.3 just explained, a significant part of the problem may involve confusing statutory and effective MTRs.

Indeed, the starting point of a simple linear income tax is instructive. For that case (and ignoring any tax expenditures for even greater sharpness), $\frac{d\text{ATR}(y)}{dy} = \frac{g}{y^2}$. Therefore, raising $\text{PROG}(y)$ requires raising $g$. And in our linear income tax with only two parameters, this means raising $t$, which is both the statutory and effective MTR in a world with no tax expenditures. If we brought tax expenditures and the possibility of tax expenditure limitation proposals back in, we would have essentially the same result that raising progressivity requires a higher marginal tax rate (except that $t$ would no longer be the effective MTR, as previously discussed).

Where, then, is the free lunch from base broadening via tax expenditure limitations? As explained from the outset, reducing the amount of junk tax expenditures reduces expenditure distortions. This is precisely the gain from eliminating differentiation in commodity taxation. In the distribution-neutral implementation, we absorbed individuals’ utility gains from this distortion reduction in the second component of our offsetting tax schedule adjustment (which was calibrated to hold individuals to their pre-reform utility levels). The dollar value of this efficiency gain constitutes the revenue gain to the treasury. In the exposition, it was imagined that this gain was redistributed pro rata.
In this setting, the effective MTR does not change, a point that should now be quite clear. And this conclusion is consistent with the point that, in baseline settings, distribution-neutral implementation has no effect on labor supply.

The only remaining wrinkle is that efficiency gain and how it might be distributed to the population – which is taken to be a choice that lies outside the distribution-neutral experiment. Note that if it was rebated pro rata, effective MTRs are unchanged but, actually, PROG rises because, like the lump-sum component of any tax schedule, an additional dollar is a greater percentage of income the lower is one’s income. Hence, the core efficiency gain from tax expenditure reform does enable a free lunch. But that, indeed, is the entire point of basic efficiency analysis. When there are avoidable inefficiencies, we are not on the Pareto frontier. Correspondingly, if there exist policies that remedy the inefficiencies (without causing other collateral damage), we then generate a surplus that can, in principle, make everyone better off. Or, instead, one could rebate the proceeds in a more or less redistributive fashion than pro rata. Or one could use the funds to provide more public goods or reduce the debt. Free lunches do exist, and the hidden benefactor is whoever found and rectified the inefficiencies: in this instance, those resulting from junk tax expenditures.16

2.5. Raising Revenue

Raising revenue is another often-advanced goal of tax expenditure limitation proposals. This too is best understood by applying the distribution-neutral framework. In the distribution-neutral implementation, as we were just reminded, revenue effects arise entirely on account of efficiency correction. And that revenue might be rebated in any pattern the policy-makers desire.

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16 Or, as explained in subsection 2.1, corrective tax expenditures that are adjusted in a manner that improves the precision of externality correction.
or retained to fund programs or deficit reduction. It is apparent, however, that most who advance
tax expenditure limitations on revenue-raising grounds are not referring to this aspect, but instead
have in mind retaining some or all of the revenue mechanically raised by the tax expenditure
limitations in order to fund programs or reduce the deficit. Regarding this motivation, the
distribution-neutral framework is also illuminating.

In particular, to analyze a tax expenditure limitation proposal wherein some of the
revenue is to be retained rather than rebated, consider the following variant of the two-step
decomposition from subsection 2.2:

1. Distribution-neutral implementation: Combine the tax expenditure limitation
   component with a distribution-neutral income tax schedule adjustment of the sort
   examined throughout. Then, an instant after this is to be enacted, and with the same
effective date, do the following:

2. Pure revenue-raising: Implement an adjustment to the income tax schedule
   that moves from the distribution-neutral schedule to the actual schedule in the overall
   proposal under consideration.

If one compares the prior description or the original two-step decomposition, one will find that
the above is identical except that the label “pure redistribution” was changed to “pure revenue-raising.” And there are similar benefits from clarity and specialization resulting from this
decomposition. As always, the first step is just our pure distribution-neutral experiment,
analyzed as such.

Here, the second step, a pure increase in (effective) tax rates to fund whatever, can be
analyzed generically, as such. That is, the analysis would be essentially the same if policy-
makers implemented step two without regard to whether it had anything to do with a tax
expenditure limitation proposal. Higher taxes may be a good thing. Or they may not. But whether that is so depends on whether that it so and does not, in any way revealed by the literature on tax expenditure limitations, depend on whether it is done in isolation, as part of a tax expenditure limitation, as part of the use of proceeds from a carbon tax, or in some other manner.

It might be thought that revenue raising is less distortionary, all else equal, after a tax expenditure limitation is implemented because one starts with lower MTRs. Because distortion rises nonlinearly with the MTR, it now appears to be less costly to raise revenue. The foregoing analysis indicates that this view is also mistaken because it confuses statutory and effective MTRs. Tax expenditure limitations, as elaborated in subsection 2.3, reduce statutory MTRs but not effective MTRs – they are held constant in a distribution-neutral implementation (and, for present purposes, a revenue-neutral implementation as well). If one enacted the tax expenditure limitation and did not use the proceeds to reduce tax rates, as in the prior illustration, effective MTRs would rise rather than be constant. The only way to keep effective MTRs the same is to rebate the proceeds in a distribution-neutral fashion, leaving no revenue. (The key qualification, as already noted, is that the efficiency gains from the reduction in consumption distortion may be retained as added revenue without raising effective MTRs, but this important feature is outside of what is ordinarily contemplated.)

There is, however, an important respect in which revenue-raising (and redistribution, if one so chooses) may become more economically efficient as a consequence of tax expenditure limitations. Even though the benchmark effective MTR on labor income is not changed – no free lunch there – it is the case that when a tax system has a broader base, it may well be less distortionary to raise MTRs. In a pure income tax regime – one with no junk tax expenditures –
raising the MTR distorts labor supply and nothing more.\textsuperscript{17} In an income tax littered with junk tax expenditures – specifically ones that are in the form of exclusions and deductions and hence a function of statutory MTRs – raising statutory MTRs caused additional consumption distortions as well as a labor supply distortion. Although it is incorrect to simply count the number of distortions when performing second best analysis, when the additional consumption distortions are orthogonal to labor supply distortions (such as when there is weak separability of labor in individuals’ utility functions, as assumed here), then this is indeed an added efficiency cost. Work by Kopczuk (2005) and Kopczuk and Slemrod (2002) elaborates this important point (which is more subtle than the foregoing suggests). Note that, once again, the source of potential gains from tax expenditure limitations resides, in the first instance, in the direct efficiency benefits from reducing consumption distortion, not in anything magic about starting from a lower statutory MTR.\textsuperscript{18}

2.6. Distribution Neutrality as a Descriptive Benchmark

It has already been argued that a distribution-neutral benchmark is clarifying in a number of ways. This subsection suggests that, even at as basic a level of how to display descriptive findings, distribution neutral implementation is clarifying. This subject is best illuminated by taking a concrete example. For this purpose, I will consider the recent paper by Burman, Toder, Berger, and Rohaly (BTBR, forthcoming). To their credit, BTBR not only do an impressive job of modeling the effects of tax expenditures on revenue and tax burdens at various levels of

\textsuperscript{17} As mentioned, this article abstracts entirely from the savings margin and capital taxation. One could extend the framework accordingly, and similar conclusions would follow, although this and other statements in the text would need to be modified accordingly.

\textsuperscript{18} Throughout, the analysis ignores how various forms of evasion and avoidance may depend on statutory MTRs. This point is analytically close to those just mentioned about how raising the statutory MTR may be less distortionary when the base is broader, even when starting from the same effective MTR.
income, but they also offer useful ways to display the results of their analysis. The greatest challenge they face in this respect, which they highlight, is that different formulations of tax expenditure limitations and different ways of rebating the revenue raised from such limitations have important effects on the resulting distributive effects. Moreover, we have the problem that the possibilities are multiplicative because we must intersect each limitation proposal with each method of using the revenue to cut tax rates. Even worse, there are an infinity of ways to do the latter any given limitation proposal, so one must choose (somewhat arbitrarily) a handful of possibilities for purposes of illustration. The resulting presentation, despite BTBR’s helpful choices in cases to be considered and methods of displaying results, is quite challenging for a reader.

A distribution-neutral benchmark can help. First, consider a particular tax expenditure limitation proposal, say, any of the three that BTBR analyze in detail. One simple way to display its consequences is to compare statutory MTRs under it to those under a distribution-neutral implementation. The pattern of differences would show the distributive effect of the limitation proposal, setting aside its method of finance. Where MTRs fall more (less), those income groups would be those that are hit harder (less) by the direct effect of the limitation, by comparison to the group whose income is somewhat lower. Instead, one might graph total taxes paid as a function of income. Such a graph of the tax schedule would capture all of this information. In the same fashion, the effect of the three tax expenditure limitation proposals versus the status quo – and versus each other – could be depicted similarly, all on a single graph. A picture is worth

19 The text refers to comparisons with the income group just below the one under consideration because the overall effect at a given income level is given by the sum (integral, if modelled continuously) of the effects of differing MTRs, starting at an income of zero. This motivates the next statement in the text: graphing the total taxes paid as a function of income.
20 See note xxx {note 4 at the moment} sketching how construction of the distribution-neutral tax schedule might be accomplished.
Second, to compare the effect of various ways of reducing tax rates in order to rebate the revenues raised by a tax expenditure limitation proposal, one could proceed similarly. That is, one can present taxes paid as a function of income under distribution-neutral implementation and compare it to the schedule under each alternative. Where an alternative’s schedule lies above (below) the schedule for distribution-neutral implementation, individuals at that income pay more (less) to that extent. Likewise, one could present the distribution-neutral schedule and the schedules for each of the posited alternative means of returning the revenue on a single graph, making clear all the differences.

Finally, BTBR consider how various packages might affect incentives, and here I will focus on the labor effort margin. The aforementioned graphs provide this information as well. We know that, in the benchmark case, the distribution-neutral version leaves labor effort unchanged. Hence, wherever the slope of the tax schedule is higher (lower) under an alternative scheme than under the distribution-neutral version, work incentives are reduced (increased).\footnote{The text refers to the substitution effect because it is MTRs that are being compared. To capture the uncompensated change, one would also have to integrate the effects, or examine the schedules for total taxes paid, to extract the income change and then determine the income effect.}

Or, more directly, by graphing the effective MTRs under the distribution-neutral version and any other, one can immediately see how labor incentives change.

Note that each of these comparisons between tax schedules under various combinations of expenditure limitation and tax rate reduction to those under the distribution-neutral implementation of the corresponding tax expenditure limitation are simply a depiction of the two-step decomposition introduced previously. Step one is the distribution-neutral curve. Each of the other curves combines steps one and two. Hence, the difference between the distribution-
neutral curve and another curve will depict step two – the purely redistributive component – in isolation.

Finally, reflecting on all of these comparisons, we can see the link between distribution and labor supply distortion that has been emphasized throughout this article. As just explained, the same graph that shows higher (lower) effective MTRs is showing greater (lesser) income redistribution. That is, these graphs – and specifically, comparisons of various reform curves with their corresponding distribution-neutral-implementation curve – show exactly how distribution and distortion go hand in hand. It would be unlikely that one examining results displayed in this fashion would mistakenly conclude that some reform package both raises distribution and reduces labor supply distortion simultaneously, or conversely. In sum, there is a tight connection between the way one displays the results of reform packages and how well one understands their consequences. At least this is so when that display makes distribution-neutral implementation a benchmark for comparison. Relatedly, this point reinforces the utility of a distribution-neutral perspective even when none of the reforms under examination are in fact distribution neutral.

3. Conclusion

The distribution-neutral framework for policy analysis that is developed in a body of work over the last two decades is an extremely powerful tool for the analysis of tax expenditure limitations. This conclusion should not be surprising because that methodology is quite general in embracing a range of fiscal tools, from taxes and transfers to regulation to expenditures on public goods. Moreover, the most basic version of the approach involves the assessment of commodity tax reform in the presence of an income tax. As explained, the methodology does
not require that the initial (or final) income tax be optimal or that the commodity tax reform be a move all the way to the optimum (or that analysis be confined to a neighborhood of the optimum). Because tax expenditures are not merely analogous to but an instance of differential commodity taxation, application of the framework to tax expenditure limitations is direct.

The distribution-neutral framework, moreover, proves to be illuminating with regard to tax expenditure limitation proposals and various ways of using the revenue derived therefrom. The analysis clarifies thinking. And the two-step decomposition allows one to isolate the distinctive effects of tax expenditure reform – reduction of distortion in expenditure choices – from effects on distribution, labor supply distortion, and revenue. In particular, it shows how a number of commonly advanced beliefs about the benefits of tax expenditure limitation proposals – including the view that there exists a free lunch wherein one can reduce MTRs and enhance redistribution simultaneously – are largely illusory.

Finally, although outside the scope of this article, a distribution-neutral approach may also have some bearing on the construction of politically feasible reform packages. TRA 1986 ostensibly broadened the tax base via the reduction of tax expenditures in a manner that was not only revenue-neutral but also distribution-neutral. As explained, distribution-neutral packages result in Pareto improvements when the underlying reforms are efficient. Although in a world with substantial heterogeneity (largely set to the side here), Pareto improvements are not practically possible, it remains the case that a distribution-neutral reform that is efficient makes it possible for those at every slice of the income distribution to be made better off on average. This possibility does seem to offer reason to believe that there may exist ways to improve the tax system that are politically feasible.
References


