BACKGROUNDER

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PEP and Pease Hurt Larger Families Most and Slow Growth

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Abstract

In the fiscal cliff deal, President Barack Obama and Congress surprisingly reinstated two long dormant tax policies: the personal exemption phaseout (PEP) and "Pease," a cap on itemized deductions. The 2001 Bush tax cuts rightfully abolished them because they are bad policies. Now they are back, raising taxes on larger families and reducing the incentives to work and save. These reduced incentives will slow economic growth and, like the tax increase, hit larger families hardest. Pease is similar to the cap on deductions and exemptions that President Obama has proposed in his budgets. Fundamental tax reform is the best way for Congress to fix its mistake of reviving these policies.

After a 12-year hiatus, Congress and President Barack Obama reinstated the personal exemption phaseout (PEP) and "Pease" in the fiscal cliff deal struck in the early hours of New Year's Day. PEP raises taxes on high-income taxpayers by reducing, then eliminating, the value of their personal exemptions. Pease—which is named after Representative Donald J. Pease, who is credited with its creation—raises their taxes by capping itemized deductions. The 2001 Bush tax cuts rightly eliminated these provisions because they are bad polices.

Congress and President Obama erred seriously by inflicting PEP and Pease once again on American taxpayers. They hurt larger families most and will slow economic growth. They are yet another reason to enact fundamental tax reform.

Key Points

- In the fiscal cliff deal, President Obama and Congress reinstated the personal exemption phaseout (PEP) and "Pease," a cap on itemized deductions. The 2001 Bush tax cuts abolished them because they are bad policies.
- PEP raises taxes the most on larger families.
- Pease reduces the value of itemized deductions and, as a result, will harm the housing market and charitable giving. It is similar to the cap on deductions and exemptions that President Obama has proposed in each of his budgets.
- PEP and Pease reduce incentives to work and save, slowing economic growth. They reduce those incentives the most for larger families.
- Tax reform is the best way for Congress to rid the tax code of these damaging polices.

This paper, in its entirety, can be found at **http://report.heritage.org/bg2803**

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TABLE 1

Personal Exemption Phase-out (PEP) Raises Taxes More for Larger Families

Exemptions *(family size)*	Total Personal Exemption	Tax Increase for Every $2,500 of Income Above the PEP Threshold *(33% marginal rate)*
1	$3,900	$26
2	$7,800	$51
3	$11,700	$77
4	$15,600	$103
5	$19,500	$129
6	$23,400	$154
7	$27,300	$180
8	$31,200	$206
9	$35,100	$232
10	$39,000	$257

Source: Heritage Foundation calculations.

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Hitting Larger Families Hardest

PEP and Pease are substantial tax increases, together raising about $150 billion over the next 10 years. This is almost one-fourth of the total tax increase resulting from the fiscal cliff deal.[1]

The personal exemption lowers taxable income by $3,900 per family member in 2013. PEP raises taxes by reducing the personal exemption for higher-income taxpayers. This exposes to a taxpayers' top marginal rate income previously exempted from tax. PEP reduces the total personal exemption by 2 percent for every $2,500 of income for married taxpayers with adjusted gross incomes (AGIs) over $300,000 and for single filers with AGIs over $250,000. This entirely eliminates personal exemptions at $422,500 for married filers and $372,500 for single filers.

Since PEP reduces the total personal exemptions available by a fixed percentage it takes a heavier toll on families with more children. For families in the 33 percent tax bracket ($223,050 to $398,350 of taxable income in 2013), PEP raises taxes $26 per family member for every $2,500 of income over the PEP threshold.

A family with an income of $347,500 and one child therefore has three exemptions and pays $1,540 in higher taxes because of PEP. A family with the same income but three children (five exemptions) faces a tax increase of $2,580 because of PEP—$1,040 more than the family with only one child.

The tax code heavily penalizes families because it forces certain dual-income married filers to pay higher tax rates than they would pay filing as two singles. PEP worsens this unfair tax treatment of families.

Reducing Itemized Deductions

The Pease provision phases down itemized deductions for taxpayers earning over the same income thresholds as PEP. It reduces deductions by 3 percent of the taxpayer's AGI over the threshold up to 80 percent of their deductions—whichever is smaller. It neither phases them out entirely as PEP does for personal exemptions, nor has an income threshold at which the phase-down concludes.[2]

Pease raises taxes the same way as PEP, by exposing more of a families' income to their marginal tax rate. For instance, for the hypothetical families above, it reduces their deductions by $1,425 and raises their taxes by $470. Unlike PEP, family size does not factor into the Pease tax increase.

Because PEP and Pease kick in at the same income level, they raise these families' tax simultaneously. Combined, they raise the family of three's taxes by $2,010 and the family of five's taxes by $3,050.

Misguidedly Targeting High-Income Taxpayers

Pease is similar to the cap on itemized deductions that President Obama has proposed in all of his

1. Jeff Zients, "American Taxpayer Relief Act Reduces Deficits by $737 Billion," Office of Management and Budget, January 1, 2013, http://www.whitehouse.gov/blog/2013/01/01/american-taxpayer-relief-act-reduces-deficits-737-billion (accessed February 4, 2013).
2. For the 80 percent method to apply, taxpayers must earn more than $625,360 AGI and have deductions only slightly over the $12,200 standard deduction. For every $27 of income over that amount, deductions would need to rise by less than a $1 for the 80 percent method to remain in effect.

TAX FORM 1

To calculate the tax increase from the Personal Exemption Phase-out (PEP), the IRS will likely use a worksheet similar to this. It is filled out for the hypothetical family of three with Adjusted Gross Income (AGI) of $347,500.

1. Is your income over $300,000 ($250,000 if you are single)?

- [x] Yes
- [ ] No

If "yes" complete rest of form.

2. Subtract $300,000 from your AGI ($250,000 if single) (AGI is found on Line 37 of form 1040.)	2	$347,500–$300,000 = $47,500
3. Divide Line 2 by $2,500	3	$47,500/$2,500 = 19
4. Add one to line 3 (This is the number of $2,500 segments the family's income is over the $300,000 PEP threshold.)	4	19 + 1 = 20
5. Multiply Line 4 by 2 percent (This is the percentage by which PEP reduces total personal exemptions.)	5	20 x 2% = 40%
6. Multiply the number of family members by the personal exemption	6	3 x $3,900 = $11,700
7. Multiply Line 6 by Line 5 (This is the amount PEP reduces the personal exemption.)	7	$11,700 x 40% = $4,680
8. Multiply Line 7 by your marginal tax rate (This is the amount PEP raises taxes.)	8	$4,680 x 33% = $1,540

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budgets, including his most recent budget proposal. That cap would limit the value of itemized deductions and some exemptions to the tax reduction taxpayers receive if they pay the 28 percent marginal tax rate.[3]

The purpose of the President's cap is to raise taxes even higher on high-income taxpayers under the guise of reducing unwarranted loopholes. Lost in the fervor to soak the rich even more is that the cap is misguided policy because, just like Pease, it ignores that certain deductions, such as the ones for mortgage interest and charitable contributions, are necessary to maintain neutrality (to prevent the tax code from influencing economic decisions).

For instance, Pease imposes a tax penalty on taking a mortgage to buy a home and for donating to charities that a neutral tax code would not. As a result, it creates disincentives to invest in housing

3. Curtis S. Dubay, "The President's 2013 Budget: More Troubling Tax Increases in the Fine Print," Heritage Foundation *Backgrounder* No. 2704, June 25, 2012, http://www.heritage.org/research/reports/2012/06/the-presidents-2013-budget-more-troubling-tax-increases-in-the-fine-print.

TAX FORM 2

To calculate the tax increases Pease causes, the IRS will likely use a worksheet similar to this, filled out for the hypothetical families with Adjusted Gross Income (AGI) of $347,500:

1. Is your income over $300,000 ($250,000 if you are single)?

☒ Yes
☐ No

If "yes" complete rest of form.

2. Subtract $300,000 from your AGI	2	$347,500–$300,000 = $47,500
3. Multiply Line 2 by 3 percent (This is the amount Pease reduces itemized deductions.)	3	$47,500 x 3% = $1,425
4. Multiply Line 3 by your marginal tax rate (This is the amount Pease raises taxes.)	4	$1,425 x 33% = $470

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and to donating to charity. This harms the still-recovering housing market and hurts civil society by reducing donations to charities that serve the neediest among us. President Obama's cap would worsen the harm that Pease already inflicts.

The folly of Pease and the President's cap does not mean that Congress should keep all deductions. The income tax code includes a variety of deductions, exemptions, and credits that are not sound tax policies. Rather, Congress should examine these provisions individually and gauge their necessity for maintaining neutrality. Congress should abolish any that do not pass the neutrality test, but only as part of revenue-neutral tax reform.

Lower Incentives to Work and Save

PEP and Pease reduce incentives to work and save because they raise marginal effective tax rates (METR). A taxpayer's METR is the percentage of an additional dollar of income that they pay in tax. In many cases, taxpayers' METR equals their statutory marginal rate on taxable income. The statutory rate is the rate prescribed in law and is the rate usually seen in tables of tax brackets.

The METR equals the statutory rate on taxable income as income rises when no reductions to tax preferences (deductions, credits, exemptions, and deductions) or additional surtaxes are assessed. Because PEP and Pease reduce personal exemptions and itemized deductions as income rises, they raise METRs for taxpayers earning above their income thresholds.

The higher METRs reduce the relative returns of working compared with leisure and of saving compared with consuming. Faced with paying a higher percentage of their additional income in taxes, some taxpayers will decide that spending more hours at work is not worth the lost leisure time. They may also decide to spend income that they otherwise would have saved.

By reducing the incentive for the highly skilled to work, PEP and Pease curtail productivity and slow economic growth.

Furthermore, the individuals most affected by the higher METRs from PEP and Pease are those with the greatest ability to respond to incentives over time. Higher METRs create an incentive for the second workers in some of these families to work fewer hours, exit the labor force entirely, or not enter the workforce at all. By reducing the incentive for the highly skilled to work, PEP and Pease curtail productivity and slow economic growth.

TABLE 2

METRs Increase More for Larger Families Because of PEP

Exemptions *(family size)*	METR Increase from PEP	METR Increase from Pease	Total METR *(33% bracket)*
1	1.00%	1.00%	35%
2	2.10%	1.00%	36.10%
3	3.10%	1.00%	37.10%
4	4.10%	1.00%	38.10%
5	5.10%	1.00%	39.10%
6	6.20%	1.00%	40.20%
7	7.20%	1.00%	41.20%
8	8.20%	1.00%	42.20%
9	9.30%	1.00%	43.30%
10	10.30%	1.00%	44.30%

Source: Heritage Foundation calculations.

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Higher METRs for Larger Families

PEP has a stronger negative effect on work incentives for larger families because it raises METRs as family size increases. It increases METRs slightly more than 1 percentage point per exemption—in other words, per every additional child.[4]

For instance, PEP raises the METR of the family of three by more than 3 percentage points and the METR of the family of five by more than 5 percentage points. As the personal exemption rises with inflation in future years, the increase in METRs PEP causes will rise as well.

Further Raising METRs

Since Pease begins at the same income thresholds as PEP, it combines with PEP to further raise METRs by another percentage point.[5] Because Pease does not depend on family size and does not have an end point like PEP, it raises METRs for every dollar over the threshold until 80 percent of the taxpayer's itemized deductions are lost.

For larger families in the PEP phaseout range, PEP and Pease combine to sharply increase the families' METRs compared with their statutory marginal rate. For instance, the family of three's total METR would be more than 37 percent compared with their statutory rate of 33 percent. The family of five's total METR would be over 39 percent because of PEP's particularly harsh treatment of larger families.

The tax code should not single out certain large families for punishment. In their rush to raise taxes on the rich by reinstituting PEP and Pease, Congress and President Obama inflicted this punitive consequence on larger families.

Tax Reform Is Best Choice

PEP and Pease are bad policies that slow economic growth and hurt larger families the most. They also sharply raise taxes, giving Washington even more money to spend when it should be correcting its overspending problem that is causing the deficit and debt crisis.

The pain that PEP and Pease inflict on larger families and the economy will remain until Congress repeals them permanently. The best way to do that is through fundamental tax reform. PEP and Pease are two more items on the list of reasons to enact pro-growth, simple tax reform, such as the New Flat Tax introduced as part of the Heritage Foundation's comprehensive plan[6] to correct America's unsustainable fiscal trajectory.

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4. To calculate the increase in METR caused by PEP for each exemption, the $26 tax increase for each exemption is divided by $2,500 ($26/$2,500 = 1.04 percent). For taxpayers in the 35 percent bracket, the METR increase because of PEP is slightly higher because the tax increase per exemption is higher.
5. To calculate the METR increase caused by Pease, the 3 percent phasedown is multiplied by the taxpayer's marginal tax rate. For the 33 percent bracket, 33 percent x 3 percent = 1 percent. In the 35 percent and 39.6 percent brackets, Pease raises METRs slightly more.
6. J. D. Foster, "The New Flat Tax: Easy as One, Two, Three," Heritage Foundation *Backgrounder* No. 2631, December 13, 2011, http://www.heritage.org/research/reports/2011/12/the-new-flat-tax-easy-as-one-two-three.