Part Two

Revenue Options

REV-01 LIMIT MORTGAGE PRINCIPAL ELIGIBLE FOR INTEREST DEDUCTION TO $300,000

	Added Revenues (Billions of dollars)
Annual	
2000	2.2
2001	3.1
2002	3.2
2003	3.4
2004	3.7
2005	4.1
2006	4.5
2007	5.0
2008	5.5
2009	6.0
Cumulative	
2000-2004	15.6
2000-2009	40.8

SOURCE: Joint Committee on Taxation.

RELATED OPTION:

REV-02

A home is the largest consumer purchase and the main investment for most Americans. The tax code has historically treated homes more favorably than other investments. Most investments pay their return in cash that is subject to income taxes. Homes, however, pay their return in housing services directly to the owner, and that return is not subject to taxation. Furthermore, owners who help finance their home purchase with a mortgage are allowed to deduct the interest even though the investment produces no taxable income. The tax code also exempts most capital gains from home sales.

Limiting mortgage interest deductions would reduce the preferential treatment of home ownership for owners who must borrow to purchase their homes. Under current law, taxpayers may deduct interest on up to $1 million of debt that they have incurred to acquire and improve first and second homes. They may also deduct interest on up to $100,000 of other loans they have secured with a home (home-equity loans), regardless of purpose. No other type of consumer interest is deductible. Current law also limits the extent to which interest deductions for carrying assets other than first and second homes can exceed income from such assets.

Lowering the limit on the amount of principal eligible for the mortgage interest deduction from $1 million to $300,000 would reduce deductions for about half a million taxpayers with large mortgages and increase revenues by $40.8 billion over the 2000-2009 period. That change would reduce the deduction only for owners of relatively expensive homes. Only 4 percent of new mortgages originated in 1998 exceeded $300,000. The fraction affected would be greatest in high-cost areas such as Honolulu and San Francisco.

Preferential treatment for home ownership encourages people to become homeowners and to purchase larger homes. Increasing home ownership may contribute to social and political stability by strengthening people's stake in their communities and governments. In addition, such preferential treatment may stabilize neighborhoods by encouraging longer-term residence and home improvement. The amount of preference, however, is probably larger than needed to maintain a high rate of home ownership among people buying homes valued over $300,000. Canada achieves about the same rate of home ownership as the United States without allowing the deduction of mortgage interest. Instead of the deduction, some provinces provide a limited tax credit for low- and middle-income people who save for a down payment.

A disadvantage of providing preferential tax treatment for investment in home ownership is that it reduces the amount of savings available for investment in taxable business enterprises. In recent years, about 30 percent of net private investment has gone into owner-occupied housing. Consequently, a reduction in investment in owner-occupied housing could raise investment noticeably in other sectors.

REV-02 LIMIT THE MORTGAGE INTEREST DEDUCTION FOR SECOND HOMES

	Added Revenues (Billions of dollars)
Annual	
2000	0.5
2001	0.7
2002	0.7
2003	0.7
2004	0.8
2005	0.8
2006	0.8
2007	0.8
2008	0.9
2009	0.9
Cumulative	
2000-2004	3.4
2000-2009	7.6

SOURCE: Joint Committee on Taxation.

RELATED OPTION:

REV-01

Taxpayers who borrow to purchase or improve a second home may deduct the interest on that mortgage on the same terms as for a first home. The only limit on the amount borrowed for the two homes is that it be under $1 million. Furthermore, equity in both homes may be used as collateral to borrow $100,000 that can be used for any purpose and whose interest may be deducted (home-equity loans).

Several arguments for and against limiting the deductibility of all mortgage interest appear in option REV-01. Additional considerations apply to mortgage interest on second homes. Permitting taxpayers to deduct the interest from mortgages on second homes—many of which are vacation homes—may seem inequitable when taxpayers cannot deduct interest from consumer loans used to finance either medical expenses or other consumer purchases. However, limiting the deduction of mortgage interest to a single home would retain the current deduction for taxpayers with high mortgage interest on a costly primary home while partially denying it for other taxpayers with equal combined mortgage interest on two less costly homes.

The deductibility of mortgage interest could be limited to debt that taxpayers incur to acquire and improve a primary residence, plus $100,000 of other debt secured by that home. That approach would require interest deductions for second homes to qualify under the $100,000 limit on home-equity loans if they are to be deductible. The limitation would increase revenue by $7.6 billion for the 2000-2009 period.

REV-03 LIMIT DEDUCTIONS OF STATE AND LOCAL TAXES TO THE EXCESS OVER 2 PERCENT OF ADJUSTED GROSS INCOME

	Added Revenues (Billions of dollars)
Annual	
2000	5.3
2001	17.9
2002	18.4
2003	18.9
2004	19.5
2005	20.0
2006	20.4
2007	20.8
2008	21.2
2009	21.5
Cumulative	
2000-2004	80.0
2000-2009	183.9

SOURCE: Joint Committee on Taxation.

In determining their taxable income, taxpayers may claim a standard deduction or itemize and deduct from their adjusted gross income (AGI) certain specific expenses, including state and local income, real estate, and personal property taxes. For taxpayers who itemize, those deductions provide a federal subsidy of state and local tax payments. Consequently, the deductions indirectly finance increased state and local government spending at the expense of other uses of federal revenues.

Limiting the deductibility of state and local tax payments to the amount in excess of 2 percent of AGI would continue the mitigating effect of the deduction on differences in taxes among states and increase federal revenues by about $184 billion over the 2000-2009 period. An alternative approach would be to prohibit deductions above a fixed ceiling, which also might be a percentage of AGI. A ceiling set at 5.75 percent of AGI would increase revenues by about the same amount—$187 billion in 2000 through 2009. A floor and a ceiling, however, would have very different effects on incentives for state and local spending. A floor would retain the incentive for increased spending, but a ceiling would reduce it.

As a way to assist state and local governments, deductibility of state and local taxes has several disadvantages. First, the deductions reduce federal tax liability only for itemizers. Second, because the value of an additional dollar of deductions increases with the marginal tax rate, the deductions are worth more to higher-bracket taxpayers. Third, deductibility favors wealthier communities. Communities with a higher average income level have more residents who itemize and are therefore more likely to spend more because of deductibility than lower-income communities. Fourth, deductibility may discourage states and localities from financing services with nondeductible user fees, thereby discouraging efficient pricing of some services.

An argument against restricting deductibility is that a taxpayer with a large state and local tax liability has less ability to pay federal taxes than one with equal total income and a smaller state and local tax bill. In some areas, a taxpayer who pays higher state and local taxes may receive more benefits from publicly provided services, such as recreational facilities. In that case, the taxes are more like payments for other goods and services (for example, private recreation) that are not deductible. Alternatively, higher public expenditures resulting from deductibility benefit all members of a community, including lower-income nonitemizers who do not receive a direct tax saving.

REV-04 LIMIT DEDUCTIONS FOR CHARITABLE GIFTS OF APPRECIATED PROPERTY TO TAX BASIS

	Added Revenues (Billions of dollars)
Annual	
2000	0.3
2001	1.7
2002	1.8
2003	1.8
2004	1.9
2005	1.9
2006	2.0
2007	2.0
2008	2.1
2009	2.1
Cumulative	
2000-2004	7.5
2000-2009	17.6

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-05, REV-23-A, REV-23-B, and REV-24

Under current law, taxpayers who itemize deductions may deduct the value of contributions they make to qualifying charitable organizations up to a maximum of 50 percent of adjusted gross income in any year. In 1996, 32 million taxpayers claimed just over $86 billion of deductions for charitable contributions, reducing federal revenues by about $22 billion. In addition to cash donations, taxpayers may deduct the fair market value of a contribution of appreciated property that they have held for more than 12 months, regardless of how much they paid for the property.

The deduction provides significant government support for charitable activities. But one criticism of the deduction is that it provides unequal federal matching rates for contributions by different taxpayers. The government subsidy rates can approach 40 percent of contributions for the highest-income taxpayers but are only 15 percent for taxpayers in the lowest tax bracket and zero for people who do not itemize deductions. Another criticism is that the electorate as a whole, and not individual donors, should make decisions about which activities deserve taxpayer support.

Limiting the deduction of appreciated property to a taxpayer's cost of an asset under the regular income tax would increase revenues by about $0.3 billion in 2000 and by more than $17.6 billion over 10 years. The existing provision allows taxpayers to deduct the entire value of assets they contributed even though they paid no tax on the gain from appreciation. That outcome provides preferential treatment to one kind of donation relative to other kinds and expands the preferential treatment of capital gains (see options REV-23A, REV-23B, and REV-24). Indisputably, however, the current provision encourages people to donate appreciated assets, such as stock or art, to eligible activities rather than leave them to their heirs at death, when any gains also escape income tax (see also option REV-05).

REV-05 LIMIT DEDUCTIONS FOR CHARITABLE GIVING TO THE AMOUNT EXCEEDING 2 PERCENT OF ADJUSTED GROSS INCOME

	Added Revenues (Billions of dollars)
Annual	
2000	1.5
2001	10.3
2002	10.9
2003	11.4
2004	12.0
2005	12.6
2006	13.3
2007	14.0
2008	14.7
2009	15.4
Cumulative	
2000-2004	46.1
2000-2009	116.1

SOURCE: Joint Committee on Taxation.

RELATED OPTION:

REV-04

Current law allows taxpayers who itemize to deduct the value of contributions they make to qualifying charitable organizations up to a maximum of 50 percent of adjusted gross income (AGI) in any year. It also allows contributions of appreciated property to be deducted at fair market value. One proposed change would limit the deduction for donations of appreciated property to its tax basis (see option REV-04). Another way to limit the charitable deduction but retain an incentive for giving would be to allow taxpayers to deduct only contributions that exceed 2 percent of AGI.

Such a limit would retain the incentive for increased giving by people who donate a large share of their income but would remove the incentive for people who contribute smaller amounts. It would completely disqualify the charitable deductions of about 17.6 million taxpayers in 2000 and reduce allowed deductions for roughly another 16.1 million. The option would increase revenues by about $1.5 billion in 2000 and by about $116 billion over the 2000-2009 period. Such a change would eliminate the tax incentive for just over half of the taxpayers who currently make and deduct charitable contributions. As a result, overall charitable giving would decline. In addition, it would encourage taxpayers who planned to make contributions over several years to lump them together in one tax year to qualify for a deduction with the 2 percent floor.

REV-06 PHASE OUT THE CHILD AND DEPENDENT CARE CREDIT

	Added Revenues (Billions of dollars)
Annual	
2000	0.3
2001	1.4
2002	1.4
2003	1.4
2004	1.4
2005	1.3
2006	1.3
2007	1.2
2008	1.1
2009	1.0
Cumulative	
2000-2004	5.9
2000-2009	11.8

SOURCE: Joint Committee on Taxation.

RELATED OPTION:

REV-12

Taxpayers who incur employment-related expenses for the care of children and certain other dependents may claim an income tax credit. The credit per dollar of qualifying expenses declines from 30 percent for taxpayers whose adjusted gross income (AGI) is $10,000 or less to 20 percent for taxpayers whose AGI is above $28,000. Tax law limits creditable expenses to $2,400 for one child and $4,800 for two or more. The maximum credit for a taxpayer with one child and income above $28,000 is thus $480 each year. Creditable expenses cannot exceed the earnings of the taxpayer or, in the case of a couple, the earnings of the spouse with lower earnings. In 1996, taxpayers claimed about $2.5 billion in credits on 6 million tax returns.

About two-fifths of the credit benefits taxpayers with an AGI of $50,000 or more. Retaining the credit for only lower-income families would reduce its revenue cost. One way to do that would be to lower the percentage of credit as income rises. For example, trimming the credit percentage by 1 percentage point for each $1,500 of AGI over $30,000—and thus eliminating it completely for those with an AGI over $58,500—would raise $11.8 billion from 2000 through 2009. That option would reduce or eliminate the credit for about 72 percent of currently eligible families. Alternatively, phasing out the credit between $50,000 and $78,500 would raise about $7.8 billion in the same period. That option would reduce or eliminate the credit for nearly half of the eligible families. Finally, phasing out the credit between $65,000 and $93,500 would raise $5.6 billion in the same period, reducing or eliminating the credit for about one-third of eligible families.

The credit provides a work subsidy for families with children. Phasing out the credit for higher-income families targets the subsidy toward families with greater economic need, but it may discourage parents in families with a reduced credit from working outside the home.

If the credit was phased out, higher-income employees could seek other tax benefits for dependent care by asking their employers to provide subsidized day care. Current law allows workers to exclude from taxable income up to $5,000 of annual earnings used to pay for dependent care through employer-based programs. If more employer-subsidized dependent care was provided, budgetary savings would fall. To preclude taxpayers from using that alternative, the Congress could limit the use of that fringe benefit (see option REV-12).

REV-07 INCLUDE SOCIAL SECURITY BENEFITS IN THE PHASEOUT OF THE EARNED INCOME TAX CREDIT

	Added Revenues[a] (Billions of dollars)
Annual	
2000	1.0
2001	1.1
2002	1.1
2003	1.2
2004	1.2
2005	1.2
2006	1.3
2007	1.3
2008	1.4
2009	1.4
Cumulative	
2000-2004	5.6
2000-2009	12.2

SOURCE: Joint Committee on Taxation.

a. Includes outlay savings.

Under current law, the earned income tax credit (EITC) is phased out as the larger of earned income or adjusted gross income (AGI) exceeds a certain threshold. To phase out the EITC, the Taxpayer Relief Act of 1997 expanded the definition of AGI to include tax-exempt interest and nontaxable distributions from pensions, annuities, and individual retirement arrangements not rolled over into similar vehicles. The modified AGI still excludes most transfer income, however. Low-income families with significant transfer income can thus claim the EITC with total income that would reduce or deny the credit to otherwise equivalent families whose income is fully included in their AGI. For single taxpayers with income above $25,000 and joint filers with income above $32,000, AGI includes up to half of Social Security benefits. This option would require that taxpayers include all Social Security benefits in a modified AGI used to phase out the EITC. That change would increase federal revenues and decrease outlays for the EITC by a total of $1 billion in 2000 and $12.2 billion over the 2000-2009 period.

Counting all Social Security benefits to phase out the EITC would give the same EITC to low-income taxpayers receiving Social Security and claiming the EITC as that received by otherwise comparable taxpayers whose income derives entirely from sources fully included in AGI. The Internal Revenue Service (IRS) already receives information on taxpayers' Social Security benefits, so administering this option would require only minor procedural changes.

Because the modified AGI would still exclude some forms of transfer income, however, this option would not remove all differences in EITC for families with the same total income. The IRS does not currently receive information on most forms of taxpayers' transfer income. As a result, counting all transfer income would require a substantial expansion of information reporting to the IRS and a marked increase in taxpayers' compliance costs. Furthermore, because most transfer income not included in AGI is means-tested, counting all transfers in phasing out the EITC would offset, at least in part, the goal of providing income to poor recipients. Even so, excluding any transfers from the income measure used to phase out the EITC would result in differential treatment of otherwise equivalent taxpayers.

In addition, counting Social Security benefits for the EITC phaseout would increase compliance costs for Social Security recipients claiming the EITC and would further complicate the already complex form required for the EITC. That would run counter to recent efforts to simplify procedures for claiming the EITC.

REV-08 LIMIT THE TAX BENEFIT OF ITEMIZED DEDUCTIONS TO 15 PERCENT

	Added Revenues (Billions of dollars)
Annual	
2000	35.9
2001	81.7
2002	86.5
2003	91.7
2004	97.5
2005	103.9
2006	111.0
2007	118.5
2008	126.6
2009	135.2
Cumulative	
2000-2004	393.2
2000-2009	988.3

SOURCE: Joint Committee on Taxation.

Current law allows taxpayers to reduce taxable income by the amount of itemized deductions. Taxpayers who itemize may deduct state and local income and property taxes, home mortgage interest payments, contributions to charity, employee business expenses, moving expenses, casualty and theft losses, and medical and dental expenses. Taxpayers benefit from itemizing if their deductions exceed the standard deduction. Current law limits some itemized deductions to the amount in excess of a percentage of adjusted gross income, and it reduces all itemized deductions for high-income taxpayers.

The tax benefit of itemized deductions, like all deductions, increases with a taxpayer's marginal tax bracket. For example, $10,000 in itemized deductions would reduce taxes by $1,500 for a taxpayer in the 15 percent tax bracket, $2,800 for a taxpayer in the 28 percent bracket, and $3,960 for a taxpayer in the 39.6 percent bracket. Most taxpayers do not itemize deductions. Of the 30 percent of taxpayers who do itemize, however, about half are in tax brackets above 15 percent. This option would limit the tax benefit of itemized deductions to 15 percent for those higher-bracket taxpayers. The limit would increase revenues by about $393 billion over five years and $988 billion over 10 years.

Limiting the tax benefit of itemized deductions would make the income tax more progressive by raising average tax rates for most middle- and upper-income taxpayers. The limit might also improve economic efficiency because it would reduce tax subsidies that lower the after-tax prices of selected goods, such as mortgage-financed, owner-occupied housing.

The itemized deductions for health expenses, casualty losses, and employee business expenses, however, are not subsidies of voluntary activities but are instead allowances for costs that reduce the ability to pay income tax. Under this option, some taxpayers would pay tax on income they use to defray such costs because they would pay tax on their gross income at rates above 15 percent but could deduct only 15 percent of the cost of earning income. Thus, an individual with unusually high medical bills, for example, would pay more tax than another individual with the same ability to pay but low medical bills.

Like other limits on itemized deductions, this option would create incentives for taxpayers to avoid the limit by converting itemized deductions into reductions in income. For example, taxpayers might draw down assets to repay mortgages, reducing both income and mortgage payments, or donate time or services rather than cash to charities. The option would also make calculating taxes more complex for itemizers.

REV-09 IMPOSE AN EXCISE TAX ON NONRETIREMENT FRINGE BENEFITS

	Added Revenues (Billions of dollars)
Annual	
2000	5.6
2001	8.3
2002	8.8
2003	9.4
2004	10.0
2005	10.6
2006	11.2
2007	11.8
2008	12.6
2009	13.2
Cumulative	
2000-2004	42.1
2000-2009	101.7

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-10, REV-11, and REV-12

Unlike employee compensation paid in cash, many fringe benefits are exempt from income and payroll taxes. The exemption of employer-paid health and life insurance premiums from tax will cost about $55 billion in income taxes and $40 billion in payroll taxes in 2000. In addition, the law explicitly excludes from gross income employer-paid dependent care and miscellaneous benefits such as employee discounts and parking valued below a specified limit. Imposing an excise tax on fringe benefits would diminish the effects of those exclusions.

Excluding fringe benefits from gross income effectively subsidizes their cost, leading people to consume more of such benefits than they would if they had to pay the full price. As a result, resources may be allocated inefficiently. For example, excluding employer-provided health insurance has contributed to the large and growing demand for health care services (see option REV-10).

Such exclusions are inequitable because individuals whose compensation is paid all in cash pay more tax than others with the same total income paid partly in fringe benefits. That inequity is exacerbated to the extent that employees' higher demand for fringe benefits drives up their price for people who have to purchase them with after-tax dollars. Moreover, because the tax exclusion is worth more to taxpayers in higher tax brackets and because higher-income taxpayers receive more fringe benefits than lower-income people, the tax savings from the exclusion are unevenly distributed among income groups.

Making all fringe benefits taxable poses difficulties in valuing benefits and in assigning their value to individual employees. That problem could be avoided by imposing on employers an excise tax on the value of the benefits they provide. Those benefits would include the employer's share of health insurance (see option REV-10); premiums to fund the first $50,000 of life insurance, the part that is excluded from income (see option REV-11); dependent care (see option REV-12); athletic facilities; employee discounts; and parking with a value up to the amount above which it is currently taxed. (Under current law, employees must include in taxable income in 1999 the market value in excess of $175 per month of any parking provided free of charge by an employer.) A 3 percent excise tax imposed on fringe benefits, for example, would raise $101.7 billion from 2000 through 2009. The bulk of those revenues would come from taxing employer-paid health insurance.

This option would require that employers know only their total fringe benefit costs, not the value of benefits paid to each employee. Because the excise tax rate would be much lower than the tax rate on wages, this option would maintain most of the incentive for employers to provide fringe benefits instead of taxable wages. An excise tax on employers would be relatively more favorable to employees in higher-wage firms than including fringe benefits in employees' taxable income because the excise tax rate would not rise with employees' income.

REV-10 LIMIT THE TAX EXEMPTION OF EMPLOYER-PAID HEALTH INSURANCE

	Added Revenues (Billions of dollars) Income Tax	Payroll Tax
Annual		
2000	6.2	3.9
2001	9.7	6.1
2002	10.8	6.8
2003	12.1	7.6
2004	13.6	8.5
2005	15.2	9.6
2006	17.0	10.7
2007	19.1	12.0
2008	21.4	13.4
2009	23.9	15.0
Cumulative		
2000-2004	52.4	32.9
2000-2009	149.0	93.7

SOURCE: Joint Committee on Taxation.

RELATED OPTION:

REV-09

RELATED CBO PUBLICATION:

The Tax Treatment of Employment-Based Health Insurance (Study), March 1994.

Employees do not pay taxes on income they receive in the form of employer-paid health insurance. In addition, health insurance premiums and health care costs paid through cafeteria plans are generally excludable from income and payroll taxes. Those exclusions will reduce income tax revenues and payroll tax revenues by a total of about $92 billion in 2000.

One way to limit the exclusion would be to treat as taxable income for employees any employer contributions for health insurance plus health care costs paid through cafeteria plans that exceed $425 a month for family coverage and $175 a month for individual coverage. Those amounts are estimated average contributions for 2000 and would be indexed to reflect future increases in the general level of prices. The option would increase income tax revenues by $149 billion and payroll tax revenues by $93.7 billion over the 2000-2009 period. Including employer-paid health care coverage in the Social Security wage base, however, would lead to increased outlays for Social Security benefits in the future that could offset a significant part of the added payroll tax revenues from this option over the long run.

This option would eliminate the tax incentive to purchase additional coverage beyond the ceiling. Employees would have more incentive to economize in the medical marketplace, which could reduce both upward pressure on medical care prices and the provision of unnecessary or marginal services. The option would index the ceiling amounts to the overall inflation rate, and since health care costs have been rising faster than that, it could constrain health care costs even more over time. The Congress has already limited the exclusion for employer-paid group term life insurance in a similar way.

One disadvantage of limiting the tax exemption of employer-paid medical insurance premiums is the difficulty of determining when extensive coverage becomes excessive. In addition, the level of coverage purchased by a given premium depends on such factors as geographic location and the characteristics of a firm's workforce. As a result, a uniform ceiling would have uneven effects. Finally, if health insurance costs continued to rise faster than the general level of prices, indexing to reflect that level would gradually reduce subsidies for employer-paid health insurance. Taken together, those factors could increase the number of workers without health insurance and generate inequities among taxpayers by region and type of employer.

REV-11 INCLUDE EMPLOYER-PAID LIFE INSURANCE IN TAXABLE INCOME

	Added Revenues (Billions of dollars)	
	Income Tax	Payroll Tax
Annual		
2000	1.0	0.6
2001	1.5	0.9
2002	1.5	0.9
2003	1.6	1.0
2004	1.6	1.0
2005	1.7	1.0
2006	1.7	1.1
2007	1.8	1.1
2008	1.9	1.1
2009	1.9	1.2
Cumulative		
2000-2004	7.2	4.4
2000-2009	16.2	9.9

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-09 and REV-15

Tax law excludes from taxable income the premiums that employers pay for group term life insurance but limits the exclusion to the cost of the first $50,000 of insurance. The exclusion is not available to the self-employed. Employer-paid life insurance is the third most expensive tax-advantaged fringe benefit (after health insurance, discussed in option REV-10, and pensions). Including employer-paid premiums in taxable income would add $16.2 billion to income tax revenues and $9.9 billion to payroll tax revenues from 2000 through 2009.

Like the tax exclusion for other employment-based fringe benefits, the tax exclusion for life insurance creates a subsidy for the fringe benefit, which causes people to purchase more life insurance than they would if they had to pay the full cost themselves. Furthermore, the tax exclusion allows workers whose employers purchase life insurance for them to pay less tax than workers who have the same total compensation but must purchase insurance on their own (see option REV-09). In addition, the value of employer-paid life insurance, unlike some other fringe benefits, could be accurately measured and allocated. Employers could report the premiums they paid for each employee on the employee's W-2 form and compute withholding in the same way as for wages. Indeed, employers already withhold taxes on life insurance premiums that fund death benefits above the $50,000 limit.

A tax subsidy to provide life insurance might be called for, however, if people buy too little life insurance because they systematically underestimate the potential financial hardship to their families resulting from their death. But whether people purchase too little insurance for that reason is unclear. Moreover, even if it was clear, a more efficient way of allocating resources might be to provide a direct tax subsidy to all purchasers of life insurance and avoid limiting the subsidy to insurance provided by employers.

REV-12 ELIMINATE THE EMPLOYER EXCLUSION FOR DEPENDENT CARE

	Added Revenues (Billions of dollars)
Annual	
2000	0.1
2001	0.2
2002	0.3
2003	0.3
2004	0.3
2005	0.4
2006	0.4
2007	0.4
2008	0.4
2009	0.5
Cumulative	
2000-2004	1.2
2000-2009	3.3

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-06 and REV-09

The tax system provides two types of subsidies for child and other dependent care expenses of working taxpayers. Those subsidies are provided as exclusions from income paid to an employee or as a tax credit for those not using employment-based subsidies. Although those subsidies provide benefits for the same activities, the value of the subsidy from employer-based exclusions can be much larger than that provided under the child and dependent care credit. Eliminating the exclusions and making all tax benefits for child and dependent care available only through the credit would increase revenues by $3.3 billion from 2000 through 2009.

Employers may exclude up to $5,000 for child and dependent care expenses from the taxable wages of their employees, either as care provided directly by the employer or as other-than-employer care if the employer has established a qualified plan. The maximum exclusion amount is limited to a taxpayer's earnings or the earnings of the lesser-earning spouse for married taxpayers, and—as with all types of exclusions—the value of the exclusion depends on the marginal tax rate of the taxpayer. The exclusion also reduces employers' and employees' liability for Social Security and Medicare payroll taxes.

Taxpayers who do not receive employment-based subsidies may claim a nonrefundable income tax credit, limited to expenses of $2,400 for one dependent and $4,800 for two or more dependents. As with the exclusion, the total amount of qualifying expenses may not exceed the earnings of the taxpayer or, in the case of a couple, the lower-earning spouse. The credit rate per dollar of qualifying expenses is 30 percent for taxpayers whose adjusted gross income (AGI) is under $10,000 and is phased down to 20 percent for taxpayers whose AGI is over $28,000. Most taxpayers receive the 20 percent rate with a resulting maximum credit of $480 for one child and $960 for two or more children. In 1996, about 6 million taxpayers claimed $2.5 billion in credits.

Even though they subsidize the same activities, the credit and the exclusion provide significantly different benefits. For example, a high-income taxpayer with one child may receive an income tax benefit of up to $1,980 under the employer exclusion but only $480 under the credit. In addition, the exclusion reduces payroll taxes, but no such benefit is available with the credit. Eliminating the exclusion would provide equitable treatment for taxpayers with similar dependent care circumstances regardless of whether their employer has established a qualifying exclusion program. In addition, it would reduce complexity by simplifying taxpayer calculations.

However, eliminating the exclusion would reduce the total subsidies available for dependent care expenses and could induce some workers (particularly second earners in couples) to leave the labor force. If dependent care is considered a cost of employment, then eliminating the exclusion may be inappropriate since some costs of employment are excludable.

REV-13 INCLUDE THE INCOME-REPLACEMENT PORTION OF WORKERS' COMPENSATION AND BLACK LUNG BENEFITS IN TAXABLE INCOME

	Added Revenues (Billions of dollars)
Annual	
2000	5.0
2001	5.3
2002	5.5
2003	5.7
2004	6.0
2005	6.2
2006	6.4
2007	6.6
2008	6.8
2009	7.2
Cumulative	
2000-2004	27.5
2000-2009	60.8

SOURCE: Joint Committee on Taxation.

Current law exempts workers' compensation and Black Lung benefits from income tax. Taxing the portion of those benefits that replaces the income employees lose from work-related injuries or black lung disease would increase revenues by $60.8 billion from 2000 through 2009. The remaining portion of benefits, which reimburses employees for their medical costs (about 40 percent), would continue to be exempt from taxation.

Taxing the income-replacement portion of those benefits would make their tax treatment comparable with that of unemployment benefits and the wage-replacement benefits that employers provide through sick pay and disability pensions. It would also improve work incentives for disabled workers who are able to return to work. (Under current law, the after-tax value of the wages they are able to earn may be less than the tax-free benefits they receive while disabled.)

An argument against taxing such benefits is that legal or insurance settlements for non-work-related injuries are not taxable, even if a portion of them reimburses lost income. Taxing workers' compensation benefits would be inconsistent with that approach.

Furthermore, if the current levels of wage-replacement benefits were established under the assumption that they would not be taxed, this option would reduce benefits below desired levels. Enacting the option might therefore lead to efforts to increase benefits, thereby potentially reducing the budget surplus.

REV-14-A INCLUDE 85 PERCENT OF SOCIAL SECURITY AND RAILROAD RETIREMENT BENEFITS IN TAXABLE INCOME FOR ALL RECIPIENTS

	Added Revenues (Billions of dollars)
Annual	
2000	8.6
2001	21.9
2002	22.8
2003	23.6
2004	24.4
2005	24.9
2006	25.3
2007	26.0
2008	27.3
2009	28.7
Cumulative	
2000-2004	101.3
2000-2009	233.6

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-14-B, REV-14-C, and REV-16

RELATED CBO PUBLICATION:

Reducing Entitlement Spending (Study), September 1994.

Under current law, most benefits from Social Security and Railroad Retirement are not subject to tax. Only if the sum of adjusted gross income (AGI), nontaxable interest income, and one-half of Social Security and Tier I benefits exceeds a fixed threshold does a recipient pay tax on any benefits. If that sum exceeds $25,000 for single returns or $32,000 for joint returns, up to 50 percent of benefits are subject to tax. Above a second set of thresholds—$34,000 (single) and $44,000 (joint)—up to 85 percent of benefits are subject to tax. About one-third of households receiving Social Security will pay income tax on some portion of their benefits in 2000, and about one-half of those households will pay tax on 85 percent of their benefits. Because the thresholds remain fixed over time, as nominal incomes increase, the percentage of households that pay tax on benefits will grow to 36 percent in 2004. Bills to remove the 85 percent rate were proposed in 1998 but were not enacted.

Requiring all beneficiaries to include 85 percent of their benefits in their AGI would raise $233.6 billion from 2000 through 2009. That change would increase the share of recipients paying tax on their benefits from 32 percent to 74 percent. Other features of the tax code would continue to exempt about one-fourth of elderly households from taxation.

Eliminating the thresholds would reduce tax disparities among middle-income households. Social Security beneficiaries receive a tax preference not available to other taxpayers because they may exclude a portion of their income—benefits below the thresholds—from AGI. As a result, middle-income elderly families pay less tax than nonelderly families with comparable income.

This option would treat Social Security roughly the same as contributory pension plans. Workers receiving benefits from the latter pay income tax on the excess of benefits over their own contributions. Social Security actuaries estimate that among workers now entering the labor force, employee-paid payroll taxes will amount to no more than 15 percent of expected benefits. Thus, 85 percent is the minimum fraction of benefits in excess of past contributions.

Retirees might consider increased taxes on benefits to violate the implicit promises of the Social Security and Railroad Retirement programs. The government has, however, changed the Social Security and Railroad Retirement programs often, altering the benefit formula, introducing partial taxation of benefits, and raising payroll tax rates to finance the programs. Finally, increased taxation of benefits is one way to apply a means test to program payments.

REV-14-B INCLUDE 85 PERCENT OF SOCIAL SECURITY AND RAILROAD RETIREMENT BENEFITS IN TAXABLE INCOME FOR HIGHER-INCOME RECIPIENTS AND INCLUDE 50 PERCENT FOR ALL OTHER RECIPIENTS

	Added Revenues (Billions of dollars)
Annual	
2000	4.1
2001	10.5
2002	10.9
2003	11.3
2004	11.6
2005	12.0
2006	12.3
2007	12.7
2008	13.1
2009	13.5
Cumulative	
2000-2004	48.4
2000-2009	112.0

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-14-A, REV-14-C, and REV-16

RELATED CBO PUBLICATION:

Reducing Entitlement Spending (Study), September 1994.

Under current law, low-income Social Security recipients pay no income tax on their benefits. Recipients with modified adjusted gross income (AGI) above $25,000 ($32,000 for joint filers) pay tax on up to half of their Social Security benefits; those with modified AGI above $34,000 ($44,000 for joint filers) must include up to 85 percent of their benefits in taxable income (see option REV-14-A). This option would continue to tax up to 85 percent of benefits for taxpayers with income above the higher thresholds but require all other recipients to include half of their benefits in AGI. It would raise $112 billion from 2000 through 2009.

Under this option, the Social Security benefits of couples with combined income below $32,000 and individuals with combined income below $25,000 would be subject to tax. Almost all beneficiaries currently taxed on up to 50 percent of their benefits—couples with combined income between $32,000 and $44,000 and individuals with combined income between $25,000 and $34,000—would be unaffected. (Because the taxation of benefits is phased in under current law, some couples with combined income just above $32,000 and singles with income just above $25,000 are now taxed on less than a full 50 percent of their benefits.)

Compared with the previous option (REV-14-A), this proposal would protect a larger share of benefits received by lower-income beneficiaries from taxation. Roughly 39 percent of beneficiaries would continue to pay no taxes, compared with about 26 percent under the previous option.

Under this option, however, beneficiaries with somewhat higher income (whose benefits now are taxed at less than 50 percent) would receive lower after-tax benefits. Any such reduction in benefits might be viewed by recipients as violating promises made during their working years about the benefits they could expect to receive during retirement.

REV-14-C INCLUDE 85 PERCENT OF SOCIAL SECURITY AND RAILROAD RETIREMENT BENEFITS IN TAXABLE INCOME FOR HIGHER-INCOME RECIPIENTS

	Added Revenues (Billions of dollars)
Annual	
2000	2.5
2001	5.2
2002	5.6
2003	6.0
2004	6.5
2005	7.0
2006	7.6
2007	8.2
2008	8.8
2009	9.4
Cumulative	
2000-2004	25.8
2000-2009	66.6

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-14-A, REV-14-B, and REV-16

RELATED CBO PUBLICATION:

Reducing Entitlement Spending (Study), September 1994.

Under current law, low-income Social Security recipients pay no income tax on their benefits. Recipients with modified adjusted gross income (AGI) above $25,000 ($32,000 for joint filers) pay tax on up to half of their Social Security benefits; those with modified AGI above $34,000 ($44,000 for joint filers) must include up to 85 percent of their benefits in taxable income (see option REV-14-A). This option would continue to exempt the Social Security benefits of low-income recipients from taxation but require recipients with modified AGI above $25,000 ($32,000 for joint filers) to include up to 85 percent of their benefits in AGI. It would raise $66.6 billion from 2000 through 2009. Moreover, it would almost exclusively affect individuals with income between $25,000 and $34,000 and couples with modified income between $32,000 and $44,000.

Few of the 70 percent of all recipients whose benefits are not now subject to the income tax would be taxed under this option. Because 85 percent rather than 50 percent of benefits would be included in modified AGI measured against the thresholds, some of those beneficiaries who now fall just below the thresholds would move above them and have a portion of their benefits subject to tax.

Like option REV-14-A, this option would treat Social Security benefits the same as private pensions, taxing roughly that portion of benefits that exceeds the recipient's own contributions. But by maintaining the thresholds, lower-income recipients would continue to receive the favorable tax treatment now accorded to their Social Security benefits.

Continuing to have thresholds, however, would also maintain some disincentive for workers to save for their retirements. Recipients whose benefits are only partly over the taxable threshold face increased effective taxes on income from savings. An additional dollar of interest income, for example, would incur not only an income tax on that dollar but would also make an additional 85 cents of Social Security benefits subject to tax by pushing that additional amount over the threshold. The dollar of interest income would thus face an effective tax rate 1.85 times that incurred by a person whose benefits are either taxed fully or not at all. Therefore, a taxpayer in the 15 percent tax bracket would owe an additional $27.75 of tax on $100 more of interest income. Although current law also has a disincentive to saving, its effect would be exacerbated by the increase in the share of benefits subject to taxation above the thresholds from 50 percent to 85 percent.

REV-15 INCLUDE INVESTMENT INCOME FROM LIFE INSURANCE AND ANNUITIES IN TAXABLE INCOME

	Added Revenues (Billions of dollars)
Annual	
2000	11.3
2001	22.9
2002	23.6
2003	24.3
2004	25.1
2005	25.9
2006	26.7
2007	27.5
2008	28.4
2009	29.3
Cumulative	
2000-2004	107.2
2000-2009	244.9

SOURCE: Joint Committee on Taxation.

RELATED OPTION:

REV-11

Life insurance policies and annuities often combine features of both insurance and tax-favored savings accounts. The investment income from the savings, sometimes called "inside buildup," is not taxed until it is paid out to the policyholder. If it is left to the policyholder's estate or used to pay for life insurance, it can escape taxation entirely.

Under this option, life insurance companies would notify policyholders annually of the investment income realized on their account, just as mutual funds do now. Individuals would include those amounts in their taxable income. Life insurance disbursements and annuity benefits would no longer be taxable as they were paid. Making the investment income taxable in that way would raise almost $245 billion in 2000 through 2009. Investment income from annuities purchased as part of a qualified pension plan or qualified individual retirement account would still be tax-deferred until benefits were paid.

The tax deferral currently allowed for life insurance and annuities is similar to the deferral allowed for unrealized capital gains income. Taxing the investment income from life insurance and annuities annually would equalize their tax treatment with that of a bank account, taxable bond, or mutual fund.

A tax incentive to purchase life insurance is desirable if people systematically underestimate the financial hardship on spouses and families caused by their own death. Such shortsightedness could cause them to buy too little life insurance. Similarly, it might cause people to buy too little annuity insurance to protect them against outliving their assets. But it is not currently known whether people would buy too little insurance without the tax incentive or the extent to which the tax incentive might increase the amount of life insurance or annuity coverage purchased. If the incentive is justified to correct for people's shortsightedness rather than subsidize the inside buildup, a better policy might be to subsidize life insurance directly by allowing a tax credit or partial deduction for insurance premiums. Annuities receive other tax incentives through the special tax treatment of pensions and retirement savings.

A tax preference for inside buildup in life insurance policies and annuities has an uncertain effect on saving. It may encourage saving because it would increase people's income when they are older for each dollar they saved when they were younger. The tax preference might, however, reduce saving because it also enables people to save less when they are younger without reducing their expected income when they are older.

REV-16 INCLUDE AN INCOME-RELATED PORTION OF THE INSURANCE VALUE OF MEDICARE BENEFITS IN TAXABLE INCOME

	Added Revenues (Billions of dollars)		
	Tax HI Only	Tax SMI Only	Tax Both
Annual			
2000	3.0	1.8	4.9
2001	7.5	4.8	12.7
2002	8.0	5.4	13.8
2003	8.6	6.2	15.2
2004	9.3	7.1	16.8
2005	10.3	8.0	18.8
2006	11.3	9.1	21.0
2007	12.5	10.3	23.4
2008	13.7	11.6	26.0
2009	15.0	13.1	28.9
Cumulative			
2000-2004	36.4	25.3	63.4
2000-2009	99.3	77.6	181.5

SOURCE: Joint Committee on Taxation.

NOTE: HI = Hospital Insurance; SMI = Supplementary Medical Insurance.

RELATED OPTIONS:

REV-14-A, REV-14-B, REV-14-C, 570-18, 570-19-A, and 570-19-B

RELATED CBO PUBLICATION:

Reducing Entitlement Spending (Study), September 1994.

Even though Social Security benefits are at least partially taxable under current law (see options REV-14-A, REV-14-B, and REV-14-C), Medicare benefits are not subject to tax. This option would include 85 percent of the insurance value of Hospital Insurance (HI) and 75 percent of the insurance value of Supplementary Medical Insurance (SMI) in adjusted gross income (AGI), to the extent that combined income (AGI plus nontaxable interest income plus one-half of Social Security, Railroad Retirement, and Medicare benefits) exceeds $34,000 for single returns and $44,000 for joint returns. Administering this option would be straightforward because a mechanism is already in place for taxing Social Security benefits. (The percentages roughly represent the share of program costs not paid for by recipients through either payroll taxes during their working years or SMI premiums.) Taxpayers with combined income below those thresholds but above $25,000 (single) and $32,000 (joint) would include 50 percent of the insurance value of both HI and SMI in AGI. Taxpayers with lower income would be unaffected. Because the thresholds are not indexed for inflation, however, a larger fraction of Medicare insurance benefits would become taxable over time.

From 2000 through 2009, the HI tax alone would increase federal revenues by $99.3 billion, and the SMI tax alone would yield $77.6 billion. Imposing both taxes simultaneously would raise revenues by about $181.5 billion over 10 years. The combined tax would generate more revenue than the sum of the HI and SMI taxes because some taxpayers would face higher tax rates as their AGI increased. In addition, combining HI and SMI taxes would move more enrollees above the threshold.

Earmarking revenues from taxing HI benefits for the HI trust fund would delay the deficit of the trust fund projected for 2007. A tax on SMI benefits would shift some SMI costs from taxpayers to enrollees. Using income thresholds would leave lower-income enrollees unaffected. In fact, because many enrollees do not have to pay income taxes, this proposal would affect only about 34 percent of enrollees in 2000.

Because the tax would apply to in-kind benefits rather than cash income, some enrollees might object that the additional income does not generate cash with which to pay the tax liability.

An alternative option would forgo income thresholds and include 85 percent of the insurance value of HI benefits and 75 percent of the insurance value of SMI in AGI for all taxpayers. With no income thresholds, the HI and SMI taxes would raise $293.6 billion over the 2000-2009 period.

REV-17 RAISE THE AGE LIMIT FOR THE KIDDIE TAX FROM 14 TO 18 FOR TAXING INVESTMENT INCOME

	Added Revenues (Billions of dollars)
Annual	
2000	a
2001	0.1
2002	0.1
2003	0.1
2004	0.1
2005	0.2
2006	0.2
2007	0.2
2008	0.2
2009	0.3
Cumulative	
2000-2004	0.4
2000-2009	1.5

SOURCE: Joint Committee on Taxation.

a. Gain of less than $50 million.

Under current law, investment income received by a dependent child under age 14 in excess of specified limits is subject to federal income tax at the parents' marginal tax rate. In 1998, the applicable limit was $1,400. The provision—often referred to as the "kiddie tax"—is intended to limit the ability of parents to reduce the income tax on investment income by transferring ownership of assets to their young children. It does not, however, preclude parents from reducing their tax bills by giving investment assets to children older than 13. This option would raise from 14 to 18 the age limit below which a child's investment income is taxed at parents' rates. It would increase income tax revenues by $1.5 billion over the 2000-2009 period.

Extending the kiddie tax to older children would help prevent parents from sheltering assets to reduce their tax liability. Under current law, income from assets in the name of a child over age 13 is taxed at the child's rate, generally 15 percent, rather than at the parents' tax rate, which can be as high as 39.6 percent. On annual asset income of $10,000, for example, that difference can cut the family's tax bill from $3,960 to $1,500, or more than 60 percent.

Raising the age for the "kiddie tax" to 18 could lead to higher taxes on the income of assets properly owned by children older than 13. Not all assets are owned by older children because their parents want to shelter investment income by shifting assets into their children's names. An older child may have earned and saved substantial funds for many years, in which case it is reasonable that the income from those assets should be taxed at the child's rate rather than the parents' rate. Imposing the parents' higher rate could discourage teenagers from saving earnings or monetary gifts. Furthermore, a policy that discourages young people's saving would conflict with the intent of recent legislation designed to promote saving for higher education.

REV-18 EXPAND MEDICARE COVERAGE TO INCLUDE STATE AND LOCAL GOVERNMENT EMPLOYEES NOT NOW COVERED

	Added Revenues (Billions of dollars)
Annual	
2000	1.1
2001	1.4
2002	1.4
2003	1.3
2004	1.2
2005	1.2
2006	1.1
2007	1.0
2008	0.9
2009	0.8
Cumulative	
2000-2004	6.4
2000-2009	11.3

Certain groups of state and local government employees are not covered by Medicare, despite expansions of coverage in 1985 and 1990. (All federal employees have been covered since 1983, as required by the Tax Equity and Fiscal Responsibility Act of 1982.) The Consolidated Omnibus Budget Reconciliation Act of 1985 mandated that state and local employees who began work after March 31, 1986, pay Medicare payroll taxes, but it did not make coverage mandatory for those hired before that date. The Omnibus Budget Reconciliation Act of 1990 expanded Medicare coverage to include all state and local government employees not covered by any retirement plan.

Under current law, many state and local employees will qualify for Medicare benefits on the basis of other employment in covered jobs or their spouse's employment. Those employees will receive benefits as if they had worked continuously in covered employment. One out of six state and local employees is not covered by Medicare through employment, but about 85 percent of those not covered receive Medicare benefits through their spouse or because of work in covered employment.

Requiring all state and local employees to pay Medicare payroll taxes would make their coverage resemble that of federal employees. Broader coverage would reduce the inequity from the high benefits those employees receive in relation to payroll taxes paid. Expanding Medicare coverage to include more state and local employees would increase the government's liability for future program benefits. The additional revenues, however, would most likely more than offset increased benefits permanently.

Expanding Medicare coverage to include state and local government employees who began work before April 1, 1986, would raise $11.3 billion from 2000 through 2009. The annual revenue gain would decline gradually as employees who were hired before April 1986 leave state and local government payrolls.

REV-19 MAKE CALCULATION OF TAXABLE WAGES FOR SELF-EMPLOYED PEOPLE EQUIVALENT TO CALCULATION FOR OTHER WORKERS

	Added Revenues (Billions of dollars)	
	On-Budget	Off-Budget
Annual		
2000	0.2	0.1
2001	0.2	0.1
2002	0.2	0.1
2003	0.2	0.1
2004	0.2	0.1
2005	0.2	0.1
2006	0.2	0.1
2007	0.2	0.1
2008	0.3	0.1
2009	0.3	0.2
Cumulative		
2000-2004	1.0	0.6
2000-2009	2.0	1.3

Social Security and Medicare taxes come in two forms: the Federal Insurance Contribution Act (FICA) tax paid on wages and the Self-Employment Contribution Act (SECA) tax paid on self-employment income. For FICA taxes, employees and employers each pay a 6.2 percent Social Security tax on wages up to a taxable maximum ($72,600 in 1999) and a 1.45 percent Medicare tax on all wages.

Until 1983, the SECA rate was explicitly set lower than the combined employer and employee FICA rate. As part of the Social Security Amendments of 1983, the Congress increased effective SECA rates starting in 1984. The conference committee said that the law was "designed to achieve parity between employees and the self-employed" beginning in 1990. Nonetheless, the current method for calculating SECA taxes allows a self-employed taxpayer to pay less tax than a non-self-employed worker with the same nominal income. For example, an employee earning $50,000 and his or her employer each pay $3,825 in FICA taxes, so that employee's total compensation is $53,825 and the total FICA tax is $7,650. But if that worker's self-employed sibling also earns total compensation of $53,825, under current law that person would pay only $7,605 in SECA taxes, $45 less than the non-self-employed sibling would pay.

For people with earnings above the taxable maximum, the amount of Social Security tax paid is the same for the self-employed and the non-self-employed; however, the amount of Medicare tax paid is less for the self-employed. For example, an employee earning $100,000 and his or her employer each pay $4,501 in Social Security taxes and $1,450 in Medicare taxes, so that employee's total compensation is $105,951 and the total FICA tax is $11,902. That person's self-employed sibling—with the same total compensation—pays the same maximum Social Security tax but a Medicare tax of only $2,838, or $62 less. High-income, self-employed taxpayers may have a SECA Medicare tax liability as much as 6.3 percent less than that of non-self-employed taxpayers. That difference has existed since 1991, when the Congress first set the Medicare taxable maximum higher than the Social Security taxable maximum. Correcting the difference would require a slight addition to Schedule SE, but it would directly affect only self-employed taxpayers with income above the taxable maximum.

Changing the SECA calculation formula would increase on-budget revenues by $2 billion from 2000 to 2009. Off-budget SECA revenues, which are deposited into the Social Security trust funds, would increase by $1.3 billion.

REV-20 ELIMINATE THE SOURCE RULES EXCEPTION FOR INVENTORY SALES

	Added Revenues (Billions of dollars)
Annual	
2000	1.4
2001	2.9
2002	3.1
2003	3.3
2004	3.6
2005	3.8
2006	4.1
2007	4.4
2008	4.8
2009	5.1
Cumulative	
2000-2004	14.3
2000-2009	36.5

SOURCE: Joint Committee on Taxation.

RELATED OPTION:

REV-21

Under current law, income allocation rules can provide a subsidy for the export of U.S.-made products of some multinational corporations. The "title passage" rule, which specifies the allocation of income between domestic and foreign business activities, routinely allows U.S. multinational corporations to use excess foreign tax credits to offset about half of the U.S. tax on their export income by characterizing it as foreign-source income, even if the inventory is purchased in the United States and the income from the sale is not subject to foreign tax.

U.S. corporations generally pay U.S. tax on their worldwide income. Corporations are allowed a tax credit against their U.S. tax liability on foreign income for the amount of income tax paid abroad on that income. The credit is limited to the U.S. tax liability that would have been assessed on that income. If the corporation paid more foreign tax on foreign income than it would have paid on otherwise identical domestic income, the firm has excess foreign tax credits. The title passage rule allows a company with excess foreign tax credits to classify more of its export income as foreign source than it could justify solely on the basis of the location of its business activities, implicitly giving the company an export subsidy. About half of the export income of such companies is effectively exempted from U.S. tax. Replacing the title passage rule with an activity-based rule, which would apportion income on the basis of actual economic activity, would increase tax revenues by $1.4 billion in 2000 and by $36.5 billion over the 2000-2009 period.

Export subsidies increase investment and employment in export industries, but most economists agree that such subsidies do not increase the overall levels of domestic investment and domestic employment as a result of foreign-exchange effects that cause imports to increase as much as exports. That reduces investment and employment in import-competing industries in the United States. Export subsidies distort the allocation of resources domestically and abroad and result in the United States receiving fewer imports in exchange for exports. In addition, the existing rule gives U.S. multinational exporters a competitive advantage over U.S. exporters that conduct all of their business domestically. Current allocation rules make U.S. corporations with excess foreign tax credits more competitive with foreign corporations operating in the same markets; U.S. corporations without foreign tax credits do not receive that advantage. Finally, the U.S. income tax treaty system, established since the title passage rule was enacted 70 years ago, often protects U.S. export sales income from local taxation in the country where the goods are sold. Because export sales income is not usually subject to foreign tax, it may not be appropriate to allow foreign tax credits to be used to offset U.S. tax liability on that income.

REV-21 TREAT FOREIGN SALES CORPORATIONS LIKE OTHER FOREIGN SUBSIDIARIES

	Added Revenues (Billions of dollars)
Annual	
2000	1.0
2001	2.1
2002	2.3
2003	2.5
2004	2.7
2005	2.9
2006	3.1
2007	3.3
2008	3.5
2009	3.7
Cumulative	
2000-2004	10.6
2000-2009	27.1

SOURCE: Joint Committee on Taxation.

RELATED OPTION:

REV-20

The tax code subsidizes U.S. exports through rules for foreign sales corporations (FSCs). Those rules offer U.S. companies an opportunity to exempt about 15 percent of their export income from U.S. tax by characterizing it as income of a foreign subsidiary that is not effectively connected with a U.S. trade or business. According to a decision by the governing council of the General Agreement on Tariffs and Trade (GATT), export income can be exempted from U.S. tax only if the economic activity that produces the income takes place outside the United States. In response to the GATT decision, the Congress amended the tax code to allow U.S. companies to charter FSCs in low-tax countries and either supply goods to the FSCs for resale abroad or pay commissions to them on export sales.

Many FSCs are largely paper corporations with very few employees. Under the tax code, when a U.S. company sells exports through an FSC, about 23 percent of the total income from production and marketing is attributed to the FSC and about 65 percent of the FSC's export income is exempt from U.S. tax. The exempt income, which is approximately 15 percent of the income from the sale, remains free from U.S. tax when the company receives it as a dividend from the FSC. The rules provide an incentive for U.S. taxpayers to locate investment domestically.

Export subsidies, such as FSCs, reduce global economic welfare and may even reduce the welfare of the country granting the subsidy, even though domestic export-producing industries may benefit. FSC rules may reduce the incentive for U.S. corporations to move economic activity, such as manufacturing, abroad. However, the effects of export subsidies on foreign exchange, which raise the value of the dollar and lower the cost of imports, cause imports and exports to increase. Consequently, companies in import-competing industries reduce domestic investment and employment.

This option would curtail the subsidy resulting from FSC rules by treating FSCs like other foreign subsidiaries. In general, all of the income repatriated from FSCs would be subject to U.S. tax. The tax on any income from an FSC that was deemed foreign-source income could be offset by unused foreign tax credits. This option would increase tax revenues by $1 billion in 2000 and by $27.1 billion over the 2000-2009 period.

REV-22 MAKE FOREIGN SUBNATIONAL TAXES DEDUCTIBLE RATHER THAN CREDITABLE

	Added Revenues (Billions of dollars)
Annual	
2000	2.3
2001	4.8
2002	5.0
2003	5.3
2004	5.5
2005	5.8
2006	6.1
2007	6.4
2008	6.7
2009	7.0
Cumulative	
2000-2004	22.7
2000-2009	54.9

SOURCE: Joint Committee on Taxation.

Under current law, U.S.-owned corporations deduct U.S. state and local income taxes from taxable income, but they receive tax credits for income taxes paid to foreign governments, including foreign subnational governments, such as states, cities, and provinces. That may favor foreign over domestic investment if the combination of federal and local income taxes imposed on domestic income exceeds the foreign tax imposed on the same type and amount of foreign-source income. U.S. local income taxes are only deductible against U.S. federal income taxes; however, all foreign income taxes generally can be credited against U.S. federal income taxes. That situation may affect the decisions of U.S. taxpayers regarding whether to invest here or abroad.

This option would equalize the tax treatment of domestic and foreign subnational income taxes by allowing corporations to credit foreign taxes to the extent that they exceed a fixed percentage of foreign-source income or a fixed percentage of foreign income taxes. The fixed percentage would be set to reflect the overall U.S. ratio of local to federal income taxes. Taxes for which credits are denied under this option would be deducted from foreign-source gross income to yield foreign-source taxable income. The rule could defer to or override existing tax treaties.

Making the federal tax treatment of foreign subnational income tax payments consistent with the tax treatment of domestic state and local income tax payments would increase tax revenues by $2.3 billion in 2000 and $54.9 billion over the 2000-2009 period. It would also level the playing field between domestic and foreign investment: it would reduce the slight incentive that U.S.-based multinational corporations have to make additional investments in countries where the overall level of foreign income tax on a foreign investment is lower than the combination of U.S. federal and local tax on domestic investment. In turn, equalizing the tax rates between foreign and domestic investment would increase the economic efficiency of the international allocation of capital.

In some cases, however, removing the creditability of foreign subnational income taxes would make U.S. corporations operating in a foreign country less competitive with other foreign corporations operating in that country. In addition, firms would probably reduce their repatriation of income from prior overseas investments to avoid paying the additional U.S. tax required under the provision. Finally, if foreign countries implemented similar rules for the U.S.-earned income of their corporations, the amount of capital flowing into the United States might decline.

REV-23-A INCLUDE ACCRUED CAPITAL GAINS IN THE LAST INCOME TAX RETURN OF THE DECEASED

	Added Revenues (Billions of dollars)
Annual	
2000	a
2001	11.2
2002	12.0
2003	10.5
2004	8.6
2005	7.5
2006	7.3
2007	7.2
2008	7.0
2009	6.8
Cumulative	
2000-2004	42.3
2000-2009	78.1

SOURCE: Joint Committee on Taxation.

a. Gain of less than $50 million.

RELATED OPTIONS:

REV-04, REV-23-B, and REV-24

A capital gain or loss is the difference between the current value of a capital asset and the owner's basis. The owner's basis is the initial cost of the asset plus the cost of any subsequent improvements and minus any deductions for depreciation. When a capital asset is sold, tax law normally requires that the owner include any realized gain in taxable income. The owner may deduct any realized losses against realized gains, and when the owner has no gains in excess of losses, he or she may deduct up to $3,000 of the loss against other income.

An exception occurs when an owner holds an asset until death. In that case, tax law allows the inheritor to "step up" the basis to the asset's value as of the date of the decedent's death. When the asset is sold, the inheritor pays income tax on the gain that accrued after the decedent's death. The gain that accrued before the decedent's death is permanently excluded from taxable income. The estate of the decedent may pay taxes under the separate estate tax, but that tax applies equally to assets on which the decedent previously paid income tax and to assets with accrued capital gains that had escaped income taxation.

Stepping up basis at death provides a tax break for capital gains income not available for other income such as wages, interest, and rental income. That encourages people to hold assets until death that they would have preferred to sell earlier. If holding those assets until death offered less of a tax benefit, people would feel freer to adjust their asset holdings as their circumstances changed. Furthermore, stepping up basis at death has spawned many tax-sheltering schemes in which, for example, people borrow against their assets for current consumption but have the loan paid off by selling the assets after they die.

A disadvantage of taxing gains at death is that the tax might force the decedent's family to sell assets to pay the tax. Sales of illiquid assets at an inopportune time can reduce their value substantially. Forcing heirs to sell a family farm or business would impose a particular hardship on families wanting to continue the enterprise. Another disadvantage of taxing gains at death is that the decedent may have left inadequate documentation of the asset's basis.

Taxing accrued but unrealized gains on the final income tax return of the decedent would raise about $78.1 billion from 2000 through 2009. This option would exclude gains on assets that a spouse inherits. Instead, the spouse would assume the basis of the decedent and pay tax on the full gain only when the asset was sold. Any gains on assets that the decedent left to charity would also be exempt. This option also includes special provisions to defer taxes for family businesses, allow use of the exclusion for gains on a home, and exclude small gains on personal property. About 10 percent of decedents would owe taxes on accrued gains on their final income tax return. Finally, taxes paid on gains realized at death would be deductible under the estate tax.

REV-23-B ENACT CARRYOVER BASIS FOR CAPITAL GAINS HELD UNTIL DEATH

	Added Revenues (Billions of dollars)
Annual	
2000	a
2001	0.9
2002	1.7
2003	2.8
2004	3.9
2005	5.2
2006	6.0
2007	6.9
2008	7.9
2009	9.1
Cumulative	
2000-2004	9.3
2000-2009	44.4

SOURCE: Joint Committee on Taxation.

a. Gain of less than $50 million.

RELATED OPTIONS:

REV-04, REV-23-A, and REV-24

Carrying over a decedent's basis in assets (known as carryover basis) is an alternative to taxing gains held at death on the last income tax return of a deceased person (see option REV-23-A). Under this option, heirs would adopt the basis of the decedent on assets they inherit. The decedent's capital gains would then be taxed when the heirs sold the assets. To allow for inadequate recordkeeping by decedents on an asset's basis, the option would allow heirs to set the basis of an inherited asset at 50 percent of the asset's current value. In addition, if the decedent's estate paid any estate tax, shares of that tax would be added to the basis of all of the estate's assets in proportion to the assets' share of the estate's value. This option would raise roughly $44.4 billion from 2000 through 2009.

Carryover basis would avoid a major disadvantage of taxing gains on the final income tax return of the deceased: the heirs would not be faced with an overwhelming tax bill that could force the sale of the assets at an inopportune time. Carryover basis could also ease the way for a family seeking to continue to operate the deceased's business. But it would not ease the problem of inadequate recordkeeping by the deceased, except to the extent that the 50 percent rule suggested above would create a safe harbor.

Carryover basis would achieve some of the objectives of taxing gains on the final tax return of the deceased. It would make most gains held at death taxable eventually, removing some of the inequity that arises from never taxing gains held until death. Furthermore, it would reduce the barrier to adjusting asset holdings before death as circumstances change. Finally, it would reduce the rewards to tax shelters that provide access to investment funds before death without an outright sale of the asset until after death. Carryover basis would succeed less in achieving those objectives than would taxing gains at death, however, because it would still provide the benefits of deferral for heirs who could afford to postpone the sale of inherited assets with large capital gains.

Gains held until death have always been exempt from income tax. The Congress enacted a carryover basis in the Tax Reform Act of 1976 but postponed it in 1978 and repealed it in 1980. Therefore, it never took effect. The primary objection voiced in the Congress at the time carryover basis was repealed was that recordkeeping by many asset owners would be inadequate for their heirs to document basis.

REV-24 ELIMINATE LIKE-KIND EXCHANGES

	Added Revenues (Billions of dollars)
Annual	
2000	0.1
2001	0.6
2002	0.6
2003	0.6
2004	0.6
2005	0.7
2006	0.7
2007	0.7
2008	0.7
2009	0.7
Cumulative	
2000-2004	2.5
2000-2009	6.0

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-04, REV-23-A, and REV-23-B

The tax law requires that people who sell or exchange capital assets report any capital gain or loss as income. An exception occurs for exchanges of certain like-kind assets, mainly real estate. No gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a like kind that is to be held for the same reasons. In those exchanges, the gain in the original property carries over to the new property, and its recognition is deferred until the new property is sold. Like-kind real estate assets are broadly defined as any properties located in the United States.

Exchanges can involve the concurrent swapping of like-kind property between two owners, but in many exchanges a single owner sells one property to a second party and purchases a replacement property from a third party. For those transactions to qualify as like-kind exchanges, the proceeds from the sale of the original property must be held outside the seller's control—for example, by a qualified intermediary—and used to purchase the replacement property. In addition, the like-kind replacement property must be designated within 45 days and purchased within 180 days.

Capital gains cannot be deferred on the trading of many financial assets. Any gain from the selling of one stock to purchase another and of a share in one partnership to purchase another is taxable in the year exchanged. Gains from trades of bonds, mortgages, and other debt instruments are taxed similarly. Eliminating the deferral for like-kind exchanges would tax people who buy and sell real estate the same way as people who buy and sell stocks, bonds, or shares in partnerships. The option would raise $6 billion from 2000 to 2009.

A justification for continuing like-kind exchanges is that the new property is a continuation of the same investment as the previous one, and no tax should be levied until the owner leaves that line of investing. When properties are swapped without cash payments, no money becomes available for payment of the tax. Furthermore, allowing like-kind exchanges facilitates property exchanges in response to changing conditions of the taxpayer or property markets. But those justifications apply to many exchanges of stocks, bonds, and partnership shares as well and therefore do not support continuing the current differential tax treatment of those assets. One reason for either continuing the current differential treatment or phasing it out slowly is that many investors purchased properties with the understanding that they would be able to exchange them for other properties without paying capital gains taxes. Changing the treatment abruptly would impose hardships on some investors and could possibly depress property prices. Finally, some tax-deferred swaps of corporate equities are permitted, such as those that take place in business mergers.

In 1987, the Ways and Means Committee passed a provision limiting the amount of gain that can be deferred under like-kind exchanges of real property to $100,000. In 1989, the committee considered limiting deferral of gain to exchanges of properties that are similar or related in service or use. That stricter standard already applies to gains on involuntary conversions. In 1997, the Treasury Department proposed that the same standard be applied to real estate exchanges.

REV-25 CONVERT THE CREDIT FOR STATE DEATH TAXES TO A DEDUCTION

	Added Revenues (Billions of dollars)
Annual	
2000	0
2001	3.7
2002	3.8
2003	4.1
2004	4.3
2005	4.6
2006	4.8
2007	5.2
2008	5.3
2009	5.7
Cumulative	
2000-2004	15.9
2000-2009	41.5

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-26 and REV-27

Current law imposes a gift tax on transfers of wealth during a taxpayer's lifetime and an estate tax on transfers at death. One of the credits used to offset final tax liability is for state death taxes: a fraction of the taxes paid to states is directly deductible from federal estate and gift tax liability.

Gift and estate taxes together constitute a unified tax: one progressive tax is imposed on cumulative transfers during life and at death. Credits built into the system have always excluded most transfers from taxation, so less than 2 percent of deaths result in an estate tax filing. The Taxpayer Relief Act of 1997 increased the credits for the first time since the late 1980s to prevent the number of estates subject to tax from rising and to lower the taxes paid by taxable estates.

The credit for state death taxes built into the federal estate tax system lowered revenues by about $3.8 billion in 1996, which is over 25 percent of total revenue in that year. State death taxes currently reduce a taxpayer's federal tax liability by a credit that ranges from 0.8 percent on transfers of $40,000 to 16 percent on transfers of more than $10 million. When enacted in 1926, the credit sometimes virtually eliminated the federal tax liability because the top marginal rate in the federal estate and gift tax was 20 percent.

The credit acts as a state revenue-sharing system for estates taxed up to the 16 percent exclusion level. Consequently, a majority of states have adopted state death tax systems that simply redistribute estate tax revenues from the federal to state governments. That shift is accomplished by imposing state death taxes according to a schedule that exactly matches the amount of the federal credit.

Changing the credit to a deduction would raise about $41.5 billion over the 2000-2009 period and would correspond to the treatment of state and local income and property taxes as itemized deductions under the federal income tax. The immediate effect of changing the credit to a deduction would be to raise the effective tax rate on state death taxes from zero to one minus the marginal tax rate under the federal estate tax, which ranges from 37 percent to 55 percent for positive tax liabilities. That would cause the biggest increase in taxes for taxpayers in states where death taxes are high.

In the long run, states may choose to change their own death tax rules to partially restore the levels and distribution of effective estate tax rates. If states behave that way, reduced state tax revenues will offset any increase in federal tax revenues, and the reduced state revenues will have to be made up by some other changes in state-level taxes or spending.

REV-26 INCLUDE LIFE INSURANCE PROCEEDS IN THE BASE FOR ESTATE TAXES

	Added Revenues (Billions of dollars)
Annual	
2000	0
2001	0.5
2002	0.5
2003	0.5
2004	0.5
2005	0.5
2006	0.6
2007	0.6
2008	0.6
2009	0.7
Cumulative	
2000-2004	2.0
2000-2009	5.0

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-25 and REV-27

Current law imposes a gift tax on transfers of wealth during a taxpayer's lifetime and an estate tax on transfers at death. One form of wealth transfer gets preferential treatment under the estate tax: payouts on life insurance policies are not counted as transferred wealth if the owner of the policy is not the decedent. Including life insurance proceeds in the tax base would raise estate tax revenues by about $5 billion between 2000 and 2009.

Gift and estate taxes together constitute a unified tax: one progressive tax is imposed on cumulative transfers during life and at death. Credits built into the system have always excluded most transfers from taxation, so that less than 2 percent of deaths result in an estate tax filing. The Taxpayer Relief Act of 1997 increased the credits for the first time since the late 1980s to prevent the number of estates subject to tax from rising and to lower the taxes paid by taxable estates.

Wealth transferred at death through life insurance is generally not subject to estate tax; if the policyowner is not the decedent, the policy payout amount is not taxable. Thus, one important element of estate tax planning during a wealthy taxpayer's lifetime is to make life insurance payments, with the intended heirs as the beneficiaries, directly or through trust arrangements. Premiums paid are not taxed as long as the amounts are below the $10,000 annual gift exclusion.

Life insurance proceeds were first included in the estate tax base in 1918, two years after the modern estate and gift tax system was put in place. The 1918 act included in the base proceeds from policies owned by the decedent and payouts in excess of $40,000 on policies owned by others. In 1942, all proceeds from policies in which the decedent paid the premiums or owned the policies were also made taxable. Legislation enacted in 1954 dropped the "premiums paid" test, leading to the current system in which only policies owned by the decedent are included in the estate tax base.

The tax advantage of excluding life insurance from the base for estate taxes can be significant. The initial transfer of premiums does not affect tax liability because those amounts could be transferred tax-free under the annual $10,000 exclusion for any reason. The real benefit comes later, however, as premiums invested in whole-life plans earn interest and dividends not subject to income tax.

Another argument for excluding life insurance from the base for estate taxes is to lower the cost of transferring wealth when assets are not liquid. For example, the owner of a closely held business can use life insurance to prepay the estate tax that will be liable on the business, and the heirs can avoid having to sell the business to pay the taxes. This option would increase the cost of that practice. The Congress raised the exclusion for closely held businesses in 1997 to help prevent businesses from being sold when the owner dies.

REV-27 ELIMINATE NONBUSINESS VALUATION DISCOUNTS UNDER THE ESTATE TAX

	Added Revenues (Billions of dollars)
Annual	
2000	0
2001	0.5
2002	0.5
2003	0.5
2004	0.6
2005	0.6
2006	0.7
2007	0.7
2008	0.8
2009	0.8
Cumulative	
2000-2004	2.1
2000-2009	5.7

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-25 and REV-26

Current law imposes a gift tax on transfers of wealth during a taxpayer's lifetime and an estate tax on such transfers at death. One accounting practice taxpayers are using is transferring marketable securities, such as stocks and bonds, to holding companies, which then issue shares (claims to the securities) to intended heirs. Although transferred assets are still taxable, the common practice of discounting minority holdings of business assets is often applied to security holding companies to undervalue the assets for the taxable estate computation.

The gift and estate taxes together constitute a unified tax: one progressive tax is imposed on cumulative transfers during life and at death. Credits built into the system have always excluded most transfers from taxation, so that less than 2 percent of deaths result in an estate tax filing. The Taxpayer Relief Act of 1997 increased the credits for the first time since the late 1980s to prevent the number of estates subject to tax from rising and to lower the taxes paid by taxable estates.

The value of minority interests in nonpublicly traded business assets are typically discounted when computing taxable estates. The practice is justified on the grounds that a buyer purchasing a minority share in an ongoing operation would generally not pay market value for the fractional interest because the majority owners can adversely affect the long-term value of the fractional owner's share. For example, if the majority owners are also officers of the company, they could in theory make decisions that would increase their income at the expense of the minority owners. Because the goal of the estate tax system is to tax only the value of the asset that would be paid by a willing buyer, large discounts are standard.

The use of such a practice for nonbusiness assets cannot be defended on the same grounds. In nonbusiness situations, a taxpayer contributes marketable assets to a family limited partnership or limited liability company and simultaneously gives or bequeaths minority interests in the holding company to intended heirs. The taxpayer then claims discounts on those gifts, using the guidelines generally agreed on for transferring business assets. The taxpayer claims a reduced value in the marketable asset simply because it was placed in a holding company before being given or bequeathed.

Restricting the practice of valuation discounts to active businesses would raise $5.7 billion over the 2000-2009 period. The exact proposal would require that interests in an entity be valued at a proportional share of the fair market value of the entity's net worth to the extent that net worth includes readily marketable assets (cash, cash equivalents, foreign currency, publicly traded securities, real property, annuities, royalty-producing assets, non-income-producing property, such as art or collectibles commodities, options, and swaps) when given or bequeathed. If the entity is part of an active business, the net worth held in marketable securities for working capital would be subject to the usual business valuation practices.

REV-28 REDUCE TAX CREDITS FOR REHABILITATING BUILDINGS

	Added Revenues (Billions of dollars)
Annual	
2000	0.2
2001	0.2
2002	0.2
2003	0.2
2004	0.2
2005	0.2
2006	0.2
2007	0.2
2008	0.2
2009	0.2
Cumulative	
2000-2004	0.9
2000-2009	2.0

SOURCE: Joint Committee on Taxation.

The Congress enacted tax credits for rehabilitation to promote the preservation of historic buildings, encourage businesses to renovate their existing premises rather than relocate, and encourage investors to refurbish older buildings. The credit rate is 10 percent for expenditures on commercial buildings built before 1936 and 20 percent for commercial and residential buildings that the Department of the Interior has certified as historic structures because of their architectural significance.

The credits favor commercial use over most rental housing and may therefore divert capital from more productive uses. Moreover, in favoring renovation over new construction, the credits may encourage more costly ways of obtaining additional housing and commercial buildings.

Rehabilitation may have social benefits when it discourages the destruction of historically noteworthy buildings. The government could promote that objective at a lower cost, however, by permitting a credit only for the renovation of certified historic buildings and lowering the credit rate. Some surveys indicate that a 15 percent credit would be sufficient to cover the extra costs of both obtaining certification and undertaking a rehabilitation of historic quality. Reducing the credit for historic structures to 15 percent and repealing the credit for nonhistoric structures would increase revenues over the 2000-2009 period by about $2 billion. Repealing both credits would raise about $6 billion over the same period.

REV-29 REPEAL THE LOW-INCOME HOUSING CREDIT

	Added Revenues (Billions of dollars)
Annual	
2000	0.1
2001	0.3
2002	0.6
2003	1.0
2004	1.5
2005	1.9
2006	2.3
2007	2.7
2008	3.1
2009	3.6
Cumulative	
2000-2004	3.5
2000-2009	17.0

SOURCE: Joint Committee on Taxation.

RELATED OPTION:

370-06

The low-income housing credit (LIHC) subsidizes the construction and substantial rehabilitation of low-income rental housing. Individuals and corporations who qualify for the LIHC receive tax credits over a 10-year period that are worth up to 70 percent, measured in present value, of the construction or rehabilitation costs of qualifying projects. The percentage is limited to 30 percent for projects that receive other federal subsidies.

To qualify for the LIHC, project owners must set aside at least 20 percent of rental units for families whose income is below 50 percent of area median income, or 40 percent of units for families whose income is below 60 percent of median income. Rents are restricted. The set-aside and rent restrictions apply for at least 15 years. State housing agencies allocate the credits subject to statutory limits.

The LIHC will reduce federal revenue by $3.3 billion in 1998 and is estimated to grow to $3.9 billion in 2001. Repealing the tax credit for new projects would raise $17 billion from 2000 through 2009.

Housing assistance could be provided to the same number of people at lower cost if the assistance was provided in the form of an expanded housing voucher program. Low-income tenants can use housing vouchers to pay for all or part of the rent for the housing of their choice, as long as it meets minimum standards for habitability. By contrast, the low-income housing credit subsidizes only new and substantially rehabilitated housing, which is the most expensive kind of housing.

High overhead costs also make some housing subsidized by the LIHC even more expensive to produce and rent. Private investors in low-income housing syndicates require high rates of return to compensate for the inherent risk of such investments as well as the specific risks imposed by the credit. For example, projects that fail to comply with the requirements of the program may be subject to heavy penalties. In addition, some investors cannot use the credits every year because of the limits on passive losses and on the use of business tax credits. Moreover, the administrative and marketing costs in organizing low-income housing syndicates are high.

Advocates of the LIHC argue that it, in combination with rental assistance subsidies, assists many poor families and can be an important part of neighborhood revitalization efforts. In addition, affordable housing that meets minimal housing standards is scarce in some areas with low-income families. For those reasons, a supply subsidy such as the LIHC might be a more effective policy tool than a demand subsidy such as housing vouchers. Advocates also argue that lower-middle-income people who benefit from the credit are neglected by traditional housing programs, which primarily assist poor families, and that state governments, which allocate the credits, are better able to assess the housing needs of their communities than is the federal government. Finally, budget constraints on discretionary spending might make it difficult to repeal the credit in favor of an expanded voucher program funded by annual appropriations.

REV-30-A TAX CREDIT UNIONS LIKE OTHER THRIFT INSTITUTIONS

	Added Revenues (Billions of dollars)
Annual	
2000	0.5
2001	0.8
2002	0.8
2003	0.9
2004	0.9
2005	0.9
2006	1.0
2007	1.0
2008	1.1
2009	1.1
Cumulative	
2000-2004	3.9
2000-2009	9.0

SOURCE: Joint Committee on Taxation.

RELATED OPTION:

REV-30-B

Credit unions are nonprofit institutions that provide their members with financial services such as accepting deposits and making loans. The federal income tax treats credit unions more favorably than competing thrift institutions, such as savings and loan institutions and mutual savings banks, by exempting their retained earnings from taxation. That situation reduces economic efficiency because different tax treatment of like institutions hinders competition and the provision of services at the lowest cost. In addition, more credit unions and fewer taxable thrift institutions now exist than would otherwise be the case.

Credit unions, savings and loans, and mutual savings banks were originally all tax-exempt, but in 1951 the Congress removed the tax exemptions for savings and loans and mutual savings banks. It considered those institutions to be similar to profit-seeking corporations. Credit unions, unlike the other depository institutions, were designed to be cooperatives whose members shared a common bond.

Since 1951, many credit unions have come to resemble other thrift institutions. Credit unions no longer limit membership to people sharing the common bond of having the same employer or occupation. Since 1982, credit union regulators have allowed credit unions to extend their services to members of other organizations. Although that was legally challenged, recent legislation (the Credit Union Membership Access Act of 1998) allows multiple, unrelated groups to join the same credit union as long as the group has 3,000 or fewer members when it joins the credit union. In addition, most credit unions allow members and their families to participate permanently, even after members have left the sponsoring organization.

Credit union membership has grown from about 5 million in 1950 to about 70 million today. Credit unions, like taxable thrifts, now serve the general public. They also resemble thrift institutions in that they retain earnings. Although credit unions argue that earnings retention protects them against unexpected events, other thrift institutions complain that credit unions use the retained earnings to finance expansion.

Finally, credit unions now provide many of the services offered by savings and loans and mutual savings banks. A significant number of credit unions offer mortgages and car loans, direct deposit, access to automatic tellers, preauthorized payments, credit cards, individual retirement accounts, safe deposit boxes, and discount brokerage services. Moreover, some large credit unions offer electronic account access by telephone as well as business loans.

Taxing credit unions like other thrift institutions would raise $3.9 billion over the five-year period from 2000 to 2004 and $9.0 billion from 2000 to 2009.

REV-30-B TAX CREDIT UNIONS WITH MORE THAN $10 MILLION IN ASSETS LIKE OTHER THRIFT INSTITUTIONS

	Added Revenues (Billions of dollars)
Annual	
2000	0.5
2001	0.7
2002	0.8
2003	0.8
2004	0.8
2005	0.9
2006	0.9
2007	1.0
2008	1.0
2009	1.0
Cumulative	
2000-2004	3.6
2000-2009	8.4

SOURCE: Joint Committee on Taxation.

RELATED OPTION:

REV-30-A

An alternative to taxing all credit unions like other thrift institutions (see option REV-30-A) would be to tax only large credit unions and allow small credit unions to retain their tax-exempt status. Unlike large credit unions, small credit unions are similar to nonprofit mutual organizations and should have similar tax treatment. Most small credit unions have members with a single common bond or association. In some cases, volunteers from the membership manage and staff the credit union. In addition, many of the small credit unions do not provide services comparable with other thrift institutions.

To protect the smaller credit unions, the Congress could choose to tax only credit unions with assets greater than $10 million. Such an action would exempt 8 percent of all assets in the credit union industry and about two-thirds of all credit unions from taxation.

Taxing credit unions with more than $10 million in assets like other thrift institutions would raise $3.6 billion over the five-year period from 2000 to 2004 and $8.4 billion from 2000 to 2009.

REV-31 REPEAL THE EXPENSING OF EXPLORATION AND DEVELOPMENT COSTS FOR EXTRACTIVE INDUSTRIES

	Added Revenues (Billions of dollars)
Annual	
2000	0.4
2001	0.5
2002	0.5
2003	0.5
2004	0.5
2005	0.6
2006	0.6
2007	0.7
2008	0.7
2009	0.7
Cumulative	
2000-2004	2.4
2000-2009	5.7

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-32, REV-33, REV-35, and REV-40

The current tax system favors extractive industries (oil, gas, and minerals producers) over most other industries through various tax preferences (see also option REV-32). One preference allows certain types of oil and gas producers and producers of hard minerals to deduct some exploration and development costs when they are incurred (a process called expensing) rather than over time as the resulting income is generated. That immediate deduction of costs contrasts with the normal tax treatment facing other industries, in which costs are deducted more slowly according to prescribed rates of depreciation or depletion. The Tax Reform Act of 1986 established uniform capitalization rules that require certain direct and indirect costs allocatable to property to be either deducted when inventory is sold or recovered over several years as depreciation deductions (so that any deduction of costs is postponed). However, intangible drilling and development costs and mine development and exploration costs are exempt from those rules. Thus, the expensing of such costs results in a tax preference for extractive industries that other industries do not have. (See options REV-33, REV-35, and REV-40 for other exceptions.)

Expensible exploration and development costs include costs for excavating mines and drilling wells. They also include prospecting costs for hard minerals but not for oil and gas. Although current law allows full expensing for independent oil and gas producers and noncorporate mineral producers, it limits expensing to 70 percent of costs for "integrated" oil and gas producers (companies involved in substantial retailing or refining activities) and corporate mineral producers. Firms subject to the 70 percent limit must deduct the remaining 30 percent of costs over a 60-month period.

Although the original rationale for expensing was that the costs of exploration and development were considered ordinary operating expenses, continuing the preference has been justified on the grounds that oil and gas are "strategic minerals," essential to national energy security. However, expensing distorts the efficient allocation of resources in several ways. First, it causes resources to be overallocated to drilling and mining, when some of those resources might be used more productively elsewhere in the economy. Second, although the preference might reduce dependence on imported oil in the short run, it encourages current extraction, perhaps at the cost of reduced future extraction and greater future reliance on foreign production. Third, expensing may result in an inefficient allocation of production within those extractive industries because the extent of the subsidy depends on factors not systematically related to economic productivity—such as the difference between the immediate deduction and the true useful life of such capital as well as on whether the producer must pay the alternative minimum tax (in which case expensing is limited).

Repealing the expensing of exploration and development costs would improve the allocation of resources and raise $5.7 billion from 2000 through 2009, assuming that firms could still expense costs from unproductive holes and mines.

REV-32 REPEAL THE PERCENTAGE DEPLETION FOR EXTRACTIVE INDUSTRIES

	Added Revenues (Billions of dollars)
Annual	
2000	0.4
2001	0.4
2002	0.4
2003	0.4
2004	0.5
2005	0.5
2006	0.5
2007	0.5
2008	0.5
2009	0.5
Cumulative	
2000-2004	2.1
2000-2009	4.6

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-31 and REV-33

The current tax system favors extractive industries (oil, gas, and mineral producers) over most other industries in various ways. One way is by allowing producers to deduct exploration and development costs when they are incurred (see option REV-31). Another way is by allowing some firms to use the "percentage depletion" method to recover costs rather than the standard "cost depletion" method.

The percentage depletion method of cost recovery allows certain types of extractive companies (independent producers and royalty owners, or nonintegrated companies) to deduct a certain percentage of a property's gross income in each taxable year, regardless of the actual capitalized costs. In contrast, other industries (and since 1975, integrated oil companies as well) use the cost depletion method. Under cost depletion, the costs recovered cannot exceed the taxpayer's expenses in acquiring and developing the property. But under percentage depletion, they may. Thus, the percentage depletion method results in a tax preference for certain types of extractive companies that other companies do not have. Unlike the expensing of exploration and development costs, however, percentage depletion applies only to a small subset of total oil, gas, and minerals production because it excludes the large integrated producers.

Current law typically allows nonintegrated oil and gas companies to deduct 15 percent of the gross income from oil and gas production up to 1,000 barrels per day. The Omnibus Budget Reconciliation Act of 1990 made percentage depletion even more generous, however, for nonintegrated companies that are considered to be "marginal" producers (those with very low total production or production that is entirely made up of heavy oil). The deduction for marginal properties can be up to 25 percent of gross income if the market price of oil drops low enough. Producers of hard minerals may also use percentage depletion, but the statutory percentages vary from 5 percent to 22 percent depending on the type of mineral. Tax law limits the amount of percentage depletion to 100 percent of the net income from an oil and gas property and 50 percent of the net income from a property with hard minerals.

Percentage depletion has been justified on the grounds that oil and gas are "strategic minerals," essential to national energy security. Percentage depletion distorts the allocation of resources, however, by encouraging production in those industries over other types of industries. It can also cause an inefficient allocation of production by extractive businesses in the same way that expensing does as well as in other ways. In particular, percentage depletion subsidizes firms according to gross income and not according to investment. Thus, it encourages developing existing properties over exploring for new ones.

Repealing the percentage depletion for extractive industries would improve the allocation of resources and raise $4.6 billion over the 2000-2009 period.

REV-33 REPEAL THE TAX CREDIT FOR ENHANCED OIL RECOVERY COSTS AND EXPENSING OF TERTIARY INJECTANTS

	Added Revenues (Billions of dollars)
Annual	
2000	0.1
2001	0.1
2002	0.1
2003	0.1
2004	0.1
2005	0.1
2006	0.1
2007	0.1
2008	0.1
2009	0.1
Cumulative	
2000-2004	0.4
2000-2009	0.8

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-31, REV-32, REV-35, and REV-40

RELATED CBO PUBLICATION:

Climate Change and the Federal Budget (Memorandum), August 1998.

The tax code provides a 15 percent credit for the costs of recovering domestic oil by a qualified "enhanced oil recovery" (EOR) method. Qualifying methods are those that allow the recovery of oil that is too viscous to be extracted by conventional methods. The costs of labor, materials, equipment, repairs, intangible drilling, and development qualify for the credit, which is phased out for oil prices above $28 per barrel (adjusted for inflation). Without the credit, EOR would not be realistic because it is more expensive than recovering oil by conventional methods.

In addition, the tax code provides for the expensing of tertiary injectants—the fluids, gases, and other chemicals that are injected into oil or gas reservoirs to extract highly viscous oil. The tax code permits deducting the full cost of the chemical injectants in the year in which the injectants are used to extract oil. The expenditures for injectants also qualify for the 15 percent EOR credit; however, the credit must be subtracted from the deduction if both are claimed for the same expenditure. Without tax incentives, the use of tertiary injectants to extract oil would not be economical.

The EOR credit was enacted as part of the Omnibus Budget Reconciliation Act of 1990 to increase the domestic supply of oil and reduce the demand for imported oil, particularly from producers in the Persian Gulf and other politically unstable areas. The expensing of tertiary injectants was enacted in 1980 for similar reasons but also to ensure that the costs of injectants would be treated the same as intangible drilling costs, which are also expensed.

Both provisions offer capital subsidies to lower the cost of producing oil by unconventional, more expensive methods. Whether the federal government should subsidize the production of high-cost domestic oil depends on the external costs of oil imports. Increased domestic production lessens short-term dependency but depletes domestic resources, encouraging long-term dependency on imports.

The world market price of oil is currently low, and oil production in the United States has been declining. Although the United States is more dependent on foreign oil than it used to be, it is less vulnerable to supply disruptions because of the stockpiling of oil under the Strategic Petroleum Reserve, the weakened power of the Organization of Petroleum Exporting Countries, and the increased competitiveness in world oil markets.

Eliminating both the EOR credit and the expensing of tertiary injectants would increase revenues by $0.8 billion over the 2000-2009 period. Eliminating the EOR credit alone would increase revenues by $0.7 billion, and eliminating expensing alone would increase revenues by $0.1 billion during the same period.

REV-34 REPEAL THE PARTIAL EXEMPTION FOR ALCOHOL FUELS FROM EXCISE TAXES ON MOTOR FUELS

	Added Revenues (Billions of dollars)
Annual	
2000	0.4
2001	0.5
2002	0.5
2003	0.5
2004	0.5
2005	0.5
2006	0.5
2007	0.5
2008	0.5
2009	0.5
Cumulative	
2000-2004	2.4
2000-2009	5.0

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-45 and 270-03

The tax code imposes excise taxes on motor fuels, but it partially exempts fuels that are blends of gasoline and alcohol. Repeal of the partial excise tax exemption would raise $5 billion in revenues over the 2000-2009 period. That estimate assumes that the Congress also repeals the alcohol fuels credit, an alternative tax benefit that can be used instead of the partial excise tax exemption. The credit, however, is in almost all cases less valuable than the exemption and is rarely used.

Ethanol (an alcohol fuel produced primarily from corn and sugar) used as a fuel is eligible for a nonrefundable tax benefit (through credit or exemption) of up to 54 cents per gallon. The exact size of the tax benefit depends on the percentage of alcohol in the fuel and whether the alcohol was made from a fossil (nonrenewable) or nonfossil (renewable) fuel source. The exemption applies only to alcohol fuels produced from nonfossil fuel sources. For example, gasohol, which is 90 percent gasoline and 10 percent ethanol (a renewable source) receives a 5.4 cents per-gallon exemption from the 18.3 cents per-gallon tax on gasoline.

The Transportation Equity Act of 1998 extended the ethanol fuels credit, which had been scheduled to expire at the end of fiscal year 1999. The tax benefit rate drops to 53 cents per gallon for 2001 to 2002, 52 cents per gallon for 2003 to 2004, and 51 cents per gallon for 2005 to 2007. The entire tax benefit is now scheduled to expire at the end of fiscal year 2007.

One purpose of the tax benefit—enacted in the late 1970s—was to increase national security by reducing the demand for imported oil and thereby reduce U.S. dependence on foreign oil sources. Another purpose was to provide an additional market for U.S. agricultural products by encouraging domestic production of ethanol. Over the past several years, U.S. environmental action has increased the value of ethanol by mandating the oxygen content of motor fuels in many areas of the country. Use of oxygenated fuels in motor vehicles generally produces less carbon monoxide pollution than does gasoline. The tax benefit appears to have successfully encouraged energy producers to substitute ethanol for gasoline.

The Clean Air Act Amendments of 1990, however, reduced the need for the partial excise exemption by mandating the minimum oxygen content of gasoline used in areas with poor air quality. Moreover, since ethanol production uses more resources than gasoline production, the allocation of resources resulting from the partial exemption may be economically inefficient if the value of those resources in alternative uses outweighs the value of the reduction in air pollution.

Repealing the excise tax exemption could result in higher federal outlays for price support loans for grains. But any increase in outlays—not included in the budget estimates shown above—would probably be much smaller than the estimated revenue increase.

REV-35 CAPITALIZE THE COSTS OF PRODUCING TIMBER

	Added Revenues (Billions of dollars)
Annual	
2000	0.3
2001	0.5
2002	0.5
2003	0.5
2004	0.5
2005	0.4
2006	0.4
2007	0.4
2008	0.4
2009	0.4
Cumulative	
2000-2004	2.3
2000-2009	4.4

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-31, REV-33, and REV-40

The current tax system allows timber producers to deduct ("expense") most of the production costs of maintaining a timber stand when those costs are incurred. That tax treatment contrasts with the uniform capitalization rules applied to most other industries. (See options REV-31, REV-33, and REV-40 for other exceptions.) Established under the Tax Reform Act of 1986 (TRA-86), such rules require that production costs not be deducted until the sale of the produced goods or services. When businesses do not account for costs properly, business income is not measured correctly because the costs of producing goods and services are not matched with the sale of the goods and services.

Although the costs of planting a timber stand are in fact subject to capitalization rules, subsequent maintenance and production costs are not. Timber producers can expense indirect carrying costs, such as property taxes, interest, insurance costs, and administrative overhead, as well as the costs of labor and materials to remove unwanted trees and to control fire, disease, and insects. By allowing timber producers to deduct such production costs before the timber is harvested or sold, the tax code in effect subsidizes timber production by deferring tax that producers otherwise would owe on their income. (Under certain circumstances, however, the deferral granted to noncorporate producers of timber may be greatly curtailed by the limits of the tax code on losses from passive business activities.)

The original rationale for expensing timber production costs was a general perception that such costs were maintenance costs and thus deductible as ordinary costs of a trade or business. When TRA-86 established uniform capitalization rules, the general reason given for exempting timber costs was that applying the rules to those industries might have been unduly burdensome.

Expensing timber production costs distorts investment behavior in two ways: more private land is devoted to timber production, and trees are allowed to grow longer before they are cut. Unless timber growing offers spillover benefits to society that are not captured by market prices, the tax preference leads to an inefficient allocation of resources and an inefficient harvesting rate.

Whether or not timber production offers important spillover benefits is unclear. Standing timber provides some spillover benefits by deterring soil erosion and absorbing carbon dioxide (a gas linked to global warming), but cutting timber can lead to soil erosion. In addition, producing and disposing of wood and paper products contribute to pollution.

Capitalizing the costs of timber production incurred after December 31, 1999, would raise $4.4 billion in revenue from 2000 through 2009 by accelerating tax payments from timber producers. In the long run, capitalizing timber production costs would raise the price of domestic timber and lower the value of land used to grow it. Moreover, lease payments to private land owners by timber growers would probably fall, causing some land that historically has been devoted to growing timber to be used in other ways. In the short run, however, capitalizing timber production costs might lower the price of domestic timber because producers would have an incentive to harvest it earlier.

REV-36 REPLACE CORPORATE CREDIT WITH A DEDUCTION FOR EMPLOYER FICA ON CERTAIN TIP INCOME

	Added Revenues (Billions of dollars)
Annual	
2000	0.2
2001	0.3
2002	0.3
2003	0.3
2004	0.3
2005	0.3
2006	0.3
2007	0.3
2008	0.3
2009	0.4
Cumulative	
2000-2004	1.4
2000-2009	3.1

SOURCE: Joint Committee on Taxation.

Since 1993, employers in the food and beverage industry have been entitled to a nonrefundable corporate income tax credit against Federal Insurance Contributions Act (FICA) taxes paid on employee tips (except for any amount of tips that makes up the difference between regular wages and the minimum wage). Replacing that tax credit with a deduction, which is the standard tax treatment for such labor costs, would increase revenues by $3.1 billion from 2000 to 2009.

Until 1988, all employers were required to pay FICA tax on tips only to the extent that the federal minimum wage exceeded the actual wage paid by the employer. Following a proposal in the President's budget, the Omnibus Budget Reconciliation Act of 1987 expanded the definition of wages subject to FICA tax to include all cash tips.

Opponents of the expanded definition of wages tried to repeal it several times. One provision in the Revenue Act of 1992 would have retained the expanded definition for FICA purposes but would have granted a full, nonrefundable credit against the new FICA tax as part of the general business credit, which applies mostly to corporate taxpayers. Legislators used that indirect approach because Congressional budget rules make lowering Social Security revenues particularly difficult. Although both houses passed the bill, President Bush pocket-vetoed it.

A similar provision was finally enacted as part of the Omnibus Budget Reconciliation Act of 1993, but the credit applied only to tips received at food and beverage establishments. The Small Business Job Protection Act of 1996 expanded the credit to tips received in connection with food served for takeout or delivered off premises, relaxed restrictions on the timing of affected wages, and allowed the credit to apply to tips not reported by the employee.

Proponents of replacing the credit with a deduction argue that the credit creates jobs. But because the credit grants a tax preference to a specific industry (food service) and a specific form of compensation (tips), the credit could be creating jobs in one sector at the cost of more productive jobs in other sectors. Proponents also assert that tips differ from wages since they are paid by customers, not employers. From an economic perspective, however, tips are the same as wages because they are earned by employees for services performed. Tips could be considered self-employment income, but such treatment would greatly increase the administrative burden of tax collection.

Because the wages of waiters and waitresses are much lower than those of most employees, the credit makes the overall tax system more progressive, at least to the extent that the credit is passed through by the recipient firms to the servers instead of to the customers, shareholders, or higher-paid employees.

REV-37 REPEAL THE "LOWER OF COST OR MARKET" INVENTORY VALUATION METHOD

	Added Revenues (Billions of dollars)
Annual	
2000	0.2
2001	0.4
2002	0.3
2003	0.3
2004	0.3
2005	0.1
2006	0.1
2007	0.1
2008	0.1
2009	0.1
Cumulative	
2000-2004	1.5
2000-2009	2.0

SOURCE: Joint Committee on Taxation.

Under the inventory valuation method called "lower of cost or market" (LCM), businesses may deduct immediately the accrued losses on year-end inventories but defer paying tax on gains until the year of sale. That situation provides favorable tax treatment, although only to firms using the first-in, first-out method of inventory accounting. Furthermore, under either the LCM or the cost method of inventory valuation, firms may deduct immediately any losses from inventory goods that arise from damage, imperfections, broken lots, or certain other causes (subnormal goods method). In that case as well, firms receive favorable tax treatment to the extent that such goods are sold—and hence income is realized—in later tax years.

This option would repeal LCM and the subnormal goods method of inventory valuation for all firms with gross receipts averaging more than $5 million annually over a three-year period. It would therefore require the businesses to value their inventories at cost and include in taxable income both gains and losses from the change in inventory value only when those goods are sold. The Administration proposed this option in its past four budgets.

LCM not only causes a timing mismatch between recognition of gains and losses, but it also has two mechanical shortcomings. First, once a firm has reduced the value of inventories using the LCM method, it need not ever record an increase in the value, even if the actual value of the inventories subsequently rises. Second, the definition of market value is somewhat skewed. Retailers are allowed to deduct losses on inventory following a markdown of the retail price, even if the new retail price remains above the original cost. Those shortcomings could be addressed, however, without repealing the LCM method.

This option would increase revenues by $2 billion over the 2000-2009 period. The increase in liability has two components—a one-time increase from the revaluation of existing inventory to exclude unrealized (accrued) losses and a smaller, permanent increase from growth in the excluded losses over time. Because the option phases in the new rules, the one-time revaluation component raises liability every year for four years. The permanent component increases over time because unrealized losses grow annually.

REV-38 TIGHTEN RULES ON INTEREST DEDUCTIONS FOR CORPORATE-OWNED LIFE INSURANCE

	Added Revenues (Billions of dollars)
Annual	
2000	0.2
2001	0.4
2002	0.4
2003	0.4
2004	0.4
2005	0.5
2006	0.5
2007	0.5
2008	0.5
2009	0.6
Cumulative	
2000-2004	1.8
2000-2009	4.4

SOURCE: Joint Committee on Taxation.

Corporations purchase life insurance policies in part as protection against financial loss from the death of their more important employees or owners. Purchases of cash-value life insurance provide a tax benefit if corporations indirectly finance them by increasing debt or other liabilities and then deduct the resulting interest expense from taxable income. The Internal Revenue Service disallows the interest deduction if it can establish a direct link between increases in debt or other liabilities and the purchase of cash-value insurance. A direct link is difficult to establish, however, because firms increase liabilities for many purposes.

This option would disallow a proportion of a firm's total interest deductions equal to the proportion of its total assets invested in cash-value life insurance policies. The option would not apply to insurance on the life of owners with 20 percent or more interest in the firm. It would raise an estimated $4.4 billion over the 2000-2009 period.

The tax code allows the tax benefit by exempting the investment income (or "inside buildup") of a life insurance policy from corporate income tax and permitting a corporation to deduct from taxable income the interest on debt that is indirectly used to finance the investment. Such asymmetric treatment provides an opportunity for tax arbitrage because corporations can generate interest deductions that they can use to shelter other taxable income. Individuals may not use that tax benefit because the tax code does not allow them to deduct those interest payments.

In 1996, the Congress disallowed the deductibility of interest on loans from an insurance company with the cash-value policy as collateral (with exceptions for insurance on certain key employees). In 1997, the Congress enacted a proportional disallowance of interest deductions, but it applied only to firms that purchase cash-value insurance on the life of people who were not employees or owners. This option would further disallow such interest deductions except for purchases of insurance on the life of those who own at least 20 percent of the firm. The Administration has proposed this option in its past two budgets. In 1986, the Congress also enacted a similar disallowance of a proportion of interest deductions for financial institutions that purchased state and local government securities whose interest was tax-exempt.

Opponents of this option argue that a firm may have business reasons to purchase life insurance policies on its employees and owners as well as other business reasons to issue debt and that the firm may not be linking the two decisions to create a tax shelter. Proponents of the option, however, argue that firms intend to use the policies and debt as tax shelters.

REV-39 REPEAL TAX-FREE CONVERSIONS OF LARGE C CORPORATIONS TO S CORPORATIONS

	Added Revenues (Billions of dollars)
Annual	
2000	a
2001	a
2002	a
2003	0.1
2004	0.1
2005	0.1
2006	0.1
2007	0.1
2008	0.1
2009	0.1
Cumulative	
2000-2004	0.2
2000-2009	0.7

SOURCE: Joint Committee on Taxation.

a. Less than $50 million.

Under current law, a C corporation may reduce taxes on some income by electing to be treated as an S corporation or converting to a partnership. The income of C corporations is generally taxed twice, once when it is earned by the corporation and again when it is distributed to stockholders. S corporation and partnership income is taxed only once, at the personal tax rates of the firm's owners. Over time, the distinction between S corporations and partnerships has become somewhat blurred, but conversion from a C corporation to either of those two corporate forms continues to receive differential tax treatment.

The election of S corporation filing status receives preferential tax treatment compared with conversion to a partnership. Converting to an S corporation is tax-free under many situations; converting to a partnership is taxable and requires the corporation to recognize any built-in gain on its assets and the shareholders to recognize any such gain in their corporate stock. Under section 1374 of the Internal Revenue Code, if a C corporation converts to an S corporation, the appreciation of the corporation's assets while it was a C corporation is not subject to the corporate-level tax unless the assets are sold within 10 years of the conversion. Current law allows a corporation to avoid the two-tier corporate tax by converting tax-free to an S corporation.

This option would repeal tax-free conversions for corporations with a value of more than $5 million at the time of conversion, thereby making the tax treatment of the two types of conversions more similar. When a C corporation with a value of over $5 million converted, to an S corporation, the corporation and its shareholders would immediately recognize the gain in their appreciated assets. This option would increase income tax revenues by $0.7 billion over the 2000-2009 period.

Repealing those tax-free conversions would equalize the tax treatment of economically similar conversions from two-tier corporate systems to single-tier flow-through systems, reducing the effect of tax considerations on decisions about organizational form. For people who think S corporations more closely resemble corporations than they do flow-through entities, such as partnerships, preserving the current differential tax treatment may be considered beneficial. According to that viewpoint, current law merely allows a corporation to change its filing status from that of C corporation to S corporation, providing it meets the legal requirements, without having to pay tax for changing its choice of corporate form.

REV-40 REPEAL THE EXPENSING OF CERTAIN AGRICULTURAL COSTS

	Added Revenues (Billions of dollars)
Annual	
2000	0.5
2001	2.9
2002	1.6
2003	0.9
2004	0.6
2005	0.4
2006	0.3
2007	0.3
2008	0.4
2009	0.4
Cumulative	
2000-2004	6.5
2000-2009	8.2

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-31, REV-33, and REV-35

Like its treatment of some costs of producing timber, the current tax code allows most farmers—except farm corporations, partnerships, and tax shelters—to expense (deduct immediately) certain capital outlays and production costs, even when such investments generate income over several years. That tax treatment contrasts with the depreciation and uniform capitalization rules applicable to most other industries, which deduct such costs more slowly. (See options REV-31, REV-33, and REV-35 for other exceptions.)

Agricultural expenses qualifying for immediate deduction include tool purchases; the costs of breeding, feeding, and raising livestock; certain soil and water conservation expenses; fertilizer purchases; and the development and planting expenses of crops that require two years or less between planting and harvesting.

Because in many cases such investments produce income over a period exceeding one year, expensing those costs understates income in the year of deduction and overstates income in the year of realization. Thus, farmers can defer taxes, which reduces their effective tax rate. The Tax Reform Acts of 1976 and 1986 limited the use of expensing for farm corporations and tax-shelter operations; the 1986 act required most other types of businesses to deduct production and resale costs more slowly according to the uniform capitalization rules. Thus, current law regarding expensing of agricultural costs favors production of small farms over that of larger ones and of the agricultural industry in general over most other industries. Such a tax preference can lead to an inefficient allocation of resources.

The original justification for the expensing of such costs, however, was to simplify financial recordkeeping for farmers. Although the administrative costs of recordkeeping are clearly lower today than they used to be, it may still be simpler for farmers to deduct costs in one period than in several periods.

Agriculture receives other special tax treatment as well. One example is income averaging, in which farmers may elect to average all or a portion of taxable income over the previous three-year period in computing current year tax liability. The Tax and Trade Relief Extension Act of 1998 made that provision permanent to mitigate the adverse tax consequences resulting from fluctuating income levels. The 1998 act also extended the carryback period for net operating losses from two to three years for farming losses incurred from disasters that have been designated as such by the President.

Subjecting all farms to the normal depreciation and uniform capitalization rules would level the tax treatment among businesses and industries, neutralizing the effects of the tax system on economic decisions. Such a change would raise $8.2 billion in revenue from 2000 through 2009.

REV-41 ELIMINATE EXEMPTION OF INCOME FOR COOPERATIVELY OWNED ELECTRIC AND TELEPHONE UTILITIES

	Added Revenues (Billions of dollars)
Annual	
2000	0.2
2001	0.3
2002	0.3
2003	0.3
2004	0.3
2005	0.3
2006	0.3
2007	0.3
2008	0.4
2009	0.4
Cumulative	
2000-2004	1.4
2000-2009	3.1

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

270-05, 270-06, and 270-07

RELATED CBO PUBLICATIONS:

Should the Federal Government Sell Electricity? (Study), November 1997.

Electric Utilities: Deregulation and Stranded Costs (Paper), October 1998.

Electric and telephone cooperatives, which are owned by their customers, are effectively or explicitly exempt from corporate income tax. Eliminating those tax exemptions and taxing those co-ops as regular for-profit corporations would raise $0.2 billion in 2000 and $3.1 billion over the 2000-2009 period.

Cooperatives may exclude from income amounts that they are required to distribute as dividends to their members. In addition to that exclusion, electric and telephone co-ops also may exclude earnings from other sources from taxable income, as long as at least 85 percent of their income is collected from members for providing their primary service (electricity or telephone service). Some forms of outside income are not even counted toward the remaining 15 percent, including rental income from telephone poles that are leased to cable or telephone companies and income from the Yellow Pages, cable TV, and Internet access. In addition, distributions of dividends to cooperative members, whether cash or payments in kind in the form of household utility services, are free from income tax. Eliminating the tax exemption on dividends to individuals could generate additional revenues.

Those tax breaks, along with the low-interest loan program available through the Rural Utilities Service (see option 270-05) were created to encourage the wiring of rural areas for service. However, since 95 percent of the United States is already connected to the electricity grid, the cost to distributors is probably the same for rural and urban customers. Moreover, all electric cooperatives have those subsidies, even generation cooperatives, which may not need subsidies. Generating electricity does not cost more in rural areas.

If the tax exemption ends and cooperatively owned electric and telephone utilities must pay the same corporate income tax as other suppliers of electricity, then electricity rates to the cooperatives' customers may rise. Electric and telephone co-ops would be subject to taxes that other co-ops do not pay. Privately owned utilities claim, however, that subsidies to rural cooperatives are unnecessary and unfair. If electricity is deregulated, this tax exemption will treat electric cooperatives differently than the investor-owned utilities they will be competing with for customers. If policymakers decide that subsidies are needed for distributing electricity in rural areas, a more direct approach would be through universal service provisions, which would provide a fund to subsidize the wire portion of the electricity service.

REV-42 INCREASE THE EXCISE TAX ON CIGARETTES BY 50 CENTS PER PACK

	Added Revenues (Billions of dollars)
Annual	
2000	4.9
2001	6.4
2002	6.3
2003	6.3
2004	6.3
2005	6.2
2006	6.2
2007	6.1
2008	6.1
2009	6.0
Cumulative	
2000-2004	30.2
2000-2009	60.8

SOURCE: Joint Committee on Taxation.

RELATED OPTION:

REV-44

RELATED CBO PUBLICATIONS:

Federal Taxation of Tobacco, Alcoholic Beverages, and Motor Fuels (Study), August 1990.

The Proposed Tobacco Settlement: Issues from a Federal Perspective (Paper), April 1998.

Taxes on certain goods and services can influence consumer choices, causing people to purchase less of the taxed items. That generally leads to a less efficient allocation of society's resources unless some costs associated with the taxed items are not reflected in their price. Tobacco creates costs to society that are not reflected in its pretax cost. Examples of those "external costs" include higher health insurance costs to cover the medical expenses linked to smoking and the effects of cigarette smoke on the health of nonsmokers. Taxes increase prices and can result in consumers paying the full cost of smoking.

Currently, the federal cigarette excise tax is 24 cents per pack; it will increase to 34 cents in 2000 and 39 cents in 2002. (Other tobacco products have similar taxes.) Federal tobacco taxes raised about $5.8 billion in fiscal year 1998, about 0.3 percent of total federal revenues. Increasing the cigarette tax by 50 cents a pack (in addition to the scheduled increases) would increase net revenue by $61 billion between 2000 and 2009. State excise taxes will average about 40 cents per pack in 1999. In addition, a settlement reached between state attorneys general and major tobacco manufacturers requires payments equivalent to an excise tax of about 35 cents per pack.

Some economists estimate the external costs of smoking to be significantly less than those taxes and fees, but others think that taxes should be increased more. Technical issues cloud the debate; for example, the magnitude of the health impact of secondhand smoke is uncertain. But much of the debate involves varying theories, such as whether to consider the health effects on the smoker's family or the public health and pension savings that arise because smokers have shorter lives.

Increasing excise taxes may be desirable regardless of the magnitude of external costs if consumers underestimate the harm of smoking or how addictive nicotine is. Teenagers, especially, may not be prepared to evaluate the long-term effects of beginning to smoke. However, all populations know that smoking has health risks.

Increasing excise taxes leads to reduced consumption of tobacco. Each 10 percent increase in cigarette prices is likely to lead to a decline in cigarette consumption of 2.5 percent to 5 percent, probably with a larger decline for teenagers.

Both because lower-income people are more likely to smoke than higher-income people and because expenditures on cigarettes for those who smoke do not rise appreciably with income, taxes on tobacco are regressive; that is, such taxes take up a greater percentage of income for low-income families than for middle- and upper-income families.

Several bills introduced in the last Congress proposed raising the excise tax. In his 2000 budget, the President proposed an increase of 55 cents per pack in the tobacco tax.

REV-43 INCREASE ALL ALCOHOLIC BEVERAGE TAXES TO $16 PER PROOF GALLON

	Added Revenues (Billions of dollars)
Annual	
2000	3.6
2001	4.4
2002	4.4
2003	4.5
2004	4.5
2005	4.5
2006	4.5
2007	4.6
2008	4.6
2009	4.6
Cumulative	
2000-2004	21.4
2000-2009	44.2

SOURCE: Joint Committee on Taxation.

RELATED OPTION:

REV-44

RELATED CBO PUBLICATION:

Federal Taxation of Tobacco, Alcoholic Beverages, and Motor Fuels (Study), August 1990.

Federal excise taxes on distilled spirits, beer, and wine raised $7.5 billion in fiscal year 1998, about 13 percent of all excise tax revenue and almost 0.5 percent of total federal revenues. Current federal excise taxes on beer and wine remain much lower than the federal excise tax on distilled spirits in tax per ounce of ethyl alcohol. The current tax on distilled spirits of $13.50 per proof gallon results in a tax of about 21 cents per ounce of alcohol. The current tax on beer of $18 per barrel results in a tax of about 10 cents per ounce of alcohol (assuming an alcohol content for beer of 4.5 percent), and the current tax on table wine of $1.07 per gallon results in a tax of about 8 cents per ounce of alcohol (assuming an average alcohol content of 11 percent).

Increasing the federal excise tax to $16 per proof gallon for all alcoholic beverages would raise about $44 billion between 2000 and 2009. A tax of $16 per proof gallon is equivalent to about 25 cents per ounce of ethyl alcohol. It would raise the tax on a 750-milliliter bottle of distilled spirits from about $2.14 to $2.54, the tax on a six-pack of beer from about 33 cents to 81 cents, and the tax on a 750-milliliter bottle of table wine from about 21 cents to 70 cents.

Alcohol consumption creates costs to society not reflected in the pretax cost of alcoholic beverages. Examples of those "external costs" include health costs covered by the public, productivity losses borne by others, and the loss of lives and property in alcohol-related accidents and crime. Calculating those costs creates both practical and theoretical difficulties, but a study sponsored by the National Institute on Alcohol Abuse and Alcoholism estimated the external economic costs of alcohol abuse to be over $80 billion in 1992.

By raising the price of alcoholic beverages, excise taxes generally result in consumers paying more of the costs of drinking. Studies consistently show that higher prices lead to lower consumption and less abuse of alcohol, even among heavy drinkers. Therefore, increasing taxes would reduce the total external costs of alcohol abuse.

Increasing excise taxes to reduce consumption may be desirable regardless of the effect on external costs if consumers are either unaware of or underestimate the harm that their drinking causes to them and others or how addictive alcohol can be.

Taxes on alcoholic beverages are regressive when compared with annual family income; that is, such taxes take up a greater percentage of income for low-income families than for middle- and upper-income families. In addition, alcohol taxes fall not only on problem drinkers but also on drinkers who impose no costs on society and are thus unduly penalized. Taxes are also likely to reduce consumption by some light drinkers who would have received beneficial health effects.

REV-44 INDEX TOBACCO AND ALCOHOL TAX RATES FOR INFLATION

	Added Revenues (Billions of dollars)
Annual	
2000	0.2
2001	0.5
2002	0.7
2003	1.1
2004	1.3
2005	1.7
2006	2.1
2007	2.4
2008	2.8
2009	3.0
Cumulative	
2000-2004	3.8
2000-2009	15.8

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-42 and REV-43

RELATED CBO PUBLICATIONS:

Federal Taxation of Tobacco, Alcoholic Beverages, and Motor Fuels (Study), August 1990.

The Proposed Tobacco Settlement: Issues from a Federal Perspective (Paper), April 1998.

Federal alcohol and tobacco taxes raised over $13 billion in 1998, including about $7.5 billion from taxes on distilled spirits, beer, and wine and about $5.8 billion from taxes on tobacco. Together those taxes represented nearly one-quarter of revenues from all excise taxes and almost 0.8 percent of total federal revenues. Tobacco and alcohol excise taxes are currently imposed on a per-unit basis. In the absence of legislation, their real cost declines with inflation. For example, despite several small legislative increases, excise taxes on distilled spirits have declined by nearly 80 percent in real terms since 1951.

Indexing the tax rates for tobacco and alcoholic beverages for inflation would raise nearly $16 billion in the 2000-2009 period. Indexing those tax rates would prevent inflation from eroding real tax rates and would avoid the need for abrupt nominal increases in the future.

Smoking and drinking create costs to society that are not reflected in the pretax prices of tobacco and alcoholic beverages, which cover only production and distribution costs. Examples of those "external costs" include medical expenses linked to smoking and drinking that are covered by the public, the effects of cigarette smoke on the health of nonsmokers, and the loss of lives and property in alcohol-related accidents.

By raising the price of tobacco and alcoholic beverages, excise taxes can result in consumers paying the full cost of smoking and drinking. Since increased excise taxes lead to reduced consumption of tobacco and alcoholic beverages, such increases will reduce the total external costs of smoking and drinking. If those external costs come mainly from heavy or abusive consumption by a minority of consumers, however, higher excise taxes could unduly penalize moderate and occasional smokers and drinkers.

Taxes on tobacco and alcoholic beverages are regressive when compared with annual family income; that is, such taxes are a greater percentage of income for low-income families than for middle- and upper-income families. In recent years, tobacco taxes have become increasingly regressive as the smoking rate has declined faster among wealthier groups.

An alternative to indexing would be to convert to ad valorem taxes, which equal a percentage of the manufacturer's price. That method would link tax revenues to price increases, although it would tie revenues to the price of taxed goods, not the general price level. A shortcoming of the ad valorem tax is that it creates incentives for manufacturers to artificially lower the prices they charge company-controlled wholesalers, thus reducing their tax liability.

REV-45 INCREASE MOTOR FUEL EXCISE TAXES BY 12 CENTS PER GALLON

	Added Revenues (Billions of dollars)
Annual	
2000	10.9
2001	14.6
2002	14.4
2003	14.4
2004	14.6
2005	15.0
2006	15.3
2007	15.6
2008	16.0
2009	16.3
Cumulative	
2000-2004	68.9
2000-2009	147.0

SOURCE: Joint Committee on Taxation.

RELATED OPTION:

REV-34

RELATED CBO PUBLICATION:

Federal Taxation of Tobacco, Alcoholic Beverages, and Motor Fuels (Study), August 1990.

Increasing petroleum taxes could encourage conservation by making petroleum more expensive, reduce pollution, and decrease the country's dependence on foreign oil suppliers while raising significant amounts of revenue.

Imposing new or higher petroleum taxes would raise petroleum prices and reduce consumption. To the extent that taxes on oil reduced the demand for imported oil, foreign suppliers would absorb part of the tax through lower world oil prices. To the extent that petroleum taxes reduced petroleum consumption, the taxes would also reduce carbon dioxide emissions and could therefore help reduce global warming.

Taxing petroleum is not the only way of reducing dependence on foreign oil supplies. Stockpiling oil would arguably be a better way of coping with the risks of increased dependence on imports because it would not artificially reduce current energy use by households and businesses. That argument is based on the premise that aside from the problem of interruptions in supply, world oil prices accurately reflect real resource costs and thus already provide an appropriate incentive to conserve.

A tax increase would reduce consumption of gasoline and diesel fuel by encouraging people to drive less or purchase more fuel-efficient cars and trucks. In addition, the tax would offset, though imperfectly, the costs of pollution and road congestion that automobile use produces. A rate increase on motor fuel taxes would not adversely affect U.S. producers relative to foreign producers because final consumers and the domestic transportation industry purchase most of the motor fuel. Moreover, the overall motor fuel tax rate is low in the United States compared with the rates in other countries.

Increasing tax rates on motor fuels would impose an added burden on the trucking industry and on people who commute long distances by car, who are not necessarily the highway users who impose the highest costs of pollution and congestion on others. Pollution and congestion costs are much higher in densely populated areas, primarily in the Northeast and coastal California, whereas per capita consumption of motor fuel is highest in rural areas. In addition, taxes on gasoline and other petroleum products take up a greater percentage of income for low-income families than for middle- and upper-income families.

Federal motor fuel taxes are currently 18.4 cents per gallon of gasoline and 24.4 cents per gallon of diesel fuel. A 12 cent increase would raise revenue by $10.9 billion in 2000 and $147 billion over the 2000-2009 period. It would raise the total federal tax rate for gasoline to 30.4 cents per gallon. To bolster the overall budget, the Congress could allocate the increased revenues to the general fund—as it did in 1998—rather than use the additional revenues to finance further highway spending.

REV-46-A TAX WATER POLLUTANTS ON THE BASIS OF BIOLOGICAL OXYGEN DEMAND

	Added Revenues (Billions of dollars)
Annual	
2000	1.4
2001	2.1
2002	1.9
2003	1.9
2004	1.8
2005	1.8
2006	1.7
2007	1.7
2008	1.7
2009	1.7
Cumulative	
2000-2004	9.1
2000-2009	17.6

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-46-B, REV-47-A, REV-47-B, REV-47-C, and REV-47-D

Major facilities that discharge pollutants directly into water or indirectly into sewer systems have to abide by regulations that specify pollution abatement technology or impose concentration limits on their discharges. Taxes on water pollutants discharged by those facilities could encourage further reductions in pollution below the level required by current regulations. Taxes can reduce pollution cost-effectively by encouraging firms with the lowest abatement costs to reduce pollution, allowing firms with high abatement costs to continue polluting and pay the tax. Reductions in discharges caused by the tax would increase welfare if the additional abatement costs were less than or equal to the social benefits from reduced pollution levels.

According to a recent survey of water quality submitted to the Environmental Protection Agency by states, tribes, and other jurisdictions, over 36 percent of the nation's surveyed rivers, lakes, and estuaries fail to meet water-quality standards at some time during the year. Organic water pollutants contribute to that failure by depleting the oxygen in the water as they decompose. Dissolved oxygen is necessary to sustain fish and other aquatic life. Biological oxygen demand (BOD) measures the intensity of oxygen-demanding wastes in water. (One BOD equals 1 milligram of oxygen consumed per 2.2 pounds of effluent.)

One option is to impose a tax on the level of BOD in discharges. Generally, firms subject to water pollution standards do not pay taxes or fees on effluents (discharges) that regulations still allow. Most of the high-volume BOD dischargers, sometimes referred to as point sources, are publicly owned treatment works (POTWs), paper and pulp mills, food processors, metal producers, and chemical plants. Discharges by point sources total about 12.5 million pounds of effluent per day, and publicly owned treatment works discharge about 8.4 million pounds of that amount.

The cost of controlling discharges at POTWs and many industries subject to Clean Water Act regulations averages about 50 cents to 75 cents per pound of effluent removed. A charge on BOD levels in discharges could encourage manufacturing facilities and POTWs with lower abatement costs to reduce pollution. Assuming effluents record an average concentration of 22 BOD, a tax of about 65 cents per pound of effluent discharged would raise $9.1 billion from 2000 through 2004 and about $17.6 billion over the 2000-2009 period.

The costs of administering a BOD water pollution excise tax would be small because allowable levels of BOD discharges are specified in the permits that state and local governments issue to regulated sources of water pollution. Levying a tax on effluents from POTWs and large industrial dischargers would ensure that the tax base included all of the largest dischargers of BOD. The tax option, however, might raise constitutional issues about federal taxation of local governments. In that case, POTWs (or a federal authority) could collect the tax directly from polluters that discharge into municipal sewer systems.

REV-46-B IMPOSE AN EXCISE TAX ON TOXIC WATER POLLUTANTS

	Added Revenues (Billions of dollars)
Annual	
2000	0.1
2001	0.2
2002	0.2
2003	0.2
2004	0.2
2005	0.2
2006	0.2
2007	0.2
2008	0.2
2009	0.2
Cumulative	
2000-2004	0.9
2000-2009	1.7

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-46-A, REV-47-A, REV-47-B, REV-47-C, and REV-47-D

RELATED CBO PUBLICATION:

Decreasing the Discharge of Bioaccumulative Toxic Water Pollutants: A Policy Analysis (Memorandum), December 1992.

Taxes on major facilities that discharge water pollutants can both raise revenue and provide incentives for firms to reduce pollution cost-effectively (see option REV-46-A). Harmful levels of toxic chemicals and metals in the water are a key concern because they do not readily break down in natural ecosystems, allowing them to accumulate in the environment. One option is to impose a tax of varying rates on companies that discharge certain toxic substances.

Manufacturers in the United States discharged more than 170 million pounds of toxic substances into water directly in 1996 and more than 230 million pounds into water indirectly through sewers. Toxic pollutants generally include organic chemicals (such as solvents and dioxins), metals (such as mercury and lead), and pesticides. Those pollutants may threaten the aquatic environment and human health.

The amount of environmental harm that toxic water pollutants cause depends on their toxicity. The Environmental Protection Agency (EPA) has devised a weighing method to indicate the toxicity of various pollutants. Using that weighing system makes it possible to measure the quantities of different types of toxic pollutants by their "toxic pound equivalents," which the EPA defines as the pounds of the pollutant multiplied by its toxic weight. This option adopts tax rates developed by the Congressional Research Service (CRS) in a study on the discharges of manufacturing firms in 1987. CRS defined five categories of pollutants on the basis of their toxicities. The tax rates varied from 65 cents per pound for the least toxic category of pollutants to $63.40 per pound for the most toxic category. Those rates correspond to a charge of $32.35 for the equivalent of each toxic pound. The variable tax rates provide firms with a greater incentive to reduce their most toxic discharges.

According to the EPA, the cost of controlling the equivalent of an incremental toxic pound varies among industries, ranging from $1.50 to $606.00 (in 1991 dollars). The tax, therefore, could encourage industries and firms with low abatement costs to reduce their toxic discharges and would raise $1.7 billion from 2000 through 2009.

The Internal Revenue Service could use information that the EPA's Toxic Release Inventory (TRI) provides on toxic discharges by manufacturing firms to assess tax payments, or the EPA could collect the tax on behalf of the Internal Revenue Service. An important consideration, however, is that the accuracy of TRI data is questionable. The TRI contains self-reported data, and many facilities that meet the reporting requirements fail to file reports or file inaccurate ones. To improve the accuracy of the TRI database and enhance enforcement, frequent auditing would be necessary.

REV-47-A IMPOSE A TAX ON SULFUR DIOXIDE EMISSIONS

	Added Revenues (Billions of dollars)
Annual	
2000	0.5
2001	0.8
2002	0.7
2003	0.7
2004	0.6
2005	0.6
2006	0.6
2007	0.5
2008	0.5
2009	0.5
Cumulative	
2000-2004	3.3
2000-2009	6.0

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-46-A, REV-46-B, REV-47-B, REV-47-C, REV-47-D, and REV-48

RELATED CBO PUBLICATION:

Factors Affecting the Relative Success of EPA's NO_x Cap-and-Trade Program (Paper), June 1998.

Under the Clean Air Act, the Environmental Protection Agency (EPA) sets national standards for ambient air quality designed to protect public health and welfare. The EPA defines acceptable levels for six "criteria" air pollutants: sulfur dioxide (SO_2), nitrogen oxides (NO_x), ozone, particulate matter, carbon monoxide (CO), and lead. Along with emissions from natural sources, emissions of air pollutants from stationary sources (such as industrial facilities and commercial operations) and mobile sources (automobiles, trains, and airplanes) contribute to the ambient levels of those criteria pollutants.

Sulfur dioxide belongs to the family of sulfur oxide gases formed during the burning of fuel containing sulfur (mainly coal and oil) and during the operation of metal smelting and other industrial processes. Exposure to high concentrations of SO_2 may promote respiratory illnesses or aggravate cardiovascular disease. In addition, SO_2 and NO_x emissions are considered the main cause of acid rain, which the EPA believes degrades surface waters, damages forests and crops, and accelerates corrosion of buildings.

The Clean Air Act Amendments of 1990 adopted a new acid rain control program that introduces a market-based system for emission allowances to reduce SO_2 emissions. An emission allowance is a limited authorization to emit a ton of SO_2. The EPA allots tradable allowances to affected electric utilities according to their past fuel use and statutory limits on emissions. Once the allowances are allotted, the act requires that annual SO_2 emissions not exceed the number of allowances held by each utility plant. Firms may trade allowances, bank them for future use, or purchase them through periodic auctions held by the EPA. Firms with relatively low abatement costs have an economic incentive to reduce emissions and sell surplus allowances to firms that have relatively high abatement costs.

In general, taxes on emissions can also help reduce pollution in a cost-effective manner by encouraging firms with the lowest abatement costs to reduce pollution and allowing firms with high abatement costs to continue polluting and pay the tax. The following three options (REV-47-B, REV-47-C, and REV-47-D) would also base tax rates on an estimate of the average cost of reducing an additional ton of pollution. Consequently, some firms with lower-than-average abatement costs might reduce their pollution levels below allowable standards.

One option is to tax emissions of SO_2 from stationary sources not already covered under the acid rain program. Imposing a tax of \$200 per ton of SO_2 emissions from those sources would raise roughly \$6 billion over the 2000-2009 period. Most firms do not pay taxes or fees on emissions that regulations still allow, although major stationary sources must pay fees annually to cover program costs of operation permits under the Clean Air Act Amendments of 1990. Basing the tax on the terms granted in those air pollution permits would minimize the cost of administering the tax for the Internal Revenue Service. Opponents argue that such a tax would impose an additional burden on many firms that already incur costs to comply with current regulations on emissions.

REV-47-B IMPOSE A TAX ON NITROGEN OXIDE EMISSIONS

	Added Revenues (Billions of dollars)
Annual	
2000	6.7
2001	9.7
2002	9.2
2003	8.9
2004	8.7
2005	8.5
2006	8.3
2007	8.2
2008	8.2
2009	8.2
Cumulative	
2000-2004	43.2
2000-2009	84.7

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-46-A, REV-46-B, REV-47-A, REV-47-C, REV-47-D, and REV-48

RELATED CBO PUBLICATION:

Factors Affecting the Relative Success of EPA's NO_x Cap-and-Trade Program (Paper), June 1998.

Nitrogen oxides (NO_x) usually enter the air as the result of high-temperature combustion processes such as those found in automobiles and power plants. Nitrogen oxides play an important role in the atmospheric reactions that generate ground-level ozone (smog) and acid rain. The Environmental Protection Agency (EPA) believes that nitrogen oxides can irritate the lungs and lower resistance to respiratory infections such as influenza. NO_x and pollutants formed from NO_x can be transported over long distances, so problems associated with the pollutant are not confined to areas where NO_x are emitted.

The Clean Air Act (CAA) requires states to implement programs to reduce ground-level ozone. Since NO_x and ozone can be transported long distances, the CAA requires upwind states to establish programs that will help downwind states meet statutory standards. The EPA ruled in 1998 that 22 northeastern states and the District of Columbia have to revise their plans to further reduce NO_x emissions. The rule does not mandate how NO_x are to be reduced but gives each affected state a NO_x emission target. The goal of the rule is to have programs in place by 2003 that reduce NO_x emissions by about 1.2 million tons in the affected states by 2007.

In addition, the EPA is encouraging the formation of a regional NO_x allowance trading program similar to the national SO_2 trading program. Such a program could be structured to encourage firms with relatively low costs for abatement to reduce their emissions and sell surplus NO_x allowances to firms that have relatively high costs for abatement.

One way to help control NO_x would be to tax the stationary sources of NO_x that do not participate in the regional NO_x allowance trading program. The cost of controlling NO_x from stationary sources ranges between $600 and $10,000 per ton abated. A tax of $1,500 per ton of NO_x emissions from stationary sources would encourage abatement at facilities with lower abatement costs. For example, firms might adopt currently available abatement techniques whose capitalized costs are lower than the tax they would otherwise pay. A tax at that level would raise about $39 billion from 2000 to 2009. Those revenue estimates assume high participation in a NO_x regional allowance trading program. If the states declined to participate in a regional allowance trading program and sources in those states were subject to the tax, the proposed tax would raise about $85 billion over the 2000-2009 period.

Proponents of pollution taxes argue that such taxes discourage activities that impose costs on society. Opponents argue that the additional cost to firms of such a tax may be greater than the additional benefits to society. Accurate estimates of additional social benefits from reducing pollution levels may not exist in some cases.

REV-47-C IMPOSE A TAX ON PARTICULATE MATTER

	Added Revenues (Billions of dollars)
Annual	
2000	0.5
2001	0.7
2002	0.6
2003	0.6
2004	0.6
2005	0.6
2006	0.6
2007	0.6
2008	0.6
2009	0.6
Cumulative	
2000-2004	3.0
2000-2009	6.0

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-46-A, REV-46-B, REV-47-A, REV-47-B, REV-47-D, and REV-48

Particulate matter (PM) is the general term used for a mixture of solid particles and liquid droplets found in the air. Those particles come in a wide range of sizes: fine particles are less than 2.5 micrometers in diameter, and coarse particles are larger than 2.5 micrometers. The particles originate from many different stationary and mobile sources as well as from natural sources. Fine particles result from fuel combustion in motor vehicles, power generation, and industrial facilities as well as from residential fireplaces and wood stoves. Coarse particles are generally emitted from power plants and factories and sources such as vehicles traveling on unpaved roads, materials handling, and crushing and grinding operations as well as from windblown dust. Some particles are emitted directly from their sources such as smokestacks and cars. In other cases, gases such as sulfur dioxide (SO_2), nitrogen oxides (NO_x), and volatile organic compounds interact with other compounds in the air to form PM.

According to Environmental Protection Agency (EPA) studies, emissions of PM (alone or combined with other air pollutants) are linked to some adverse health effects. For example, particulate matter can carry heavy metals and cancer-causing organic compounds into the lungs, increasing the incidence and severity of respiratory diseases. Other health effects may include increased hospital admissions and emergency room visits for respiratory-related illnesses and chronic bronchitis.

Under the Clean Air Act, the EPA sets national standards for ambient air quality and is directed to review those standards every five years. In 1997, the EPA completed its review of the standards, finalized standards for fine particulate matter, and revised those for ozone and coarse particulate matter. The new standard for fine particles will require that a national monitoring network be established before states can develop plans showing how areas will attain the new PM standard. Under the EPA's current timetable, states would begin to submit plans for controlling fine PM for EPA approval in 2005. The deadline for compliance with the new standard for fine PM is approximately 2017.

Since monitoring systems and a permit system are already in place for coarse particle emissions, one option would be to tax such emissions from stationary sources. That tax could be administered similarly to the taxes on SO_2 and NO_x. A tax of $500 per ton of coarse PM would raise about $6 billion from 2000 through 2009. A tax on coarse PM may cause some electric utilities and manufacturing plants to install improved electrostatic precipitators, wet scrubbers, or other equipment to reduce their PM emissions and lower their tax burden. Reductions in emissions caused by the tax would be economically efficient if the additional abatement costs were less than the social benefits from reduced pollution.

Opponents of such a tax argue that it would impose an excessive burden on firms that already incur costs to comply with current standards. Furthermore, to the extent that a tax on PM would eventually raise the price of energy, it might be regressive.

REV-47-D IMPOSE A TAX ON VOLATILE ORGANIC COMPOUNDS

	Added Revenues (Billions of dollars)
Annual	
2000	12.0
2001	17.3
2002	16.3
2003	15.5
2004	14.8
2005	14.2
2006	13.7
2007	13.7
2008	13.8
2009	13.9
Cumulative	
2000-2004	75.9
2000-2009	145.3

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-46-A, REV-46-B, REV-47-A, REV-47-B, REV-47-C, and REV-48

Ground-level ozone has remained a pervasive pollution problem in many areas of the United States. Ozone is not emitted directly into the air but is formed by the reaction of volatile organic compounds (VOCs) and nitrogen oxides (NO_x) in the presence of heat and sunlight. Ozone occurs naturally in the stratosphere (the upper atmosphere) and provides a protective layer high above the earth. At ground level, however, ozone is the prime ingredient of smog. Short-term exposures (one to three hours) to ambient ozone concentrations have been linked to increased hospital admissions and emergency room visits for respiratory causes. Repeated exposure to ozone may make people more susceptible to respiratory infection and lung inflammation. In 1997, the Environmental Protection Agency (EPA) revised the national ambient air-quality standards for ozone. The new standard will replace the 0.12 parts per million (ppm) standard measured over one hour with a more stringent 0.08 ppm standard measured over eight hours.

To control ozone pollution, the EPA has traditionally focused on reducing emissions of VOCs (and, more recently, NO_x). VOCs include chemicals such as benzene, toluene, methylene chloride, and methyl chloroform. VOCs are released from burning fuel (gasoline, oil, wood, coal, natural gas, and the like) or from using solvents, paints, glues, and other products.

One option is to tax emissions of VOCs from stationary sources. (See options REV-47-B and REV-48 on taxing emissions of NO_x and emissions from mobile sources, respectively.) Those sources range from huge industrial facilities, such as chemical plants, petroleum refineries, and coke ovens, to small sources, such as bakeries and dry cleaners. The vast number and diversity of stationary sources make it difficult to estimate emissions and the cost of abatement. A tax of $3,000 per ton on all VOC emissions from stationary sources might promote some abatement and would generate slightly over $145 billion in revenues from 2000 through 2009.

The advantage of a broad-based tax on VOCs is that it would affect large and small sources of the compounds. The EPA estimates that the small sources account for a large portion of emissions from stationary sources. Because stationary sources emitting less than 2.5 tons of VOCs per year are not currently subject to federal regulation, however, a broad-based VOC tax would be administratively harder to implement than a tax on the large sources alone. Imposing the tax on small sources of VOCs through technology-based estimates of emissions rather than measured emissions would reduce administrative costs but it would also somewhat reduce the incentive to emit less. A disadvantage of such a broad-based tax is that it may be regressive. To the extent that the tax raises the prices of consumer goods, including food, it may take up a larger share of household income for low-income consumers than for higher-income consumers.

REV-48 IMPOSE A ONE-TIME TAX ON EMISSIONS FROM NEW AUTOMOBILES AND LIGHT TRUCKS

	Added Revenues (Billions of dollars)
Annual	
2000	2.0
2001	2.9
2002	2.9
2003	2.9
2004	2.9
2005	2.9
2006	2.9
2007	2.9
2008	2.9
2009	2.9
Cumulative	
2000-2004	13.6
2000-2009	27.9

SOURCE: Joint Committee on Taxation.

RELATED OPTIONS:

REV-47-A, REV-47-B, REV-47-C, and REV-47-D

The Clean Air Act Amendments of 1990 strengthened the components of the earlier law that addressed mobile sources of pollution. They raised the tailpipe standards for cars, buses, and trucks and expanded inspection and maintenance programs to include more regions with pollution problems and to promote more stringent testing. The amendments also introduced several regulations to reduce air pollution from mobile sources, including regulations for selling improved gasoline formulations in some polluted cities to reduce pollutant levels. In addition, the amendments provided new programs that tighten emission standards for vehicles to encourage the development of even cleaner cars and fuels.

Despite progress to date in controlling air pollution from motor vehicles, mobile sources continue to significantly affect national air quality. On average nationwide, highway motor vehicles account for over one-quarter of all volatile organic compound (VOC) emissions, almost one-third of nitrogen oxide (NO_x) emissions, and about 60 percent of carbon monoxide (CO) emissions. A tax on emissions from mobile sources could provide an additional incentive for consumers to purchase cleaner cars and trucks, which could help to reduce emissions from those sources.

One option is to tax emissions of NO_x, VOCs, and CO from mobile sources. A one-time tax imposed on new automobiles and light trucks could be based on grams of NO_x, VOCs (measured in grams of hydrocarbons), and CO emitted per mile as estimated by the emissions tests that the Environmental Protection Agency requires for every new vehicle. The tax could be administered like the "gas guzzler" excise tax. The auto dealer would collect the tax on behalf of the Internal Revenue Service from the vehicle's purchaser.

Such a tax averaging $250 per new passenger car and light-duty truck could raise $27.9 billion in revenues from 2000 through 2009. Vehicles made in earlier years have been excluded from the estimate because of the administrative problems of collecting the tax. A disadvantage of excluding older vehicles, however, is that they account for a larger share of emissions from mobile sources than do new vehicles. Opponents of this option argue that such a tax would raise vehicle prices and therefore might encourage people to delay purchasing new vehicles.