

Significant revenue gains could result from limiting deductions and credits. Excess itemized deductions--that is, itemized deductions over and above the "zero bracket" amount--totaled more than \$125 billion in 1980 (the latest year for which actual data are available). This implies a revenue loss of more than \$30 billion (assuming conservatively that those deductions are claimed on average against a 25 percent tax rate). In the same year, tax credits came to more than \$7 billion. Thus, a cutback of 20 percent in the value of these tax benefits would raise in excess of \$7 billion.

The rationale for limiting deductions and credits is that such tax preferences are special provisions that do not benefit all taxpayers. If belt-tightening is needed, those preferences could be a fair place to start. Taxpayers who itemize deductions tend to have higher incomes than those who do not, and so itemizers may be better able to bear the additional burden of narrowing the deficit. Thus, this approach can be argued on grounds of equity. The burden of this approach would be more broadly spread by marginally reducing each deduction and credit, rather than eliminating some and leaving others intact.

An economic efficiency argument could be made as well, in that deductions and credits can sometimes create incentives that distort economic activity away from the outcomes suggested by the free market. Limiting such preferences, therefore, would reduce the role of the federal government in the allocation of resources. Further, reducing the revenue losses attributable to deductions and credits could permit lower, less distorting, tax rates on other sources of income. So, while such a limit might be seen in the short run merely as a revenue raiser, in the longer view it could take on greater significance as a step toward some form of simplified, broad-based tax.

One precedent for a limitation scheme is a Kennedy Administration proposal that was dropped from what eventually became the tax cut of 1964. It would have allowed itemized deductions to be used only to the extent that they exceeded 5 percent of income (though alternative figures could certainly be proposed); the percentage of income would in effect become a "floor" under itemized deductions. Such a floor would suggest that all taxpayers were likely to have itemizable deductions equal to that fraction of income, and that only extraordinary amounts of itemizable deductions--those above that floor--should be deductible.

The limitation approach would likely be subject to some objection, probably relating to the roles that the different itemized deductions and credits play in the tax system. Some itemized deductions and credits are needed to measure true income or to compute tax liability appropriately. The itemized deduction for employee business expenses, for example,

derives from the notion that certain costs (such as for special work clothes or tools) of earning wage or salary income are not part of net income and should not be taxed. The foreign tax credit, similarly, is allowed so that U.S. tax is reduced by one dollar if a dollar of foreign tax liability is incurred. Allowing only a fraction of such deductions or credits would seem to violate some of the basic premises of the tax system. Other deductions, such as those for medical expenses and casualty losses, are intended to relieve hardship and have their own floors with respect to income. Limiting those deductions (especially after they were cut back in TEFRA) might seem to be targeting a revenue-raising measure on hardship. Other itemized deductions--particularly the charitable contributions deduction--are seen as incentives to promote socially desirable behavior; limiting those deductions might be thought to discourage such desired practices.

A limitation could possibly be implemented in ways that would minimize these problems. A limit on tax credits would probably be most practicable. Tax credits needed to compute final tax liability appropriately (such as the foreign tax credit) could be left unchanged. Credits that provide selective incentives (such as the political contributions credit) could be reduced in their individual computations (for example, the political contributions credit could be cut back by 20 percent by reducing the credit from 50 percent of contributions made to 40 percent and reducing the maximum credit from \$100 to \$80). Because each of these credits must in any event be individually computed according to some credit rate and some maximum credit amount, changing those parameters would add no complication to the tax forms. Of course, the choice of whether to include any particular tax credit in such a cutback scheme could become the focus of heated political debate, and the equity appeal of the across-the-board approach could be lost.

A limit on itemized deductions would be somewhat more complicated. Deductions needed to measure income appropriately (or considered essential in their present forms for whatever reason) could be excluded from the limit; again, though, such treatment could be criticized as preferential. The deduction for medical expenses already has its own floor of 5 percent of adjusted gross income; that floor could be left in place and separate floors applied to all other itemized deductions. That would, of course, increase the number of computations the taxpayer would have to make. Alternatively, a single floor could be applied to all itemized deductions, replacing the now-separate floor for medical expenses. That would have the possible drawback, however, of allowing a taxpayer with a large deduction for mortgage interest, for example, to deduct his first dollars of medical expenses, while leaving another taxpayer with no such large deduction unable to itemize his medical expenses. Yet another alternative would be to reduce either all or selected itemized deductions by a flat percentage. Such

a percentage reduction could be applied to the total amount of deductions, or only to those deductions that exceeded the zero-bracket amount (that is, "excess itemized deductions"). This approach would reduce, but not eliminate, the incentives embodied in the itemized deductions.

If the prevailing sentiment were to treat each itemized deduction or tax credit differently under such a limit approach, the resulting complexity could quickly become overwhelming. A limit on deductions and credits would only be workable if it were kept simple and general in application. Thus, given the likely disputes over the treatment of different deductions and credits, such a limit would likely be viewed as only a temporary revenue-raising measure. If a long-term change in the tax code were desired, effort might more profitably be directed toward ridding the law of obsolete or inefficient provisions on the list of itemizable deductions and credits.

Temporary Income Tax Rate Increase or Surtax. Another incremental across-the-board approach to narrowing the budget gap would be a temporary increase in tax rates. Such a step would likely follow at least the general outline of the 1968 tax surcharge that was imposed to cover the extraordinary expenses associated with the Vietnam War. That surtax was formulated as a flat 10 percent increase in tax liability across the board, though the lowest-income taxpayers were made exempt from the surtax (and a "phase-up" of the surtax liability was necessary to achieve that 10 percent surtax at a higher income level). If imposed today, with no relief for low-income taxpayers, such a surtax would raise more than \$30 billion in its first full year (Table X-3).

Whatever form such a surtax took, it would have important macroeconomic policy implications, and its timing would likely be an important criterion for judging it. Such a temporary tax would raise revenues in the short run, but it would presumably be phased out at some pre-established future date. (If such a phase-out were not intended, it would be simpler to impose a permanent rate increase than a surtax.) Such a surtax might be helpful if the economy were embarking on an unsustainable boom; but if imposed in the current slump, it might prolong the slowdown (and then possibly be removed in a subsequent recovery when the economy did not need the stimulus). In contrast, a surtax timed to take effect after the recovery is well under way would not prolong the recession, but it would be more appropriate than a similarly timed permanent rate increase only if future revenues without the surtax would clearly be sufficient to match outlays by some well-defined later date.

Several tax policy issues would be raised by a surtax as well. A surtax would increase marginal tax rates, which might have an adverse effect on

economic incentives. Further, depending on the choice of the surtax base, it might or might not be perceived as being fair. A surtax like that applied in 1968, in which all but the lowest-income taxpayers' liabilities were increased by 10 percent, would completely bypass any taxpayer who used various tax shelters or other devices to avoid paying tax. To solve this problem, the base for a surcharge could be some comprehensive measure of income rather than actual tax liabilities, but that would complicate the surtax. It might also make the tax system less progressive overall (apart from the inclusion of a small number of conspicuous tax avoiders), because a surtax based on a progressive income tax liability would be more progressive than a surtax based directly on income. Thus, a family with a \$15,000 income and a \$1,000 tax liability would pay \$100 in a 10 percent surtax based on tax liability, but \$150 in a 1 percent surtax based on income; a \$150,000 income family with a \$30,000 tax liability would pay \$3,000 (30 times as much) under the 10 percent surtax on ordinary tax liability, but only \$1,500 (10 times as much) under the 1 percent surtax on income.

Thus, though a temporary surtax could be quite simple in outline form, in actual practice it would surely raise many difficult tax policy issues. The appropriateness of the surtax for macroeconomic policy could also be a very contentious issue.

A Corporate Surtax or Minimum Tax. Additional revenues might also be sought from corporations. Businesses have already borne the greater share of the additional taxes as a result of the enactment of TEFRA, but the business tax reductions in ERTA were also very large. Revenue-raising measures for the corporate tax, like those for the individual income tax, ideally should increase revenues more in the future than in the current fiscal year to avoid impeding recovery. Any tax increase should also impose the minimum possible cost in terms of economic distortions and inefficiency.

One approach would be a corporate surtax, possibly to accompany an individual surtax (as was done in 1968). As in the 1968 precedent, such a surtax could be based on tax liability, though in that case firms with no tax liability due only to the use of rapid cost recovery allowances or other tax preferences would avoid the surtax as well as the ordinary tax. At a 10 percent rate, such a surtax would raise about \$8 billion in its first full year (Table X-3). An alternative might be to base the surtax on a more comprehensive measure of income that would not allow tax preferences such as accelerated depreciation.

Whatever the precise formulation, the main justification for a corporate surtax is its beneficial effect on the deficit; it is less justifiable on economic and tax policy grounds. An immediate revenue increase through a surtax would impose a drag on the private economy, which is still foundering

in recession. Though most formulations would impose a surtax only on firms that are profitable, even those firms have had their profits reduced sharply by the recession. A bigger tax on a smaller profit margin would leave less capital in private hands for financing investment. In terms of tax policy, a surtax that left the current corporate tax base unchanged would not be an improvement.

One approach to broadening the base would be to expand TEFRA's 15 percent cutback of certain corporate tax preferences, including, among others, percentage depletion of coal and iron ore deposits, bad debt reserves, and deferral of tax by Domestic International Sales Corporations (DISCs). That provision of TEFRA is estimated to raise \$0.9 billion in 1984 and \$1.1 billion in 1988. The rate of the cutback could be increased, or the list of preferences could be expanded. The merits of such a policy depend on the view one holds of the proper role of the tax system in encouraging investment. Some economists argue that the current law's preferences for investment in general (the Accelerated Cost Recovery System, the investment tax credit) and in particular forms (depletion, DISC) provide needed incentives for desirable forms of economic activity. Others counter that such incentives are ineffective in some cases, are easily manipulated and abused, and require higher marginal tax rates on nonpreferred activities (and thus on profits in general). From the former point of view, the current system is preferable; from the latter, a broader-based corporate tax with lower rates would provide the best incentive for the free-market pursuit of profit.

#### Possible New Taxes

A Value-Added Tax. A value-added tax has often been discussed in recent years as an add-on revenue raiser or as a substitute for one or more taxes now in use. A VAT is, in effect, a sales tax; but rather than being collected in one operation at the retail level, it is collected in parts at every stage of the production process.

The VAT has the advantage that its base can be very broad. Depending on the precise definitions chosen, the VAT base (at 1984 income levels) could be anywhere from \$1.6 trillion to \$2.6 trillion, and so a 10 percent VAT could raise from \$160 billion to \$260 billion a year. Such a revenue gain would be so great that it would likely be necessary to reduce other taxes to avoid significantly depressing the economy. To some economists, the revenue potential of the VAT is an important tool for deficit cutting; to others, the revenue yield (plus the hidden nature of the VAT, because it is embedded in market prices) poses a threat that expanding revenues will stimulate spending and swell the public sector.

Advocates of the VAT point out that it is a tax on consumption, rather than on income or wealth. It follows that additional revenues collected by a VAT would not impinge so strongly on saving as revenues collected through an income or wealth tax, and revenues collected through a VAT to replace those now collected through income or wealth taxes should induce net increases in saving. This is because the VAT would make consumption more expensive and saving more profitable after taxes. The greater saving under the VAT would presumably be channeled into productive investment. Just how much additional saving would be stimulated by a complete changeover from income to consumption taxation is subject to much dispute, but the increase would likely be less than 10 percent of personal saving, and less than 2 percent of total private saving.

The fairness of a VAT would probably be controversial. A VAT would increase prices and ultimately be borne by final consumers. This would cause a one-time inflationary shock upon imposition of the tax and would greatly increase the tax burden of lower-income households. This burden could be relieved through an end-of-year refundable income tax credit, but such a credit would not prevent a significant cash flow problem from occurring if low-income households had to pay the substantial VAT all year and then wait until after the year ended to receive their compensating tax credit. Any program to provide a VAT refund continuously over the year would be extremely complicated.

Other ways to reduce the burden on low-income consumers would be to exempt basic goods or necessities from the VAT, or conversely, to apply higher rates to luxury goods. Either course would also lead to complexity, however; the distinction between necessities and luxuries is inevitably ambiguous. Further, the administration of a tax with varying rates would be extremely difficult. Other nations' experience suggests that a VAT with varying rates is at least as difficult and costly to administer as a corporate income tax.

In fact, a VAT would likely be administratively burdensome, whatever its provisions for low-income relief. The mechanics of a VAT would be entirely different from any tax currently levied by the federal government or any state.<sup>1/</sup> It would therefore require an entirely new administrative apparatus and new forms for filing. For this reason, it is generally assumed that only a VAT of at least 10 percent would justify the administrative load; a low-rate VAT would not be worthwhile. These administrative problems

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1. The one exception is Michigan, which imposes a single business tax that is not unlike a VAT.

could be avoided by enacting a national sales tax instead of a VAT; the ultimate economic effects would be the same, but the sales tax would be both more familiar and easier to administer.

Either a VAT or a national sales tax would also raise questions concerning intergovernmental fiscal relations. Many states raise much of their revenues through sales taxes, and a federal VAT or sales tax would intrude to some extent on that important revenue base of the states and lead to a high total (federal plus state) rate of sales taxation.

An Expenditure or Consumption Tax. A different approach to shifting the tax burden from saving to consumption would be to substitute an expenditure or consumption tax for the present individual income tax. An expenditure tax is essentially an income tax with a deduction for saving. Taxpayers would compute their liabilities by adding up all their income, and then deducting from that total all saving (purchases of stocks and bonds, deposits in bank accounts, business investments, and so on). Their liabilities would be computed on the income that they did not save--that is, their expenditure. (For corporations, the equivalent of the deduction of saving would be immediate expensing, rather than depreciation, of investment.) Many recent income tax initiatives that have exempted from tax various forms of saving have moved in the direction of an expenditure tax; such piecemeal approaches, however, have left the tax code much more complicated and susceptible to abuse than would a true expenditure tax.

While all forms of saving would be deductible without limit under an expenditure tax, the definition of taxable receipts would be much broader than it now is. All receipts of spendable cash would be subject to tax, including the entire proceeds of sales of capital assets (not just the capital gain) and all amounts borrowed. If these amounts were saved or reinvested, however, they would not be taxed. An investor could borrow a sum of money (a taxable receipt) and save it (a deduction for saving) with no tax consequences.

The major argument for the expenditure tax is that it would increase the incentive to save. The savings deduction would also eliminate the income tax's present "double tax" on saving--that is, taxing the money saved when it is earned, and then also taxing the interest that the savings earn. The additional saving would likely result in increased investment. Economists differ on just how much additional saving would be forthcoming under an expenditure tax, but the amount is likely to be similar to that from switching to a VAT--less than 10 percent of personal saving, and less than 2 percent of total private saving. Also, the expenditure tax base would be smaller than that of an equivalent income tax by the amount of saving (about 5 percent of income). That means that the expenditure tax would

need somewhat higher tax rates than the income tax, and those higher rates would discourage work to a small degree. An expenditure tax would be less vulnerable to distortion during periods of inflation; because the cost of capital investments would be written off immediately, the mismeasurement of depreciation that can occur with an unindexed income tax would not be a problem.

Like the VAT, the expenditure tax would shift the tax burden from upper-income taxpayers (who find it easiest to save) to lower-income taxpayers (who find it hardest to save). To prevent this redistribution, the tax rate schedule under the expenditure tax would have to be made more steeply graduated than that under the current income tax. The concentration of holdings of wealth would increase unless gifts and bequests were taxed as the consumption of the donor, or a more stringent estate tax or a periodic wealth tax were enacted.

An expenditure tax cannot be viewed as a short-term revenue-raising option. The federal government has had no experience with a consumption tax, and formidable problems could arise in making the transition from an income to a consumption tax. In the long run, however, the expenditure tax could be a realistic option, depending on whether the potential increases in economic growth are judged to outweigh the sizable transition costs.

#### Base-Broadening with Rate Reductions

A major across-the-board strategy would be to restructure the income tax by combining revenue-raising steps that by themselves would exceed the desired revenue yield, with the excess revenue returned to the taxpayers through across-the-board tax rate cuts. An embodiment of this strategy--a flat rate income tax--has recently drawn considerable attention, and numerous pieces of legislation have been introduced. Under this approach, most or all special tax expenditures or preferences would be repealed, and all of the resulting taxable income (as reduced by some form of personal exemption or standard deduction) would be taxed at a single uniform rate.

The first part of the flat rate tax, the broadening of the tax base through the elimination of tax preferences, might be seen as a more comprehensive extension of TEFRA. That legislation narrowed two individual tax expenditures--the medical expense and casualty loss deductions--and a number of corporate preferences (described earlier). A flat rate tax, or indeed any broad-based revenue-raising strategy, could go further in that direction, up to and including the elimination of all preferences. Broadening the tax base might be desirable on grounds of both equity and efficiency. Proponents point to the fairness of taxing every taxpayer's income, what-

ever its source, in the same manner. Moreover, economic efficiency is generally reduced by many deductions and credits that alter the private market's relative prices. Each individual base-broadening step might either simplify or complicate the tax system, however. Eliminating itemized deductions would reduce the required number of forms and the amount of record keeping, but taxing heretofore untaxed incomes (such as employer contributions for life and health insurance) would lengthen the forms and complicate tax accounting. Also, many current tax preferences (such as the deductions for mortgage interest and charitable contributions) are deeply embedded in the economy. Repeal would encounter stiff opposition and entail considerable transition costs.

Taxing such a broadened tax base at a flat rate would likely be controversial. On average, the flat tax rate would have the effect of increasing the tax burden for low- and middle-income taxpayers and reducing it for those with higher incomes. The marginal tax rate would be lower for upper-income taxpayers but higher for lower-income taxpayers under a flat tax, so the overall incentive effects would be ambiguous. If the tax base were substantially broadened, however, the current structure of graduated rates could be decreased across the board, improving incentives for all taxpayers and preventing any systematic redistribution of the tax burden.

One approach to a broader-based, flat rate income tax would be to repeal all itemized deductions and the exclusion for long-term capital gains, while increasing the personal exemptions and zero-bracket amounts to protect low-income taxpayers from tax increases. If the personal exemption were raised from \$1,000 to \$1,500, and the zero-bracket amounts from \$2,300 for single persons and \$3,400 for couples to \$3,000 and \$6,000, respectively, the tax rate necessary to match projected calendar year 1984 revenues (about \$300 billion) would be about 19 percent. If revenues were to be raised by 5 percent, or about \$15 billion, the flat tax rate would have to be increased to about 20 percent. The constraint that the tax rate be flat would require, however, that the impact across income groups not be uniform. Taxpayers with incomes over \$100,000 would have their taxes cut by about 21 percent because of the reduction of the upper-bracket tax rates--from a maximum of 50 percent to 20 percent. Taxpayers with incomes of from \$5,000 to \$10,000 would also have their taxes cut, in this case by 2 percent (from a very small base of only about 3 percent of total revenues) because of the larger exemptions and zero brackets. Those with incomes between those two levels would have to take up the slack, however; their taxes would rise by about 10 percent.

In contrast, a broader-based graduated tax could be designed to achieve any desired distribution, including the replication of that of current

law. One legislative proposal was designed to collect 1984 law revenues (before TEFRA was passed) with very nearly the same distribution of liabilities by income group with four marginal tax rates ranging from 14 to 28 percent. <sup>2/</sup> That proposed tax system (or any other designed to achieve revenue and distribution neutrality) could raise 5 percent more revenue from every income group across the board by simply increasing all the marginal rates by about 5 percent (that is, from a range of 14 to 28 percent to one of 15 to 30 percent). At the same time, low-income taxpayers could be excused any additional tax liabilities by increasing the exemptions or the zero-bracket amounts.

The corporate income tax could be treated analogously to the individual income tax. Tax preferences such as the investment tax credit and special provisions for mineral exploration could be repealed, and the corporate tax rate set at a single low level coordinated with the individual income tax rate or rates. (Under a graduated individual income tax, the corporate rate would likely be chosen to equal the highest individual rate.) Alternatively, the corporate and individual income taxes could be integrated to eliminate the double taxation of corporate dividends, which occurs when corporations pay tax on their income, and shareholders pay taxes again on the corporate-source income they receive as dividends. One approach would be to abolish the corporate tax entirely and attribute all corporate income to shareholders for taxation at the individual level. Another would be to retain the corporate tax, but to provide individuals with a tax credit for the corporate tax paid on the dividends they receive. Both of these approaches would eliminate the additional tax on dividends, but both would lose revenue, thereby requiring higher tax rates (especially for upper-income taxpayers, if it were desirable to recover the lost revenue from those whose taxes were cut most by integration), and would also complicate the tax system.

A broad-based low-rate income tax is in principle an attractive way to increase tax revenues while minimizing the efficiency cost to the economy. In the final analysis, however, the amount of tax rate reduction possible is directly related to the degree by which the tax base is broadened. Numerous politically popular tax preferences would have to be cut back or eliminated to make the lower-rate tax work, and if a net revenue gain were required, not all of the gains from base broadening could be devoted to rate reduction.

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2. During the 97th Congress, the plan was introduced in the Senate by Senator Bill Bradley as S. 2817, and in the House of Representatives by Representative Richard Gephardt as H.R. 6944.

Table X-5 lists a number of base-broadening possibilities for both the individual and the corporate income taxes. For the individual income tax, the revenue base would have to be broadened by about \$15 billion to finance a one-percentage-point reduction in all marginal tax rates. This amount could be achieved, for example, by limiting the deductibility of consumer interest payments, eliminating the deduction for state and local sales taxes, and taxing the accrued interest on life insurance reserves. A one-percentage-point reduction in the top corporate income tax rate would require about \$1.5 billion from base broadening. This could be achieved, for example, by repealing the expensing of intangible oil and gas drilling costs or by increasing from 15 to 20 years the period over which buildings must be depreciated.

## TARGETED REDUCTION STRATEGIES

Instead of adopting an across-the-board strategy of imposing relatively small tax increases on a wide range of taxpayers and economic activities, the Congress could pursue a more targeted strategy that would have narrower effects. Taxes could be increased for particular groups of individuals or types of activities that are currently thought to be undertaxed or better able than others to bear the burden of tax increases. The base-broadening approach discussed above includes many possible changes of this kind. This section covers other possibilities, such as increased energy taxes, excise taxes, user charges, and Social Security payroll taxes, which could raise issues different from those arising from income tax changes. This section also includes a brief discussion of some options for making direct trade-offs between reductions in spending programs and closely related tax expenditures.

### Energy Taxes

The United States continues to depend on foreign oil for approximately 33 percent of its oil consumption and more than 10 percent of total energy consumption. This dependence creates a series of risks for the U.S. economy, the most important of which is the danger that these supplies will be interrupted and the U.S. economy severely dislocated as a consequence. Reducing U.S. dependence on foreign petroleum can relieve this vulnerability, decrease the outflow of dollars that pay for oil, and remove constraints on the conduct of U.S. foreign policy.

Despite these compelling reasons to encourage energy conservation and replacement of oil with other energy sources, the recent slowdown in oil prices has diminished the incentives to do either. At the same time, the

TABLE X-5. ESTIMATED REVENUE GAINS FROM INCOME TAX BASE-BROADENING OPTIONS (In billions of dollars)

Options	Individual Income Tax					Cumulative Five-Year Increase	Corporate Income Tax					Cumulative Five-Year Increase
	1984	1985	1986	1987	1988		1984	1985	1986	1987	1988	
Phase Out Domestic International Sales Corporations	--	--	--	--	--	--	*	0.2	0.3	0.5	0.6	1.7
Reduce Credit for Incremental Research Expenditures	*	*	*	*	*	0.1	0.3	0.4	0.2	*	*	0.9
Repeal Percentage Depletion Allowance for Oil and Gas	0.6	1.3	1.4	1.5	1.6	6.4	0.3	0.4	0.5	0.5	0.6	2.3
Repeal Expensing of Intangible Drilling Costs for Oil and Gas	0.3	0.9	1.0	1.1	1.1	4.5	2.3	3.6	3.2	3.0	2.8	14.8
Repeal Residential Energy Tax Credits	0.1	0.9	1.0	0.1	*	2.0	--	--	--	--	--	--
Repeal Business Energy Tax Incentives	*	*	*	*	*	0.2	0.3	0.5	0.4	0.5	0.5	2.1
Eliminate Capital Gains Treatment of Timber	--	0.2	0.2	0.2	0.2	0.8	0.2	0.4	0.5	0.6	0.6	2.3
Eliminate Tax Exemption for Pollution Control Bonds	*	*	0.1	0.1	0.2	0.4	*	0.1	0.2	0.2	0.3	0.8
Limit Nonbusiness, Non-Investment Interest Deductions to \$10,000	0.6	1.8	2.0	2.2	2.4	9.0	--	--	--	--	--	--
Tax 10 Percent of the Capital Gain on Home Sales	--	0.8	1.0	1.2	1.4	4.4	--	--	--	--	--	--
Lengthen the Building Depreciation Period to 20 Years	0.1	0.3	0.7	1.1	1.5	3.6	0.4	1.5	3.0	4.6	6.2	15.8
Tax the Accrued Interest on Life Insurance Reserves	2.1	5.8	6.6	7.6	8.7	30.8	--	--	--	--	--	--
Repeal Net Interest Exclusion	--	1.1	3.0	3.4	3.7	11.2	--	--	--	--	--	--
Eliminate Tax Exemption for Small Issue Industrial Revenue Bonds	*	*	0.1	0.2	0.3	0.7	*	0.2	0.5	1.0	1.2	3.0
Limit the Business Deduction for Entertainment to 50 Percent of Amount Spent	0.2	0.4	0.5	0.5	0.6	2.1	0.4	0.7	0.8	0.8	0.9	3.6
Require Full Basis Adjustment for the Investment Tax Credit	--	0.2	0.4	0.5	0.8	1.9	0.3	1.0	2.0	3.0	4.1	10.3
Eliminate the Accumulated Earnings Allowance for Personal Service Corporations	0.2	0.7	0.7	0.8	0.8	3.3	-0.1	-0.3	-0.3	-0.3	-0.3	-1.3
Eliminate Tax Credits for Rehabilitating Older Buildings	0.4	0.6	0.8	0.8	0.9	3.5	0.4	0.6	0.6	0.8	0.9	3.3

(Continued)

\* Less than \$50 million.

TABLE X-5. (Continued)

	Individual Income Tax						Corporate Income Tax					
	1984	1985	1986	1987	1988	Cumulative Five-Year Increase	1984	1985	1986	1987	1988	Cumulative Five-Year Increase
Repeal Extra Parental Personal Exemption for Students	0.3	0.8	0.8	0.9	0.9	3.7	--	--	--	--	--	--
Tax Nonstatutory Fringe Benefits	0.6	1.2	1.3	1.5	1.8	6.4	--	--	--	--	--	--
Limit Charitable Deduction for Non-itemizers to \$100	--	0.2	1.9	3.6	--	5.7	--	--	--	--	--	--
Repeal the Tax Credit for Employee Stock Ownership Plans	--	--	--	--	--	--	0.7	1.7	2.1	2.3	1.1	7.8
Tax Some Employer-Paid Health Insurance												
Income Tax	2.7	4.9	6.0	7.2	8.7	29.6	--	--	--	--	--	--
Payroll Tax	--	--	--	--	--	--	0.8	1.5	1.9	2.2	2.6	9.1
Eliminate Tax Exemption for Private Hospital Bonds	*	0.1	0.2	0.3	0.4	1.0	0.1	0.2	0.4	0.6	0.8	2.0
Eliminate Extra Tax Exemptions for the Elderly or the Blind	1.0	2.5	2.6	2.8	2.9	11.8	--	--	--	--	--	--
Tax 50% of OASDI Benefits for Families with Total Incomes Above \$12,000/\$18,000 <sup>a/</sup>	1.7	5.8	6.6	7.4	8.2	29.7	--	--	--	--	--	--
Tax 40 Percent of Railroad Retirement Benefits <sup>b/</sup>	0.5	0.7	0.8	0.8	0.8	3.6	--	--	--	--	--	--
Tax Workers' Compensation Benefits <sup>b/</sup>	1.5	2.4	2.8	3.2	3.6	13.5	--	--	--	--	--	--
Tax All of Unemployment Insurance Benefits <sup>b/</sup>	*	1.7	1.6	1.7	1.6	6.5	--	--	--	--	--	--
Eliminate Income Averaging	3.5	3.8	4.2	4.5	4.9	20.9	--	--	--	--	--	--
Freeze Estate and Gift Credit at Exemption Equivalent of \$275,000	--	0.5	1.1	1.8	2.6	6.1	--	--	--	--	--	--
Tax Veterans' Compensation <sup>b/</sup>	1.1	1.8	1.8	1.8	1.8	8.4	--	--	--	--	--	--
Eliminate Deductibility of State and Local Sales Taxes	0.9	5.8	6.4	7.0	7.8	27.9	--	--	--	--	--	--
Improve Taxpayer Compliance <sup>c/</sup>	1.2	2.0	3.5	4.0	4.4	15.1	0.0	0.2	0.7	0.7	0.7	2.3

SOURCE: Joint Committee on Taxation and Congressional Budget Office.

NOTE: Unless indicated otherwise, explanations and arguments pertaining to these options are detailed in Appendix A. All revenue gain estimates assume January 1, 1984 effective dates. Totals may not add because of rounding.

- a. Discussed in detail in Chapter III.
- b. Discussed in detail in Chapter V.
- c. This amount is gross of outlay offset.

current glut in the oil market increases the likelihood that a tax on oil imports would be absorbed in part by producers. These energy policy considerations, combined with the need to raise large amounts of revenue, have focused attention on energy tax increases as a major option for reducing future deficits.

Imposing energy taxes, however, involves a basic trade-off between two policy objectives--the goal of sending correct signals to the energy market, and the goal of imposing new taxes at minimum economic cost. An oil import fee, for example, sends correct signals to the energy market by raising the price that consumers pay for imported oil. Such a price increase, however, would lead to parallel increases in the prices of domestic oil, natural gas, and some coal. While these parallel price increases are desirable from the standpoint of energy policy (since they create incentives to supply more of these substitutes for foreign oil), they also increase the energy costs of all users, even those who do not use foreign oil. One way to minimize this cost burden while raising the same amount of revenue would be to tax all energy sources directly at a lower rate. This would reduce the cost burden on any particular user by spreading the burden more thinly, but it would also discourage the production of these potential substitutes for foreign oil. Thus, minimizing the burden placed on the economy through an energy tax would require compromising the drive to substitute for foreign oil. Conservation would still be encouraged as a result of the higher prices, and this by itself would help to reduce reliance on imported oil, but the incentive to substitute domestic production would be dampened. Table X-6 displays the estimated revenue increases from the energy taxes considered in this section.

Oil Import Fee. An oil import fee would raise about \$2 billion a year in revenue for each \$1 per barrel. About one-quarter of that amount would come from higher windfall profit taxes, since the import fee would allow the price of all domestically produced oil to increase, thereby increasing the profits of domestic oil producers. An oil import fee could also add to inflation, however, thereby increasing federal outlays for inflation-sensitive programs such as Social Security and Food Stamps. These increased outlays could offset about 30 percent of the increases in revenues. If tight monetary policy limited price increases, both revenues and offsetting increases in outlays could be reduced.

A fee on oil imports would heighten conservation incentives by pushing up the price of all imported and domestically produced oil, and the higher price for domestic oil would increase incentives for domestic production. Both effects would reduce U.S. dependence on foreign oil in the short term, although long-term dependence might be increased as U.S. energy sources become depleted. At the same time, a fee on imported oil would increase

TABLE X-6. ESTIMATED REVENUE GAINS FROM ENERGY TAXES  
(In billions of dollars)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Increase
Impose Oil Import Fee (\$2 per barrel)	3.1	4.4	4.3	4.3	4.3	20.4
Impose Broad-Based Tax on Domestic Energy (5 percent of value)	11.3	17.2	18.5	20.0	21.6	88.6
Impose Tax on Domestic and Imported Oil (\$2 per barrel)	5.9	8.5	8.5	8.5	8.5	39.9
Impose Excise Tax on Natural Gas (30 cents per 1,000 cubic feet)	2.1	3.0	3.0	3.0	3.0	14.1
Increase Gasoline Excise Tax (5 cents per gallon)	2.9	4.1	4.1	4.2	4.2	19.5

SOURCE: CBO and the Joint Committee on Taxation.

inflation and reduce employment somewhat in the United States. With the rate of increase in world oil prices now leveling off, the effects of an import fee on inflation could be easier to absorb than they would have been in earlier years, when rapid increases in world oil prices were themselves imposing substantial dislocation and transition costs.

At least initially, an oil import fee would have its heaviest impact in certain areas of the country, such as the Northeast, where homeowners depend heavily on imported fuel oil to heat their homes. As the effects of the oil import fee worked their way through the economy, however, other energy prices, such as those for coal and natural gas, would gradually rise to the levels set by imported oil prices, thereby spreading the effects of the oil import fee more evenly to all parts of the country and all energy users.

It should be noted that an oil import fee provides a subsidy to all the energy sources that compete with foreign oil in energy markets, since it allows their prices to increase. Thus, if an oil import fee is imposed, the Congress might wish to reconsider some existing, more explicit subsidies to energy producers and users. These might include the special tax treatment for the oil and gas industry, research and development subsidies for alternative energy sources, and tax credits for installing energy conservation or substitution investments. Reducing or eliminating these tax subsidies could provide a stable source of long-term revenue to help reduce future deficits. Some options of this kind are listed in Table X-5.

Broad-Based Tax on Imported and Domestic Energy. A broad-based tax on all energy--both domestically produced and imported--could raise substantial amounts of revenue (see Table X-6). A five-percent-of-value tax on all U.S. energy consumption, including coal, petroleum, natural gas, hydroelectric, and nuclear power, would raise about \$15 to \$20 billion a year in revenues. Limiting the tax to domestic and imported oil would still raise significant revenue. A \$2-per-barrel tax on all oil would raise about \$8 to \$9 billion per year. A national energy tax could be based on units produced (such as barrels of oil, tons of coal, cubic feet of gas), on the value or price of the energy produced (ad valorem tax), or on the heat content--in British thermal units--of the fuel (Btu tax). It could be collected at the source of initial production, or at the wholesale level if that was administratively more convenient. If the tax was uniformly based on Btu content it would alter the relative prices of different energy sources; oil is more expensive per Btu than is natural gas, and natural gas is more expensive than coal. Therefore, a uniform Btu tax would raise the price of coal most and oil least in percentage terms.

A national energy tax would raise the price to consumers of all domestically produced energy, just as an oil import fee would. But all of the resulting energy cost increase would be captured in taxes by the federal government. This contrasts with an oil import fee, which allows domestic energy producers to raise their prices in tandem, but with only part of the increase captured through windfall profit taxes. The effects of the price increase would also be spread more evenly across different parts of the country and different types of energy consumers than would the initial effects of an oil import fee.

Since the domestic price of energy continues to be set by the world oil price, a national energy tax would tend to be absorbed in part by energy producers, who would be unable to pass on the full cost of the tax to consumers. Though this would lessen the impact on consumers, it would also lessen incentives for domestic energy production.

Windfall or Excise Tax on Decontrolled Natural Gas. Price controls on a large share of domestic natural gas production are due to be lifted on January 1, 1985, under the terms of the Natural Gas Policy Act of 1978 (NGPA). Not all gas will be decontrolled; an estimated 60 to 75 percent of natural gas will remain regulated and still subject to price controls in 1985.

Economists generally agree that the price controls under NGPA have led to an inefficient allocation of natural gas. In addition, because of "take-or-pay" contracts negotiated by gas pipeline companies (which require them to pay gas producers for high-priced gas whether or not there is consumer demand for it), the market for natural gas is not currently functioning efficiently. Indeed, there have been relatively large price increases during a period of slack gas demand, and low-cost natural gas has been held off the market. Thus, even though decontrol of all natural gas may make sense for energy policy in the long term, pressures to impose further price controls are now strong. To a great extent, however, the present distortions in the gas market are exacerbated by the drop in demand caused by the recession. Once economic growth resumes and demand for gas rises, the high fixed costs of gas purchased under take-or-pay contracts will be spread out over a larger volume of gas, easing the upward pressure on prices. Growth in demand will also draw into the market more relatively low-cost gas, further reducing cost pressures.

Decontrol of all natural gas on January 1, 1984 could give producers large profits, which the Congress may want to tax similarly to the present windfall profit tax on oil. Depending on how it was structured, such a tax could raise as much as \$2 to \$5 billion in revenue in 1984, although already-high gas prices and the current soft market for natural gas could limit both the price and profit increases from decontrol. If the tax was limited only to the profits from the acceleration of decontrol before the scheduled date of January 1, 1985, revenues would drop sharply after the first year. Such a tax would thus not be consistent with the economic and budgetary goals outlined earlier, which emphasize minimizing tax increases in 1983 and 1984 as the economy is recovering while building in stable sources of revenue for the longer term.

An alternative that would raise revenues on a long-term basis would be to impose a simple excise tax unrelated to any windfall profits from decontrol. An excise tax of 30 cents per 1,000 cubic feet, for example, would raise about \$3 billion a year. Such a tax would be similar to the broad-based tax on energy production discussed above, but it would apply only to natural gas. An excise tax limited to natural gas would provide an incentive for gas users to switch to oil, coal (of which the United States has abundant reserves), or other substitutes, which might or might not be consistent with energy and other policy goals. A shift to oil, for example,

could increase dependence on imports, while a switch to coal would lessen dependence on imports but could impose environmental costs. A selective excise tax on natural gas would have the side effect of burdening households already hard hit by increases in their home heating bills. If an excise tax on natural gas was part of a broad-based tax on all energy, it would not distort consumers' choices among fuels.

Gasoline Excise Tax. The federal tax on gasoline was increased by 5 cents per gallon in January 1983 as a result of the Surface Transportation Assistance Act of 1982; it had been 4 cents per gallon since 1959. This tax increase was not designed to reduce the deficit; the amounts raised are to be spent on highways, bridges, and mass transit. In addition to the current federal tax of 9 cents per gallon, state governments impose gasoline taxes ranging from 5 to 14 cents per gallon. Gasoline taxes were increased in 26 states in 1981 and 1982, as a result of either legislation or formulas in the law.

If the Congress wanted to raise additional revenues from this source to reduce the deficit, an increase in the federal tax beyond the amount enacted last year could be considered. Each 1 cent increase in excise tax on gasoline and diesel fuel raises about \$1.1 billion in excise tax revenues. There would be offsetting reductions in individual and corporate income taxes, however, so the net reduction in the deficit would be about 25 percent less than that.

Since the average national price of gasoline has dropped from a peak of about \$1.39 a gallon in March 1981 to about \$1.20 now, raising the tax on gasoline by more than 5 cents per gallon would not put the total cost above what consumers have recently experienced. The 4-cents-per-gallon tax imposed in 1959 would be 13 cents now if it had been increased in line with other prices, and 16 cents if it had kept pace with gasoline price increases.

Beyond raising revenue, an excise tax on gasoline would reduce gasoline consumption and thus somewhat lessen U.S. dependence on foreign oil. Each 1 cent increase in the gasoline excise tax is estimated to reduce consumption by about 0.3 percent in the long run. Some income groups would bear disproportionately heavy burdens from an increase in gasoline excise taxes. Lower-income families pay fewer dollars but higher percentages of their incomes for gasoline than do families with higher incomes. The 20 percent of families with the lowest incomes spend an estimated 7 percent of their incomes on gasoline, while those in the top 20 percent only spend an estimated 3 percent.

Gasoline consumption also varies by region and population density, with the heaviest use in the South and West and in rural areas, and the least use in the Northeast and in urban areas. Because of this pattern, combining

an increase in gasoline excise taxes with a tariff on imported oil, which would have its heaviest initial impact in the Northeast, would have a more balanced geographic impact than implementing either policy by itself.

Further increases in the federal gasoline tax could make it more difficult for states to raise their gasoline taxes. The new Surface Transportation Assistance Act requires state matching funds for federally assisted projects, and states have other highway financing needs as well. Some consideration should be given, therefore, to the total potential burden that can be placed on this revenue source.

### Excise Taxes

The major federal excise taxes, other than those levied on gasoline and windfall oil profits, are on alcohol, tobacco, and telephone use. Several other excise taxes support the Airport and Airway Trust Fund. Although TEFRA made no changes in the excise taxes on alcohol, it did temporarily double the excise tax on cigarettes. In addition, it temporarily tripled the excise tax on telephone use, and substantially increased the taxes that finance the Airport and Airway Trust Fund.

Additional revenues could be raised by extending the temporary increases in the tobacco and telephone excise taxes and increasing the excise taxes on alcohol. Excise taxes could also be imposed on various "luxuries," provided definitions could be agreed on. Table X-7 displays the estimated added revenues from these options.

Cigarettes. TEFRA increased the 8-cents-per-pack tax on cigarettes to 16-cents-per-pack for the period from January 1, 1983, through September 30, 1985; this will raise net federal revenues by about \$1.7 billion a year, taking into account the effect of the excise in narrowing the income tax base. Extending the higher taxes past the 1985 expiration date now scheduled would continue the flow of additional revenues from this source at about that same level. The 16-cents-per-pack tax represents about 18 percent of the current cost per pack, still less than the 37 percent of the cost per pack that 8 cents represented back in 1951, when cigarette excise taxes were last raised.

Another option would be to index the unit tax on cigarettes to the rate of change of the Consumer Price Index. Such indexing would raise at least an additional \$0.4 billion each fiscal year, and the cigarette excise tax would be maintained at about 18 percent of the current per-pack cost of cigarettes.

TABLE X-7. ESTIMATED NET REVENUE GAINS FROM EXCISE TAX INCREASES (In billions of dollars)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Increase
Extend Doubling of Cigarette Excise Tax Beyond 1985 <u>a/</u>	---	---	1.7	1.7	1.7	5.1
Continue 3 Percent Excise Tax on Telephone Service Beyond 1985 <u>b/</u>	---	---	1.3	2.3	2.7	6.3
Double Excise Taxes on Alcohol <u>c/</u>	2.5	4.0	4.0	4.0	4.1	18.6
Impose Excise Tax on Luxuries <u>c/ d/</u>	0.2	0.3	0.4	0.4	0.4	1.7

SOURCE: Congressional Budget Office and the Joint Committee on Taxation.

NOTE: The revenue effects are net of income tax offsets. Excise tax increases lower income tax revenues because they can be deductible business expenses and because, unless monetary policy is fully accommodating, they lower taxable incomes throughout the economy. Taking both of these effects into account, and assuming an economy-wide marginal tax rate of 25 percent, results in a net revenue effect that is 75 percent of the gross effect.

- a. The doubling of the cigarette excise tax expires October 1, 1985, under current law. The extension beyond 1985 assumes no break in tax collections.
- b. The telephone excise terminates December 31, 1985, under current law.
- c. The effective date is January 1, 1984.
- d. The base of luxury excise taxes is defined as the price of cars, boats, and yachts in excess of \$20,000 and jewelry in excess of \$1,000.