

with the scheduled partial decontrol of natural gas prices, the cost of energy has risen to world market price levels for oil and is approaching those levels for natural gas. Decontrol, therefore, may have already removed the need for additional energy-conservation incentives in the market.

One argument against repeal is that the reward of a tax credit may be more effective than high energy prices alone in stimulating conservation efforts, since it is more visible to homeowners, tangible, and easy to calculate than the cost savings from reduced energy use. Another argument is that many taxpayers have made their energy-conservation plans on the assumption that these credits would be available until the end of 1985; earlier repeal might be unfair to homeowners who have planned later conservation investments.

REPEAL BUSINESS ENERGY TAX INCENTIVES

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	0.3	0.5	0.5	0.5	0.5	2.3

Although most business energy tax incentives expired on December 31, 1982, several of the larger ones will continue until the end of 1985 or later. Most of these are for equipment and technologies that supply energy: solar and wind equipment and technology for geothermal and ocean thermal energy conversion are eligible for a 15 percent investment credit; machinery to burn and convert biomass, a 10 percent investment credit; and small-scale hydroelectric facilities, an 11 percent investment credit. Those mentioned are scheduled to expire December 31, 1985, although some have lengthy carry-over rules. In addition, tax-exempt industrial development bonds may be issued to finance facilities that produce steam or alcohol from solid waste, small-scale hydroelectric facilities (until the end of 1985), and (in Oregon only) renewable energy property.

Production of alternative fuels is eligible for a tax credit until December 31, 2000 (with some exceptions), depending on the price of oil. This credit is intended to encourage alternative fuel production during times when the deregulated price of oil is temporarily low (below \$29.50 a barrel, adjusted for inflation since 1979). Because of the recent lower oil prices, the credit has been in effect since 1981. The alcohol fuel tax credit and excise tax exemption, slated to expire December 31, 1992, are also intended to promote the use of nonpetroleum fuels. One conservation tax incentive, the 10 percent investment credit for intercity buses, is to remain in place until December 31, 1985.

Of the group, the largest revenue losers are the alternative fuel production credit and the investment credits for biomass equipment and small-scale hydroelectric facilities. The alternative fuel production credit represents 13 percent of the revenue gain in 1984 for repeal of all business energy tax incentives and about two-thirds of the revenue gain in 1988. Oil and gas prices are not projected to rise significantly in real terms over the period and the credit will therefore probably remain in effect until its expiration in the year 2000. In 1984, the biomass and hydroelectric credits are estimated to account for about 50 percent of the total business energy tax incentives' revenue loss of \$0.4 billion, and in 1985, the last year they

are to be in effect, about 65 percent. Repeal of all the business energy tax incentives would especially affect producers of paper and wood pulp products (who often supplement energy from other sources with hydroelectricity and the burning of wood chips), and other firms that use hydroelectricity and alternative fuels (mainly solar and wind) in their production processes. Biomass equipment and small-scale hydroelectric facilities are fairly conventional technologies; many firms installed them several years before the credits were enacted. To the extent that the credits help pay for investments that would be made in any event, repeal of these provisions would end some "windfall" tax savings.

The major argument in favor of the credits is that private individuals and firms considering only the dollar return to themselves from investments in energy production and conservation may not invest soon enough, or in large enough amounts, to meet the national energy and foreign policy goal of energy independence. Government subsidies may thus be justified as a way of meeting this larger public goal.

ELIMINATE CAPITAL GAINS TREATMENT OF TIMBER

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	0.2	0.6	0.7	0.8	0.8	3.1

Income from harvested timber held for at least one year before cutting is taxed at preferential capital gains rates. This special provision overrides the tax code's general denial of capital gains treatment to "stock in trade . . . or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." (Otherwise any manufacturer could produce a product, put it on a shelf for one year before selling it, and reduce the tax owed by 60 percent.) Repealing this provision would add about \$3.1 billion to federal revenues over the 1984-1988 period.

Advocates of repeal argue that the current large tax preferences for timber divert investment resources to timber from more productive uses. Besides having access to the capital gains tax preference, the timber industry also benefits from two other favorable tax provisions--the 10 percent investment tax credit and seven-year amortization for up to \$10,000 of reforestation expenditures (enacted in 1980). The capital gains preference disproportionately benefits a small number of large timber-growing firms that also produce wood and paper. These firms can assign some of the taxable income from their other operations to the cutting of timber, thereby increasing their tax savings from the preference.

Defenders of the timber tax preference argue that its benefits have long been capitalized into timberland prices. More stringent tax treatment would likely depress the price of timberland, hitting hard at recent purchasers who expected tax code stability. Further, treating income from timber sales as ordinary income could promote abuses. Producers, rather than selling timber directly to processors and incurring ordinary tax liabilities, would be encouraged to transact artificial sales among one another (of both timber and timberland) in order to claim the proceeds as more advantageous capital gains. Finally, defenders argue that ordinary income treatment would be burdensome to producers because of the long development time of timber.

ELIMINATE TAX EXEMPTION FOR POLLUTION CONTROL BONDS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	<u>a/</u>	0.1	0.2	0.4	0.5	1.2

a. Less than \$50 million.

In 1982, sales of tax-exempt pollution control bonds, authorized under the Revenue Expenditure and Control Act of 1968, reached \$6.1 billion, up from \$3.9 billion in 1981, and accounted for approximately 7 percent of all new long-term tax-exempt bond issues. The bonds finance roughly 40 percent of all private investment in pollution control equipment. Eliminating the subsidy would add \$1.2 billion to federal revenues in the 1984-1988 period.

Availability of the bonds--or any other subsidy for pollution control--can have only limited influence on a company's decision to invest in pollution control equipment. Federal pollution control regulations are highly prescriptive, so that existing firms have little choice but to make the improvement required.

Advocates of eliminating the use of tax-exempt bonds for pollution control cite several arguments. The large business tax cuts in ERTA may have reduced the need for interest-cost subsidies in general. Even if they had not, a direct subsidy would be less costly than tax-exempt bonds, because it would provide benefits only to the investor in pollution control equipment. With tax-exempt bonds, bondholders and intermediaries also realize gains. Moreover, substituting direct subsidies for tax-exempt bonds would ease the strain on municipal bond interest rates, which in the past two years have been approaching those for taxable issues. Finally, pollution control bonds encourage technological inefficiency, because they are available only for "end-of-pipe" capital investments, such as "scrubbers," which are used to remove sulphur dioxide emissions from combustion processes. Thus, they discourage selection of other, possibly more effective, solutions to underlying pollution problems--such as the use of less-polluting raw materials or production methods.

LIMIT NONBUSINESS, NON-INVESTMENT
INTEREST DEDUCTIONS TO \$10,000

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	0.6	1.8	2.0	2.2	2.4	9.0

Taxpayers who itemize can deduct all interest payments on home mortgages, auto loans and other installment purchases, credit card carry-overs, and other consumption borrowing. The only limit, enacted in 1976, is on investment borrowing; investment interest deductions are limited to \$10,000 in excess of investment income. In 1980, 27 million individuals and families deducted about \$80 billion of interest on consumption borrowing--an average of \$3,000. Sixty-seven million other taxpayers, most with lower incomes, did not deduct any interest.

Limiting all nonbusiness non-investment interest deductions to \$10,000, paralleling the limit on investment interest deductions, would affect 1 percent of all taxpayers and raise \$9.0 billion from 1984 through 1988. Alternatively, disallowing 3 percent of each taxpayer's nonbusiness non-investment interest deductions would raise about the same amount of revenue.

Most economic concepts of income would not allow interest deductions for loans to finance housing, consumer durables, or other consumption because this interest is not a cost of earning taxable income. Nonetheless, consumer interest deductions have been permitted since the beginning of the income tax in 1913. The deduction had relatively little impact until the 1940s, however, when higher tax rates and the rise of long-term home mortgages turned it into a major incentive for homeownership.

A \$10,000 cap on interest deductions would leave a substantial incentive for home or other consumer borrowing. At a 14 percent interest rate, interest on borrowings up to \$71,000 would be fully deductible; at 10 percent, the limit would be \$100,000. The incentive would cease above these limits, making larger investments in housing and other consumer borrowing less advantageous. In the current recession, continued incentives for housing, autos, and consumer durables may be desirable. Once recovery comes, though, decreased incentives for consumer borrowing would free

savings for business investment that increases productivity and economic growth.

Applying the interest cap to existing loans would affect few taxpayers, but those with interest deductions well above the limit could find their current income strained. Also, those with homes costing over \$100,000 would probably suffer some decline in real estate value. Delaying implementation of the limit for two years would give affected persons time to realign their yearly expenses, although the delay would not ease the impact on home values much. Alternatively, implementing a small percentage disallowance on all consumer interest deductions would affect every taxpayer who itemizes interest payments, but no one very much. This latter approach would also reduce every itemizer's incentive for consumption borrowing rather than severely reducing it for just a few.

The separate \$10,000 limits on consumption and investment interest deductions suggested here would permit taxpayers with assets to disguise a portion of their borrowing as investment borrowing and thereby deduct more than \$10,000 in consumption interest. For example, a landowner could borrow against the land and purchase a car. This fungibility between the two limits could be reduced by strict enforcement of rules distinguishing between consumption and investment borrowing or by a single limit for both. Either approach would raise more revenue, but strict enforcement would require a difficult tracing of the uses made of borrowed funds, and a combined limit could squeeze out legitimate investment interest deductions.

Exempting homeowners' mortgage interest would greatly expand the opportunity for taxpayers to avoid the limit. Most taxpayers who itemize are homeowners, and most homeowners could hide their other consumption borrowing by taking out a loan against their home. The limit on all consumption interest is harder to evade.

TAX 10 PERCENT OF THE CAPITAL GAINS ON HOME SALES

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	--	0.8	1.0	1.2	1.4	4.4

Capital gains taxes on home sales may be deferred so long as the seller buys another home costing at least as much as the one sold within two years. In addition, the first \$125,000 of capital gains on a home sold by a person aged 55 or over is not taxed at all. Replacing these provisions with a tax on 10 percent of all accrued long-term capital gains on home sales would add about \$4.4 billion to federal revenues in the 1984-1988 period.

The tax deferral, enacted in 1951, was intended to prevent hardships for owners who had to sell because of an increase in family size or an unexpected employment change. The exclusion for elderly homeowners, first enacted in 1964 and most recently liberalized in 1981, was designed to obviate a large tax liability after a lifetime of home price increases, with much of the increase perhaps due to inflation.

During the 1970s, homeownership came increasingly to be viewed as an excellent financial investment, competing with other forms of investment for household savings. To the extent that the tax system favors capital gains from homeownership over capital gains from stock and other forms of business investment, savings are diverted from business investments into homes.

Replacing both provisions--the tax deferral and the \$125,000 exclusion--with a small tax on long-term capital gains on housing would make the treatment of housing more like that of other assets. If 10 percent of the gain were taxed, instead of 40 percent as on other long-term gains, the tax on home gains would never exceed 5 percent of the total gain, and would be less for taxpayers with marginal income tax rates below the top 50 percent rate. Also, by reducing the need for homeowners to keep track of gains and expenses on a lifetime of principal residences, this option would simplify both tax administration and taxpayer compliance.

If the option applied to gains accrued throughout the period of ownership, rather than just to those occurring after the date of enactment, it would have some of its most pronounced effects on persons who owned

homes in the early 1970s and therefore benefited from the fixed-interest mortgages and rapidly increasing home prices that made homeownership such a good investment during that decade. If only gains occurring after the date of enactment were taxed, the option would affect mainly new home purchasers, who face an environment in which mortgages with high and variable interest rates have made homeownership a less desirable financial investment. Also, applying the tax just to gains occurring after the date of enactment would be administratively difficult because there is no convenient, equitable method for allocating the accumulated gain between pre-and post-enactment periods of ownership. The option discussed here thus assumes that 10 percent of all accrued gains are taxed at the time of sale.

LENGTHEN THE BUILDING DEPRECIATION PERIOD TO 20 YEARS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	0.4	1.8	3.7	5.7	7.7	19.3

Under ERTA, both new and newly-purchased buildings can be depreciated over 15 years using the 175 percent declining balance method. ^{1/} The 15 year life is reduced from about 30 years under prior law. The 175 percent declining balance method is a speedup for all existing buildings and new nonresidential structures; it is a slow-down for new rental housing, but the halving of the tax life more than offsets the slow-down.

The 1981 law also increased tax incentives for investment in equipment, particularly through the investment tax credit (examined elsewhere in this Appendix). In 1982, TEFRA rescinded up to 80 percent of ERTA's incentives for investment in equipment while rescinding none of those for investment in structures. Rescinding a portion of ERTA's incentives for investment in structures would restore the historical balance between equipment and structure investments. It would also raise substantial revenue; lengthening structures' tax life from 15 years to 20 years would raise \$0.4 billion in 1984 and \$19.3 billion over the five-year period 1984-1988.

Although TEFRA raised taxes on equipment and not those on structures, corporate tax provisions historically have favored--and since TEFRA, still do favor--investment in equipment over structures. (The main reason is that equipment is eligible for an investment tax credit, while structures are not). Therefore, TEFRA's increases can be seen as partially redressing an historical imbalance. Calculations of effective corporate tax rates after TEFRA find a nearly zero-percent rate on equipment and a 30 percent to 40 percent rate on structures.

1. The 175 percent declining balance method raises straight-line depreciation by 175 percent in the first year. In the second and subsequent years, the balance remaining is depreciated at 175 percent of its straight-line amount. In later years, the declining balance method yields less rapid write-offs than does straight-line on the remaining balance. At that time, depreciation schedules switch to straight-line.

Though effective tax rates on corporate investment in structures are higher than on equipment, only about half of the depreciable buildings are held by corporations. The other half, mostly rental housing projects, office buildings, and some commercial buildings, frequently serve as tax shelters for individuals and probably bear substantially lower effective tax rates than corporate structures. Unlike corporations, tax shelter investors borrow almost all the amounts needed to purchase structures, thereby obtaining substantial interest deductions. They then sell the buildings as soon as the main depreciation advantages have been claimed. CBO has not calculated the effective tax rates for all types of tax-sheltered building investments, but other sources show that ERTA raised the value of new residential tax-shelter projects by 30 percent to 50 percent. In a period of large budget deficits, recently conferred gains to tax shelter investments could arguably be reduced, as lengthening the tax-life to 20 years would do. The added imbalance caused for corporate tax treatment of buildings and equipment could be offset by raising the effective tax rate on corporate equipment investments.

The construction industry is one of the hardest hit in the current recession: its unemployment rate is double the national average. Reductions now in the tax incentives for buildings could delay recovery in this sector. Tax increases enacted now but taking effect after the recovery begins, however, might spur new building now, when it is needed, and raise revenue once construction needs less stimulation.

TAX THE ACCRUED INTEREST ON LIFE INSURANCE RESERVES

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	2.1	5.8	6.6	7.6	8.7	30.8

Premiums paid for whole life insurance policies can be divided into the price of death protection and a separate saving component. While death benefits paid out by insurance companies on average approximately equal the death protection component of the premiums paid in each year, the saving component builds up as a reserve or cash value that earns interest year by year.

Attributing, on a current basis, interest on life insurance reserves to policyholders for income tax purposes (even though they did not receive the interest in cash) would raise \$2.1 billion in 1984, and \$30.8 billion over the 1984-1988 period. About 25 million tax returns would be affected. The impact on the least-affluent policyholders could be reduced by taxing only interest in excess of some floor, perhaps \$100 a year. Such a limit would likely reduce the revenue gain by about half.

In most respects, saving through whole life insurance is identical to saving through other interest-bearing instruments. Interest earned on life insurance reserves receives a special tax advantage, however, since the interest is not taxable until the policy matures. At the same time, interest paid by policyholders on their policy loans is tax deductible. Though whole life insurance policies have until recently offered low guaranteed rates of return through conservative investments of premiums, new policies are now being offered with much higher rates of return to capitalize on this tax advantage. Unlike tax-deferred individual retirement accounts (IRAs), in which money must be deposited until retirement age to avoid stiff penalties, whole life insurance policies can be tailored to allow policyholders easy and early access to their funds.

Opponents of the exclusion of life insurance interest argue that life insurance companies can invest their policyholders' savings tax free, while the policyholder investing in the same assets either directly or through a mutual fund is subject to tax. The Internal Revenue Service recently tightened requirements for the very similar so-called "wrap-around annui-

ties," but experience suggests that tax can be avoided on virtually any investment by calling it insurance and purchasing it through an insurance company according to certain technical restrictions. Such a tax avoidance opportunity is arguably unfair and inefficient.

Advocates of excluding life insurance interest argue that the interest is not received in cash until the policy matures (though this is also true of some long-term bank deposit certificates, the interest on which is taxed currently). They also contend that the uncertainty of earnings would cause taxation to be a disruptive burden to the entire life insurance industry, and make whole life insurance much less attractive.

REPEAL NET INTEREST EXCLUSION

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	--	1.1	3.0	3.4	3.7	11.2

Under ERTA a tax exclusion of 15 percent of the first \$3,000 of net interest income on individual returns and \$6,000 on joint returns is to become effective January 1, 1985. Net interest income is the difference between total taxable interest income and total itemized interest payments (exclusive of mortgage and business interest deductions). Repeal of the net interest exclusion would raise \$1.1 billion in 1985 and \$11.2 billion from 1985 through 1988.

The provision was enacted to encourage saving and thereby investment and economic growth. Proponents point out that, compared with some faster-growing nations, the United States has higher taxes on saving and a lower saving rate. They also note that taxation of interest payments is excessive in periods of high inflation, because part of the payment is compensation for erosion of principal rather than real interest income. This factor, along with the deductibility of interest payments, is said to favor borrowing and discourage saving. The partial exclusion of interest income would redress these imbalances by increasing the reward to saving, which, it is hoped, will increase total savings.

Objections to the credit range from doubts about its effectiveness in increasing saving to questions about the underlying principle of favoring saving. Doubts about the credit's effectiveness at stimulating saving arise from the historical record. Apart from war years and normal cyclical fluctuations, the saving rate in the United States has been stable at least since 1900, in spite of large changes in inflation and tax rates. Also, in defining net interest income, mortgage interest deductions are not offset against interest earnings so a homeowner who takes out a larger-than-necessary mortgage and invests the extra funds could claim the credit without saving more. Doubts about the need for the credit have also been raised by the sharp decline in inflation since ERTA was enacted and by ERTA's reduction in marginal tax rates. Objections to the principle of favoring saving are based on the idea that economic efficiency is best served if all forms of income are taxed alike and at the lowest rates. From this viewpoint, an exclusion of interest income from the tax base would

mean that tax rates must be higher on other activities--such as work and investment in non-interest-bearing assets--and thus, these other activities are discouraged.

If the interest exclusion were repealed, saving and investment could still be encouraged by restricting existing tax incentives for consumer borrowing. For example, itemized deductions on home mortgage interest and other consumer interest could be reduced by 3 percent, as discussed elsewhere in this Appendix. Besides discouraging borrowing, the additional revenue raised from limiting interest deductions could be used to reduce income tax rates, which would encourage both saving and work equally; or the revenue could be used to reduce the federal deficit further, which would free existing savings for private investment.

ELIMINATE TAX EXEMPTION FOR SMALL ISSUE
INDUSTRIAL REVENUE BONDS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	a/	0.3	0.7	1.2	1.5	3.7

a. Less than \$50 million.

Small issue industrial revenue bonds (IRBs), issued by state and local government agencies and exempt from federal taxation, in effect subsidize private businesses by enabling them to borrow for plant and equipment at below-market municipal bond interest rates. Before the 1960s, IRBs were used infrequently. But growth in sales from roughly \$100 million in 1960 to \$1.8 billion in 1968 led the Congress to limit their use. The bonds are now issued either for special purposes, such as pollution control (treated as another item in this Appendix), or are limited to "small issues" (now \$10 million or less) regardless of purpose. Eliminating the tax exemption for small issue IRBs would raise \$3.7 billion in new revenue over the 1984-1988 period.

Small issues finance a wide variety of enterprises. In 1981, they amounted to more than \$11.0 billion (up from \$8.4 billion in 1980) and accounted for about 20 percent of all new long-term tax-exempt bond issues. Preliminary indications are that the volume of issues in 1982 was 25 percent greater than in 1981. Although TEFRA imposed some restrictions, the volume of bonds will continue to grow until 1987, when small issue IRBs will no longer be exempt from taxation. Under TEFRA, most projects financed with small issue IRBs are ineligible for the accelerated rates of depreciation enacted in ERTA. But since IRB-financed plant and equipment can benefit from the shorter depreciation recovery periods that were also enacted in 1981, tax-exempt financing continues to be highly advantageous. Restrictions in TEFRA will limit the use of small issues for restaurants, bars, and other entertainment and recreational facilities, but growth in the use of the bonds for other purposes, including agricultural land and equipment, is likely to cancel out the savings that might otherwise have resulted from the legislation.

Even with the restrictions in TEFRA, IRBs are more broadly available than any direct federal assistance to private businesses. Aid under such

programs is generally limited to specific geographic areas in need of economic development assistance or to specific businesses that have difficulty obtaining conventional credit.

Advocates of continued tax exemption for small issue IRBs maintain that the bonds stimulate investment and promote job development. Opponents argue that, since not all projects are eligible for IRB financing, the primary effect of the interest subsidy is to shift the allocation of investment dollars, rather than to increase the total amount of investment. Total investment is more likely to increase in response to general business tax cuts, critics argue.

LIMIT TO 50 PERCENT OF AMOUNT SPENT THE TAX DEDUCTION
FOR BUSINESS ENTERTAINMENT AND MEALS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	0.5	1.1	1.2	1.4	1.5	5.7

Firms and individuals may deduct from taxable income the full amount spent on business meals and other forms of entertainment as "ordinary and necessary" business expenses if the meal or entertainment is directly related to or associated with the firm's business. Limiting business meal and entertainment expense deductions to 50 percent of the amount spent would increase revenues by an estimated \$5.7 billion in the 1984-1988 period.

This deduction has been the subject of continuing controversy. Opponents argue that it provides a government subsidy for personal pleasures that have only a remote business purpose; defenders counter that the conduct of business is greatly facilitated by such expenditures. Both the Kennedy Administration (in 1961-1962) and the Carter Administration (in 1978) proposed major cutbacks in business meal and entertainment deductions. But opposition from the hotel, restaurant, and resort industries and their employees prevented significant changes. Last year, the Senate approved an amendment limiting the deduction for business meals to 50 percent of the amount spent, but the plan was dropped in conference with the House.

Difficulties often arise in drawing a line between ordinary and necessary--hence deductible--business expenses and nondeductible personal expenses. If the line were drawn at expenses that serve the personal pleasure, comfort, or convenience of business executives and employees, for example, many common expenses--lavish offices, company automobiles and airplanes, and expensive midtown lodgings for traveling executives--might become nondeductible. Limiting deductible meal expenses to a specific dollar amount would not take into account the wide variation in restaurant meal costs, and would not, in fact, distinguish business from nonbusiness meals.

To avoid these line-drawing problems, but at the same time to restrain the government's subsidy for business meals and entertainment, deductions for these expenses could be limited to 50 percent of the amount spent. In the case of corporations, to which a top marginal tax rate of 46 percent

applies, the government would then, in effect, pay 23 percent of the cost (half of 46 percent) rather than the full 46 percent. Because businesses would have to pay a larger share of the costs of meal and entertainment expenses, they would likely impose somewhat tighter internal controls on these expenses. Firms themselves would have to consider more carefully whether a particular expense was closely enough related to an important business purpose to justify it.

REQUIRE FULL BASIS ADJUSTMENT FOR
THE INVESTMENT TAX CREDIT

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	0.3	1.2	2.4	3.6	4.9	12.4

Currently, taxpayers are allowed tax credits for certain authorized investments--for example, in general machinery and equipment, energy conservation equipment, and rehabilitation of certified historical structures. The tax credit for property with a five-year tax life (which includes most investment) is 10 percent, effectively reducing the acquisition cost to the investing firm by 10 percent. Prior to TEFRA, firms were allowed to depreciate 100 percent of an asset's price according to prescribed schedules. This allowed firms to receive two overlapping tax benefits for the same investment: one benefit paying for 10 percent of the asset's cost, and the other allowing the firm to depreciate that 10 percent as well as the other 90 percent of the cost of the asset. This overlap could be avoided through a "basis adjustment" that would reduce the amount that can be depreciated by the amount of the credit. Such a basis adjustment was required when the regular investment tax credit was enacted in 1962, but the adjustment was repealed after two years. In TEFRA, the Congress limited the depreciable basis of an asset to its price less 50 percent of the eligible credit; thus, in the case of the regular credit, firms may now only depreciate 95 percent of an asset's price. A full basis adjustment would restrict depreciation to the firm's net cost of the asset--90 percent in the case of the regular investment credit. This proposal, if applied to the regular investment credit for machinery and equipment, would raise \$0.3 billion in 1984 and \$12.4 billion from 1984 to 1988.

The allowance of depreciation deductions as well as the investment credit on a portion of an asset's cost (currently 5 percent) has been justified as a way of encouraging investment. The double benefit results in effective tax rates on new equipment investment close to zero on average at 6 percent inflation. This has been criticized, however, as furnishing an overly generous tax subsidy for investment. A 100 percent basis adjustment would result in tax rates on investment that are positive, but well below the statutory corporate tax rate of 46 percent; the rates on most new equipment in the corporate sector would be in the range of 5 to 20 percent.