ELIMINATE THE ACCUMULATED EARNINGS ALLOWANCE
FOR PERSONAL SERVICE CORPORATIONS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	0.1	0.4	0.4	0.5	0.5	1.9

At present, corporations are taxed at rates ranging from 15 percent on the first $25,000 of income to 46 percent on income of more than $100,000:

Taxable Income	Tax Rate (Percent)
$0 - $25,000	15
25,000 - 50,000	18
50,001 - 75,000	30
75,001 - 100,000	40
100,000 and above	46

The lower rates on income of less than $100,000 have both positive and negative effects. Smaller and newer firms benefit from a progressive rate structure. But the structure also encourages self-employed persons earning $100,000 or more a year to incorporate so that they can shield ordinary income from taxation at individual rates (which currently range up to 50 percent for income exceeding $85,000).

Those most likely to incorporate are entertainers, brokers, consultants, and other professionals such as physicians and accountants, who form either personal-service or professional corporations. These corporations loan out or hire the incorporator's services at a salary that is set forth in an employment contract. This permits the first $100,000 (and, in particular, the first $75,000) of income to be taxed at much lower rates if retained as corporate earnings.

Personal service corporations may accumulate up to $150,000 in retained earnings for the "reasonable" needs of the business. Savings are greatest if the amount retained falls within the lowest 15 percent tax bracket. Thus, an actor may earn, after expenses, $200,000 a year; pay himself or herself a salary of $175,000 which would be taxed at individual

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rates; and let the "corporation" retain $25,000, which would be taxed at 15 percent. This procedure could be repeated for six years for a tax saving of $52,500. (Retained earnings of $50,000 a year for three years would result in tax savings of $52,250.)

One remedy would be simply to eliminate the graduation in the corporate tax rate, leaving a 46 percent flat rate. The argument against doing away with a progressive corporate tax structure is that not all small businesses are personal service corporations, and some companies, particularly fledgling firms that are just beginning to show profits, would be adversely affected.

An alternative would be to tax the net income of personal service corporations at individual rates. This would result in savings to the federal government of about $100 million in 1984 and $1.9 billion in the 1984-1988 period. ERTA set a precedent for distinguishing between personal service and other corporations: the act increased the accumulated earnings allowance from $150,000 to $250,000 for all but personal service corporations in the fields of health, law, accounting, engineering, architecture, performing arts, and consulting. If personal service corporations became ineligible for the accumulated earnings allowance, the tax shelter could be eliminated with no adverse effects on economic growth.

ELIMINATE TAX CREDITS FOR REHABILITATING OLDER BUILDINGS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	0.8	1.2	1.4	1.6	1.8	6.8

The Congress has enacted large tax credits for amounts spent rehabilitating older income-producing buildings. The credits were designed to encourage businesses to renovate their existing premises rather than to relocate, to encourage people to purchase and put to new use older buildings that have outlived their original usefulness, and to encourage the preservation of historic buildings. The credits range from 15 to 25 percent, depending on the age of the building and whether it is registered with the Department of the Interior as an historic structure. Eliminating the tax credits would save $6.8 billion over the 1984-1988 period. Retaining only a 15 percent credit for certified historic renovations would save $0.6 billion in 1984, growing to $1.3 billion in 1988, for a five-year savings of $5.1 billion.

Because the current tax credits are so large, they seem certain to promote a great deal of renovation as interest rates fall and the economy revives. Their size also, however, ensures that many owners will receive large tax savings for doing what they would have done even if the credits did not exist or were not so large. Moreover, since the credits are available for rehabilitation of commercial buildings only and not for rental housing (with the exception of housing in historic buildings), they will promote the conversion of some structures to commercial use and generally draw investment funds away from rental housing. They will similarly draw funds away from some new construction that could have contributed more to the efficient operation of the economy than the renovation that takes its place.

Retaining a credit just for renovation of certified historic buildings would limit the tax loss to projects clearly preserving historic buildings. Preliminary surveys indicate a 15 percent credit would be sufficient to cover the extra costs of certification and historic-quality rehabilitation. Finally, retaining only the historic credit would remove the incentive for converting older rental housing to commercial use.

REPEAL EXTRA PARENTAL PERSONAL EXEMPTION FOR STUDENTS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	0.3	0.8	0.8	0.9	0.9	3.7

Until a child turns 19, the parents can claim an exemption of $1,000 if they contribute at least half of the child's support. Beyond that age, an additional test is imposed--the child must earn less than $1,000 to qualify as a dependent. If the child is a student, however, the parents can claim an exemption regardless of the student's income, so long as they provide half the support. If the special exemption for students was repealed effective January 1, 1984, the increased federal revenues over the 1984-1988 period would total about $3.7 billion.

The rule allowing a parental personal exemption for students, even if they earn more than the amount of the exemption, was adopted in 1954. The main reason for the rule was to avoid the "notch" problem that resulted when a dependent's earnings were close to the exemption amount; an extra few dollars in earnings could deprive the parents of the exemption, costing them hundreds of dollars in extra taxes. Even though parents who support nonstudents aged 19 and over also face this problem under present law, most nonstudents earn well over $1,000 a year so that the notch problem normally does not arise. Students, who often work only part time, are much more likely to have earnings for the year that come close to the $1,000 dividing line. The exemption was also justified as a way of taking into account the added costs parents incur for students.

This provision has been criticized as inequitable because it subsidizes households that send their children to college at the expense of those whose children go straight to work. In effect, the exemption provides a tax subsidy for higher education. In light of the fact that the exemption is worth more to households in higher tax brackets, the subsidy benefits most those who may need it least.

TAX NONSTATUTORY FRINGE BENEFITS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	0.6	1.2	1.3	1.5	1.8	6.4

The Congress has for several years prohibited the Internal Revenue Service (IRS) from publishing regulations for the taxation of "fringe benefits," which are certain forms of nonwage employee compensation. Although fringe benefits are legally subject to tax, they cannot be taxed on a consistent basis without comprehensive regulations, and so in practice they have generally been excluded from taxation. Examples of such benefits are the private use of a company car, discounts on employers' products, reduced-price meals, subsidized day care, reimbursement for recreational expenditures while on business travel, tickets to sporting or cultural events, and club dues. (Some other fringe benefits, such as employer contributions for life and health insurance premiums, are specifically excluded from taxation by law and thus do not fall into this category.) If the Congress would permit the IRS to issue regulations governing the taxation of these fringe benefits, the revenue gain over 1984-1988 could be about $6 billion.

At present, a taxpayer with no employer-provided fringe benefits pays the same tax as another with an equal salary and generous fringe benefits. Employees have a strong incentive to bargain for more of their compensation in the form of untaxed fringe benefits. This shrinks the overall tax base, increases the tax rates necessary for all taxpayers, and--in a continuing cycle--further increases the incentive to bargain for untaxed fringe benefits. The exemption from tax further misallocates resources by inducing employees to bargain for fringe benefits that they would not buy themselves. Thus, an employee in the 30 percent tax bracket is encouraged by the tax exemption to seek fringe benefits costing the employer $1 that the employee would not buy for more than 70 cents.

Taxing some fringe benefits, such as small employee discounts, would involve collection costs greater than the revenue to be collected; but larger items could be taxed cost-effectively. In all likelihood, some fringe benefits would be converted to cash income by mutual agreement of employers and employees; this would add to tax revenues in the same way as the direct taxation of fringe benefits.

LIMIT CHARITABLE DEDUCTION FOR NON-ITEMIZERS TO $100

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	--	0.2	1.9	3.6	--	5.7

Under a provision of ERTA, taxpayers who claim the standard deduction can also claim a separate itemized deduction for contributions to charitable organizations (as defined for the usual itemized deduction). The special itemized deduction is phased in over the period 1982-1986; for 1982 the deduction is limited to 25 percent of no more than $100 of contributions, but by 1986 both the percentage and the dollar limits are eliminated. The provision is scheduled to expire at the end of 1986.

The special charitable contributions deduction for nonitemizers will reduce federal revenues by $0.7 billion in 1985 and $2.7 billion in 1986. One way to hold this revenue loss in check would be to limit the deduction to $100 while allowing the percentage limit to increase as scheduled. Such a limit would increase federal individual income tax revenues by $5.7 billion over the lifetime of the provision.

While the encouragement of charitable giving is desirable, a case can be made against the special itemized deduction. Though the provision may seem to afford the same incentive and benefit of a deduction for charitable contributions as have previously been given to itemizers, in fact the incentive and the benefit are both small. Because nonitemizers tend to be those with the lowest incomes and in the lowest tax rate brackets, both their ability to give and the incentive effect of the special deduction are still quite limited despite the special deduction. The special deduction also loses tax revenue for contributions that nonitemizers would have made even in the absence of the provision, reducing its cost-effectiveness in stimulating new giving. The provision requires additional recordkeeping and computations from the 69 percent of taxfilers who now claim the standard deduction, for whom tax simplification has been an important objective. At the same time, the Internal Revenue Service is likely to be confronted with millions of tax returns claiming small deductions for charitable contributions; these deductions will be difficult and costly to verify, but taken together will have tremendous potential for abuse.

The special deduction for charitable contributions threatens to undermine recent steps toward tax simplification. The Congress in recent years has substantially increased the standard deduction (or "zero bracket amount"), at least in part to save taxpayers the difficulty and expense of itemizing numerous deductions. The special charitable deduction is a significant departure from this trend. It may also be a precedent for the creation of further "add on" deductions, thereby undermining the purpose of the standard deduction and complicating the tax filing process for those most in need of simplification.

REPEAL THE TAX CREDIT FOR EMPLOYEE STOCK OWNERSHIP PLANS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	0.7	1.7	2.1	2.3	1.1	7.8

An Employee Stock Ownership Plan (ESOP) acquires and holds the firm's stock for the benefit of its employees. As long as rules similar to those for employer-paid pensions are followed, contributions to the plan are tax deferred until they are distributed. A tax-credit ESOP is one to which an employer either contributes stock or cash to buy stock; the employer receives a tax credit for the contribution. (Other ESOPs, called "leveraged ESOPs," are ineligible for the tax credit. 1/) In 1975, when the Congress first enacted the ESOP tax credit, it was an add-on to the investment tax credit and was to expire in 1976. The credit has been modified and extended several times since its inception and is now scheduled to expire in 1987. The tax credit allows employers to recover fully their ESOP contribution up to a limit based--in 1983 and later years--on earnings of covered employees. Repealing the credit as of 1984 would raise revenues by $0.7 billion in the first year and by a total of $7.8 billion through its currently legislated expiration.

The prime benefit of the tax credit is that it strongly encourages corporations to set up and contribute to ESOPs. Because ESOPs give employees a stake in their business, they may improve employee motivation, raise productivity and enhance company profits. Several corporations report ESOPs have had these desirable effects while others find no change. Proponents argue that in addition to improving motivation, ESOPs broaden

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1. A leveraged ESOP borrows from a financial institution to buy employer stock and then repays the loan over time out of employer contributions to the plan. Employer contributions to the leveraged ESOP are deductible (up to a limit based on total compensation) as part of overall employee compensation. Employers' contributions to tax-credit ESOPs are not deductible to the extent the credit is claimed.

ownership of corporate wealth, supplement labor income and extend political support for private enterprise.

The prime objection to continuation of the tax credit is one of equity. Through the tax credit the government is, in effect, buying corporate stock and giving it to trusts for particular individuals. These stock gifts are only available to employees of corporations choosing to participate in the plans. Because the credit originally was tied to the investment tax credit, tax credit ESOPs are currently concentrated among capital intensive corporations. The stock gifts are not available to employees of unincorporated businesses, to self-employed persons, or to such others as employees of not-for-profit organizations. Repeal of the tax credit would place tax credit ESOPs on a par with other fringe benefits such as pensions and health plans, and would make the tax base somewhat broader, thus potentially permitting tax rates to be slightly lower.

TAX SOME EMPLOYER-PAID HEALTH INSURANCE

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

Employees do not pay taxes on income received in the form of employer-paid health care coverage. This exclusion will reduce 1984 income tax revenues by about $20.2 billion--an amount comparable to total federal spending for Medicaid, the major program financing health care services for the poor. This form of income also escapes payroll taxation, costing the Social Security trust fund about $8.9 billion in lost 1984 revenues.

One proposal for limiting the present exclusion would be to treat as taxable income in 1984 any portion of employer contributions exceeding $160 a month for family coverage and $65 per month for individual coverage, with the amount indexed to medical care prices in future years. This is similar to the approach already adopted by the Congress in connection with employer-provided group life insurance. The proposal would raise income tax revenues by $2.7 billion and payroll tax revenues by $0.8 billion in 1984. Over the 1984-1988 period, the revenue increases would amount to $29.6 billion and $9.1 billion, respectively. Any "grandfathering" of existing contributions would reduce these revenue increases.

In 1984, such a limitation would affect about 40 percent of those who participate in employer-sponsored health insurance plans. Several bills introduced in the 97th Congress included similar limits, but none was acted on.

Both health-policy and tax-policy arguments have been made for limiting this exclusion. The exclusion leads to what many consider to be overly extensive health insurance coverage, which has expanded use of health care services unnecessarily and, consequently, driven up their prices. Moreover, the provision disproportionately benefits persons with higher incomes, both because they tend to have larger employer-paid health insurance premiums that are excluded from taxation and because they are in higher marginal tax brackets. The average annual tax benefit in 1983 for all households with incomes between $10,001 and $15,000 is $83; for all households with incomes between $50,001 and $100,000, it is $622.

Opponents of taxing any portion of employer-paid health insurance argue that present health insurance coverage is not excessive and that changing the current policy would result in less insurance coverage; this might, in turn, cause some people to forgo important medical care. Also, they argue that a uniform ceiling would have uneven effects, since a given employer contribution purchases different levels of coverage depending on several factors such as geographic location and the demographic characteristics of the firm's work force.

ELIMINATE TAX EXEMPTION FOR PRIVATE HOSPITAL BONDS

	Annual Added Revenues (billions of dollars)					Cumulative Five-year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	0.1	0.3	0.6	0.9	1.1	3.0

The volume of tax-exempt bonds used to finance construction of hospitals increased from $3.8 billion in 1981 to an estimated $6.9 billion in 1982, accounting for some 8 percent of all new long-term tax-exempt financing in that year. (Direct federal subsidies for new hospital construction have been unavailable since 1974, although minimal funds were subsequently authorized, primarily for rehabilitation of public hospitals.) Approximately half of all new hospital construction is financed with tax-exempt bonds. Eliminating the tax exemption would increase federal revenues by about $3.0 billion in the 1984-1988 period.

The necessity of providing subsidies for new hospital construction has come into question in recent years because the United States has a surplus of hospital beds. Most analysts concur that an average of four hospital beds for each 1,000 population is sufficient. At present, the ratio stands at 4.4 to 1,000; this would indicate an oversupply. The main argument against repealing the tax exemption for private hospital bonds is that, although the supply of hospital beds on a nationwide basis may be excessive, certain areas still lack adequate hospital facilities. A possible solution to this imbalance might be to target tax-exempt hospital bonds toward areas that have shortages of adequate facilities. Opponents of this approach argue, however, that tax-exempt financing cannot be as efficiently targeted toward specific geographic areas or toward specific types of funding needs as direct subsidies have been in the past. Also, direct subsidies may be a less expensive and more efficient alternative, since the entire subsidy would go to the institution; with tax-exempt bond financing, as much as one-third of the subsidy goes to bondholders, underwriters, and bond counsel. In addition, direct subsidies would help to relieve the pressures on the municipal bond market, where rates in some instances have climbed high enough to cancel out almost completely the savings usually realized from tax exemption.

ELIMINATE EXTRA TAX EXEMPTIONS FOR THE ELDERLY OR THE BLIND

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	1.0	2.5	2.6	2.8	2.9	11.8

Any taxpayer aged 65 or older or blind is permitted to claim an extra $1,000 exemption. The most widely perceived reasons for this feature of the tax law are the lower income and the extra costs of living (especially medical costs) of the aged or blind. Repeal of the extra exemption would increase revenues by $1.0 billion in 1984, and by $11.8 billion during the 1984-1988 period. Of this amount, 99 percent would be paid by the elderly.

The extra exemption is criticized on several grounds. Neither age nor blindness is itself proof of financial need; more than one-third of all 1980 tax returns with adjusted gross income (AGI) over $1 million claimed an extra exemption for age. Over 20 percent of the returns that claimed an elderly exemption had an AGI over $20,000, and AGI completely excludes any income from Social Security. Because the exemption saves more tax dollars for those in higher brackets, 33 percent of the current tax saving goes to the 11.7 percent of all elderly taxpayers with over $30,000 in AGI. The elderly whose income is so low that they do not file returns at all do not benefit from the exemption; in 1980 only 11.8 million exemptions were claimed by an estimated elderly population of 25.5 million.

This extra exemption was adopted when Social Security benefits were low and the elderly had a much higher poverty incidence than the population in general (35.2 percent versus 22.4 percent in 1959). In 1980, largely as a result of Social Security, only 15.7 percent of the aged were in poverty (compared with 13.0 percent for all persons). The elderly and the blind who are faced with extraordinary medical expenses can deduct them--an additional exemption is not needed for that purpose.

ELIMINATE INCOME AVERAGING

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	3.5	3.8	4.2	4.5	4.9	20.9

The tax code allows income averaging by taxpayers who experience large increases of income in a particular year. Without averaging, a taxpayer with an uneven flow of income would, under the progressive income tax rate structure, pay more taxes than one earning the same total income at a more constant rate over the same period.

The averaging provision, enacted in 1964 and liberalized in 1969, was specifically designed to allow more equitable treatment of taxpayers--inventors and authors, for example--who receive relatively large payoffs in a short period for efforts expended over several previous years. 1/ But owing to the rapid inflation during the 1970s, many taxpayers have become unintended beneficiaries--those with rapidly growing incomes (such as recent graduates of professional schools) or who have family members entering the labor force or changing from part-time to full-time employment.

The best available data (in a 1977 Treasury Department study) strongly suggest that there is as much fluctuation of income among the general population as among those who use the income averaging provision. The increased incomes of averagers were largely wages and salaries; more than 60 percent of averagers had wage and salary increases over $3,000. These characteristics--simple growth (rather than variability) of income and a predominance of wage and salary income--are not consistent with the original intent of the provision. In addition, as more taxpayers become potential beneficiaries, a larger total effort is expended in calculating liability and eligibility for averaging.

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1. The House Report on the 1964 Revenue Act said its purpose was "to accord those whose incomes . . . fluctuate widely from year to year the same treatment accorded those with relatively stable incomes."

While the revenue loss from averaging was modest in its early years, greater familiarity with and use of the provision together with the high rates of inflation and income growth in the 1970s have increased the loss substantially. Since 1964, the percentage of all filers averaging has expanded by about 16 times, from 0.38 percent to more than 6 percent in 1980. Averagers saved a total of $133 million in 1964; by 1980, the revenue loss from averaging exceeded $3.5 billion. Although averaging is expected to continue to grow with an expanding economy, it will be tempered by the lower inflation now being projected and by the indexing of the income tax scheduled to start in 1985. If income averaging were eliminated entirely, total revenues would increase by about $3.5 billion in 1984, rising to almost $5 billion by 1988. If averaging provisions were tightened, the revenue gain would be less but the originally targeted population would receive a larger share of the tax relief. For example, a requirement of a 140 percent increase over the average of four previous years' income, rather than the current 120 percent increase, would restrict the number of averagers. Dropping the $3,000 income-increase threshold would allow more low-income filers to qualify.

FREEZE ESTATE AND GIFT CREDIT AT EXEMPTION EQUIVALENT OF $275,000

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	0.0	0.5	1.1	1.8	2.6	6.1

The Economic Recovery Tax Act of 1981 substantially reduced taxes on estates and gifts over a six-year phase-in period. The act provides for a credit of $79,300 against estate and gift tax liabilities starting in 1983. This credit effectively exempts all estates valued under $275,000 from the estate tax, and is scheduled to rise in yearly steps to $192,800 in 1987, thereby exempting all estates worth less than $600,000. The estate tax exemption was set at $60,000 in 1942, which is equivalent to about $353,500 in today's dollars. Freezing the credit at its 1983 level would head off further revenue losses, thereby raising $6 billion over the 1984-1988 period.

The expanded estate tax credit was adopted as a way to offset the effects of inflation on estates and provide tax relief to small- or moderate-sized estates, especially those that primarily consist of family businesses. While freezing the credit at its 1983 level would rescind the scheduled increase in the credit applicable to estates valued over $275,000, it would not affect the other estate tax relief measures provided by ERTA. These include significant tax rate reductions, an unlimited marital deduction, and tax-preferred valuation of small firms and businesses.

Further expansion of the estate tax credit can be criticized on several grounds. According to 1979 data, only about 3.5 percent of those dying in 1979 at age 45 and over had estates valued at more than $250,000. Any extension of the credit thus applies to only a small percentage of very wealthy taxpayers. Although it has been argued that estates and gifts should not be taxed because they have already been subject to the personal income tax during the accumulation process, large estates often consist of unrealized and untaxed capital gains (for example, corporate stock or housing). In the case of assets transferred at death, the heir does not have to pay capital gains taxes on any increase in value occurring before the owner's death; accrued appreciation will go totally untaxed if it is also exempt from the estate tax. In 1979, 25 percent of the value of gross estates over $300,000 consisted of unrealized capital gains appreciation--over 50 percent derived from corporate stock holdings. Thus, freezing the estate tax credit would strengthen the only tax on capital gains at death.

ELIMINATE DEDUCTIBILITY OF STATE AND LOCAL SALES TAXES

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	0.9	5.8	6.4	7.0	7.8	27.9

State and local sales taxes paid may be claimed as an itemized deduction. Eliminating the sales tax deduction would increase federal income tax revenues by $0.9 billion in 1984 and by $27.9 billion in 1984-1988. Should some states choose to shift from sales to other taxes to preserve deductibility for their residents, the revenue gain would be reduced.

Sales taxes reduce the taxpayer's net income, and thus his ability to pay federal taxes. Normally, however, only expenses that are relatively large and that vary substantially from one taxpayer to another are deductible on ability-to-pay grounds; small, uniform, and predictable expenses are ignored and implicitly taken into account when the "zero bracket amount," personal exemptions, and general tax rates are established. The sales tax is that kind of a small, uniform, and predictable expense. Sales taxes are collected in 45 of the 50 states; in 1980, the latest year for which detailed data are available, 95.6 percent of all itemizers claimed the deduction, in amounts varying only from 2.0 percent of adjusted gross income for taxpayers with $10,000 to $15,000 of income, to 0.2 percent for those with over $1 million of income. The sales tax deduction is usually a small item (less than half as large as real estate taxes and about a third of income taxes on average in 1980). Sales tax liabilities do not vary substantially from state to state.

Any ability-to-pay rationale for the sales tax deduction is further undermined by the way it is usually calculated. The deduction amounts in most cases come from printed tables based on the state and on the size and income of the family, and presented in the Form 1040 instructions. The deduction is thus usually not based on actual tax payments, and does not compensate for variations in the burden among taxpayers. Further, taxpayers can only justify a deduction of actual liabilities greater than the Internal Revenue Service (IRS) table value by documenting each of the hundreds of retail transactions they made during the year. (Alternatively, if a household made a major purchase such as an auto, it can claim the deduction from the IRS table plus a further deduction for the sales tax on

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the major item. Because the major purchase would likely displace some other consumption, this method probably overcorrects for ability to pay.) Thus, the sales tax deduction may be both the most imprecise and the most burdensome (in terms of recordkeeping) of all the itemized deductions.

Beyond the considerable revenue loss, the imprecision, and the complexity of the deduction, it also has unfortunate incentive effects on both taxpayers and state and local governments. For taxpayers, it marginally and indirectly reduces the cost of consumption at a time when many observers believe the nation would be better served by more saving. For state and local governments, the deduction cushions the burden of the sales tax on taxpayers; but the sales tax, because it adds to the price level, contributes to inflation at the retail level. If the states and localities shifted toward taxes that do not increase prices, this would temporarily decrease the rate of inflation directly, and indirectly reduce business costs through cost-of-living escalators in labor contracts. (Direct reductions of sales taxes would, of course, make consumption even more attractive.)

Advocates of the sales tax deduction argue that the federal government should not influence the states' choice of taxes through selective deductibility. Another argument is that use of the sales tax, popularly held to be a fair tax, should not be discouraged.

IMPROVE TAXPAYER COMPLIANCE

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline						
Improve Audit Coverage:						
Increased Collections	0.2	0.7	2.3	2.4	2.5	8.0
Administrative Outlay Cost	-0.1	-0.2	-0.4	-0.5	-0.5	-1.7
Withholding:						
Royalties	0.4	0.5	0.7	1.0	1.3	3.9
Independent Contractors	0.6	0.9	1.2	1.3	1.4	5.4
Net Deficit Reduction	1.1	1.9	3.7	4.2	4.7	15.6

Substantial evidence shows that compliance with the tax laws has been declining in recent years. The Internal Revenue Service (IRS) estimates that about $95 billion in taxes went unpaid in 1981, an increase of nearly 200 percent since 1973 (67 percent after adjusting for inflation). Although illegal activities, such as prostitution or drug trafficking, are responsible for part of the "tax gap," 90 percent of the revenue shortfall results from underreporting or nonreporting of income from legal activities. Income underreporting is thought to account for over two-thirds of the gap--an estimated $66.1 billion in 1981. Overstated expenses, deductions, and credits account for $12.3 billion, and nonfilers for $4.9 billion. The largest share of underreported income is in the unincorporated business sector--over $30 billion in 1981. While additional complicated rules and regulations would be undesirable, tax evasion imposes an unfair burden on taxpayers who honestly comply. Improving taxpayer compliance would increase both revenues and fairness. These benefits, however, must be weighed against the additional burdens of paperwork and recordkeeping that would be imposed on all taxpayers.

The Congress adopted several compliance provisions in 1982 in TEFRA that are projected to raise $51 billion over the 1984-1988 period. Other areas offer additional potential for improved compliance. The provisions outlined below could reduce the deficit $1.1 billion in 1984 and $15.6 billion over the 1984-1988 period.

Increased Audit Coverage. Examination resources at the IRS have not kept pace with either the workload or the increasing complexity of the tax code. Since 1976, audit coverage has fallen from 2.6 percent of all returns to an expected 1.7 percent in 1983. Adding new staff could have an immediate and high payoff in revenues--estimated by the IRS at about $6 or $7 for every $1 of outlay. A permanent increase in staff of 15,000 average positions (10,000 positions for additional audit coverage and 5,000 positions for increased matching of information returns) would be consistent with the sense-of-the-Congress resolution in TEFRA that sufficient funds should be provided to collect additional tax revenues of $1 billion in 1984 and $2 billion in 1985. This would raise audit coverage to 2.1 percent by 1986, yielding additional revenues of $0.2 billion in 1984 and $8.0 billion in 1984-1988. The additional revenues would be partly offset by $1.7 billion in 1984-1988 outlays for the additional positions.

Expanded Coverage of Withholding. Increasing the coverage of withholding and/or raising rates (when they are too low) could improve taxpayer compliance. In TEFRA, the Congress adopted withholding on interest and dividends and optional withholding on pensions, annuities, and lump-sum distributions. After these procedures have become established, the Congress might want to make withholding on pensions and other retirement income mandatory and/or increase withholding rates to reflect actual taxpayer tax rates.

Two other options would be to cover business royalty payments and the earnings of independent contractors. Current law provides for information reporting on all royalty payments in excess of $600 on an annual basis. Businesses could also be required to withhold taxes on royalty payments for items such as patents, copyrights, and oil and gas rights. Firms could be required, for example, to withhold taxes at a rate of 10 percent on all payments over $600 on an annual basis. This proposal would raise $0.4 billion in 1984 and $3.9 billion in 1984-1988. Current law also requires information returns to be filed by employers of independent contractors on aggregate annual payments in excess of $600. Withholding could be applied to these payments at a rate of 10 percent, and contractors provided a W-2 form. This proposal would raise $0.6 in 1984 and $5.4 billion in 1984-1988.

Improved Recordkeeping. Unincorporated businesses are the largest source of tax evasion. Although it is extremely difficult to control or detect unrecorded cash transactions, this practice could be inhibited by increasing the penalty for negligent recordkeeping. Current law provides that taxpayers shall be fined 5 percent of their tax underpayment and 50 percent of the interest due on the underpayment if any part of an underpayment results from negligence or intentional disregard of rules and regulations, but without intent to defraud. Failure to maintain adequate