REV-11 TAX EMPLOYER-PAID LIFE INSURANCE

Addition to Current-Law Revenues	Annual Added Revenues (Billions of dollars) 1996	1997	1998	1999	2000	Cumulative Five-Year Addition
Income Tax	1.4	2.0	2.1	2.1	2.2	9.8
Payroll Tax[a]	0.8	1.2	1.2	1.2	1.3	5.7
Total	2.2	3.2	3.3	3.3	3.5	15.5

SOURCE: Joint Committee on Taxation.

a. Estimates are net of reduced income tax revenues.

The tax law excludes from taxable income the premiums that employers pay for group term life insurance, but limits the exclusion to the cost of the first $50,000 of insurance. The exclusion is not available to the self-employed. Employer-paid life insurance is the third most expensive tax-free fringe benefit (after health insurance, discussed in REV-10, and pensions, discussed in REV-12 and REV-13). Including employer-paid premiums in taxable income would add about $10 billion to income tax revenues and almost $6 billion to payroll tax revenues from 1996 through 2000.

Like the tax exclusion for other employment-based fringe benefits, the tax exclusion for life insurance creates a subsidy for the fringe benefit, which causes people to purchase more life insurance than they would if they had to pay the full cost for insurance. Furthermore, the tax exclusion allows workers who receive life insurance benefits to pay less tax than workers with the same total compensation but who must purchase insurance on their own (see REV-09). Unlike most other fringe benefits, however, the value of employer-paid life insurance would be easy to measure and allocate to employees. Employers could report the premiums they pay for each employee on the employee's W-2 form and compute withholding in the same way as for wages. Employers already withhold taxes on life insurance premiums that fund death benefits above the $50,000 limit.

Taxing employer-paid life insurance would leave a preference for death benefits provided by many employers under pension plans as substitutes for life insurance. Employees can defer income tax and pay no payroll tax on employer contributions to pension plans. Also, the first $5,000 of employee death benefits are tax-exempt. If the Congress made employer-paid life insurance plans taxable, employers might choose to offer less life insurance and larger death benefits on pension plans instead.

REV-12 DECREASE LIMITS ON CONTRIBUTIONS TO QUALIFIED PENSION AND PROFIT-SHARING PLANS

Addition to Current-Law Revenues	Annual Added Revenues (Billions of dollars) 1996	1997	1998	1999	2000	Cumulative Five-Year Addition
Decrease Limits for Defined Benefit Plans to the Social Security Wage Base (With equivalent reductions for defined contribution plans)	0.5	1.5	1.4	1.4	1.4	6.2
Decrease the Limit for Deferrals in Salary Reduction Plans to $4,000	0.4	0.5	0.7	0.7	0.8	3.1

SOURCE: Joint Committee on Taxation.

Saving for retirement through employer-provided qualified pension and profit-sharing plans provides two tax advantages: it exempts from taxes the investment income earned by the assets in qualified plans, and it defers tax on employer contributions to qualified plans until retirement, when an employee's marginal tax rate is often lower.

Decrease Limits on Employer Contributions. Section 415 of the tax code establishes limits on the benefits that an employer can fund in qualified plans for any employee. The limits depend on the type of plan the employer offers.

Defined contribution plans specify how much the employer will contribute for each employee's retirement--for example, 5 percent of pay. The employee's pension depends on how much the employee's retirement fund accumulates by the time he or she retires. Current law limits annual contributions to such plans to 25 percent of compensation or $30,000, whichever is less.

Defined benefit plans specify the pension amount employees will receive in retirement, which is usually a percentage of preretirement earnings. Employers adjust their annual contributions so that enough will accumulate by the time the employee retires to pay the promised pension. Current law limits contributions to defined benefit plans so that annual benefits for pensions that begin at age 65 are no more than 100 percent of preretirement wages or $120,000 for 1995, whichever is less. The tax law reduces that limit on an actuarial basis for pensions that begin at an earlier age. When an employer sponsors both types of plans, a higher limit applies--the lesser of 140 percent of wages or $150,000 for 1995.

The limits on employer contributions are intended to limit the size of the tax benefits received by highly paid people. Those people are better able to provide adequately for retirement without the full tax benefits and may use pensions to shelter nonretirement savings from taxation. Furthermore, providing full tax benefits for these people would reduce the progressivity of the tax code.

The main argument for lowering the current limits on contributions is that they allow the funding of pensions far higher than the preretirement earnings of most workers. Three percent of people who worked full time throughout 1993 earned as much as $100,000. Yet current limits allow the funding of pensions up to $120,000. Workers who accrue pensions that large are unlikely to need the full tax advantage to provide adequately for their retirement. Limiting funding for defined benefit plans to amounts necessary to pay benefits equal to the Social Security wage base ($61,200 in 1995), and making proportionate reductions in limits for defined contribution plans, would raise about $6 billion from 1996 through 2000 because more employment income would be subject to taxes. Those limits would still be higher than the earnings of all but about 9 percent of full-time workers.

One argument against reducing funding limits is that it would make participation less attractive to high-income business owners and top managers and thus might discourage them from sponsoring those plans for both themselves and their employees. Although the higher-paid managers and owners might not need tax-advantaged pension plans to save adequately for retirement, their employees might. A further argument against reducing the limits is a concern that national saving is too low. Limiting incentives for pension saving could reduce total saving.

Limit 401(k) Deferrals to $4,000. Section 401(k) of the tax code allows employees to choose to receive lower current (taxable) compensation and defer the remainder of compensation as a contribution to an employer retirement plan. Similar arrangements are possible for some workers in the nonprofit sector (403(b) tax-sheltered annuities), federal workers, and workers enrolled in some simplified employer plans (SEPs).

Section 402(g) specifies indexed limits for employee deferrals. In 1995, the limit for deferrals to 401(k) plans, SEPs, and the federal plan is $9,240. A temporarily higher limit of $9,500 exists for tax-sheltered annuities authorized under section 403(b). Limiting deferrals in all plans with cash or deferred arrangements to $4,000 in 1996, and indexing that limit thereafter, would raise about $3 billion in 1996 through 2000.

Lowering the limit would affect higher-income workers who are likely to provide adequately for their own retirement without the tax incentive. In addition, many employers have added 401(k) plans on top of other pension plans that already meet the basic retirement needs of employees. The 401(k) plans provide supplementary saving for those who prefer higher retirement income. Thus, limiting contributions to 401(k) plans would not threaten the basic retirement security of those workers.

Alternatively, higher limits provide a greater incentive for employers to initiate the plans, which benefit employees at all income levels. In particular, 401(k) plans appeal to small employers who have traditionally not established pension plans. Lower limits may discourage small employers from offering what could be the only retirement benefit available to their employees. Lowering limits on those plans and not on other plans encourages traditional pensions, which are primarily defined benefit plans. Unlike defined benefit plans, 401(k) plans and other defined contribution plans do not discriminate against workers who change employers or drop out of the workforce temporarily. In addition, the voluntary nature of plans with cash or deferred arrangements allows workers who have spouses without coverage to save more for retirement than other workers.

Recent Change in Other Funding Limit. In addition to the section 415 and section 402(g) limits described above, section 401(a)(17) limits the amount of compensation that can be considered in calculating an employee's benefits. The Omnibus Budget Reconciliation Act of 1993 reduced that compensation limit from $235,840 in 1993 to $150,000 in 1994 and provided for indexing the limit in subsequent years. The reduction was estimated to raise $2.5 billion between 1994 and 1998.

The limits in section 415 and section 402(g) primarily restrict pension benefits for high-income employees with generous pension plans. The compensation limit primarily restricts pension benefits for all high-income employees.

REV-13 IMPOSE A 5 PERCENT TAX ON INVESTMENT INCOME OF PENSION PLANS AND INDIVIDUAL RETIREMENT ACCOUNTS

	Annual Added Revenues (Billions of dollars)					Cumulative Five-Year Addition
	1996	1997	1998	1999	2000	
Addition to Current-Law Revenues	7.3	12.1	12.9	13.6	14.3	60.2

SOURCE: Joint Committee on Taxation.

Under normal income tax rules, the interest earnings of savings accounts are fully taxable each year. The absence of that annual tax is one of the tax advantages for employer pensions and individual retirement accounts (IRAs). Instituting a tax at a low rate on the earnings of pension funds and IRAs would reduce the size of that advantage. A 5 percent tax rate would raise about $60 billion between 1996 and 2000. (The other tax advantage of pensions and IRAs is the deferral of tax on contributions until retirement, when an employee's marginal tax rate is often lower.)

The tax advantages for pensions and IRAs encourage firms and workers to provide for retirement. Most studies of pensions find that they increase saving; the studies of IRAs are less conclusive. Although the tax advantages promote a public objective, many people receive little or no benefit from them. Only about half of employees receive pension coverage or contribute to IRAs. The largest pension benefits go disproportionately to higher-paid workers or to workers with long-term employment at large firms.

Imposing a tax at a low rate on pension and IRA earnings would reduce the tax advantage of saving for retirement through those vehicles. Such a tax would reduce the use of pensions and IRAs slightly and probably result in less retirement saving. The smaller tax advantage for pensions and IRAs would, however, make the tax burden between employees with pensions and IRAs and those without them slightly more equal. It would also increase taxes relatively more for higher-paid workers.

Taxing pension and IRA earnings would affect more taxpayers than would setting lower limits on employer contributions to pension plans (see REV-12). Lowering the contribution limits would increase taxes on a small number of the highest-paid workers, and would increase taxes substantially for some of them. Taxing pension and IRA earnings would affect workers throughout the income distribution. Moreover, because it would affect so many more workers, it could raise more revenue with a smaller impact for each employee who pays more tax.

Taxing the annual earnings of pension funds and IRAs would encourage fund managers to shift their investments toward assets that appreciate in value, such as growth stocks and real estate, because they can defer tax on capital gains until realization (see REV-22). To obtain that tax deferral, however, pension funds would have to invest in riskier assets. Although that portfolio shift would reduce the security of workers' retirement funds, it would make it easier for risky enterprises to obtain funding.

REV-14 TAX THE INCOME-REPLACEMENT PORTION OF WORKERS' COMPENSATION AND BLACK LUNG BENEFITS

	Annual Added Revenues (Billions of dollars)					Cumulative Five-Year Addition
	1996	1997	1998	1999	2000	
Addition to Current-Law Revenues	1.4	4.0	4.1	4.2	4.3	18.0

SOURCE: Joint Committee on Taxation.

Current law exempts workers' compensation and Black Lung benefits from income taxation. Taxing the portion of those benefits that replaces the income employees lose from work-related injuries or black lung disease would increase revenues by $18 billion from 1996 through 2000. The remaining portion, which reimburses employees for medical costs (about 40 percent), would continue to be exempt from taxation.

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

An argument against taxing such benefits is that legal or insurance settlements for non-work-related injuries are not taxable, even if a portion of them reimburses lost income. Hence, taxing workers' compensation benefits would treat those two types of compensation inconsistently.

Furthermore, to the extent that the current levels of wage-replacement benefits were established under the assumption that they would be untaxed, this option would reduce benefits below desired levels. Enacting the option, therefore, might lead to efforts to increase benefits.

REV-15 INCREASE TAXATION OF SOCIAL SECURITY AND RAILROAD RETIREMENT BENEFITS

Addition to Current-Law Revenues	Annual Added Revenues (Billions of dollars) 1996	1997	1998	1999	2000	Cumulative Five-Year Addition
Tax 85 Percent of Benefits for All Recipients	8.3	21.1	21.9	22.8	23.7	97.8
Tax 85 Percent of Benefits for Recipients with Income Above $44,000 (Couples) and $34,000 (Individuals) and Tax 50 Percent of Benefits for All Other Recipients	4.0	10.2	10.6	11.0	11.4	47.2
Tax 85 Percent of Benefits for Recipients with Income Above $32,000 (Couples) and $25,000 (Individuals)	0.4	0.8	0.9	0.9	1.0	4.0

SOURCE: Joint Committee on Taxation.

Social Security and Railroad Retirement (Tier I) together constitute the federal government's largest entitlement program. Most benefits are not subject to tax. Under current law, a taxpayer first calculates his or her combined income, which is the sum of adjusted gross income (AGI), nontaxable interest income, and one-half of Social Security and Tier I benefits. If a taxpayer's combined income exceeds a fixed threshold, he or she includes a fraction of benefits in AGI. The thresholds at which up to 50 percent of benefits are subject to tax are $25,000 for single returns and $32,000 for joint returns. About 22 percent of households receiving Social Security benefits pay income tax on those benefits. Because the thresholds remain fixed over time, as nominal incomes increase, the percentage of households that pay tax on benefits will grow to 27 percent in 2000.

The Omnibus Budget Reconciliation Act of 1993 (OBRA-93) increased the fraction of Social Security and Tier I benefits subject to tax for higher-income taxpayers by adding new income thresholds, $34,000 (single) and $44,000 (joint), above which up to 85 percent of benefits become subject to tax. OBRA-93 allocated the additional revenues from this change to the Medicare trust fund. All other revenues from taxing Social Security benefits go to the Social Security retirement and disability trust funds. H.R. 8, a bill introduced in 1995 and based on a proposal in the Contract with America, would repeal the changes to the taxation of Social Security and Railroad Retirement benefits that the Congress enacted in OBRA-93.

Couples with income below $32,000 and individuals below $25,000 currently pay no tax on their benefits. Options one and two expand the population of beneficiaries subject to tax. Options one and three increase the fraction of benefits subject to tax to 85 percent for taxpayers currently taxed on up to 50 percent of their benefits. None of the options affect taxpayers currently subject to tax on 85 percent of their benefits.

Increasing the percentage of benefits that are taxable from 50 percent to 85 percent would make the treatment of Social Security roughly similar to that of contributory pension plans. Workers receiving benefits from contributory plans pay income tax on the excess of benefits over their own contributions. Social Security actuaries estimate that among workers now entering the labor force, payroll taxes will represent 15 percent of expected benefits for high-earning, unmarried workers and a lower percentage for all other workers. Thus, 85 percent is the minimum fraction of benefits in excess of past contributions. However, a lower rate might be appropriate for two reasons. First, benefits will have to be cut or taxes raised at some point in the future to restore the long-run balance of Social Security. Either change would raise taxes as a share of benefits above 15 percent for some workers. Second, keeping the inclusion rate at 50 percent would make the treatment of Social Security equivalent in terms of present value to that of noncontributory pensions, the more common form of pension.

Increasing the tax on benefits would reduce the net benefits of retirees compared with what some people consider to be the implicit promises of the Social Security and Railroad Retirement programs at the time recipients were working. The government has, however, made numerous changes in the Social Security and Railroad Retirement programs over time, including changing the benefit formula, introducing partial taxation of benefits, and raising payroll tax rates to finance the programs.

The first option would eliminate the income thresholds entirely and would require all beneficiaries to include 85 percent of their benefits in their adjusted gross income. It would raise nearly $100 billion from 1996 through 2000. Eliminating the income thresholds would cause many more, but not all, Social Security recipients to pay income tax on their benefits. In addition to the thresholds, the tax code protects lower-income elderly households from taxation of income through personal exemptions, the regular standard deduction, and an additional standard deduction for the elderly. Under current law, 22 percent of elderly couples and individuals with benefits pay income tax on their benefits. Eliminating the thresholds on taxing benefits would raise the share of couples and individuals paying tax on their benefits to 68 percent.

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

The second option would not change the treatment of couples with combined income above $44,000 and individuals with combined income above $34,000--they would still be taxed on up to 85 percent of their benefits--but would require all other recipients to include 50 percent of benefits in their adjusted gross income. This option would raise $47.2 billion from 1996 through 2000. Couples with combined income below $32,000 and individuals with combined income below $25,000 would be added to the beneficiaries whose benefits are subject to tax. Almost all beneficiaries currently taxed on up to 50 percent of their benefits--couples with combined income between $32,000 and $44,000 and individuals with combined income between $25,000 and $34,000--would be unaffected. (Because the taxation of benefits is phased in under current law, some couples with combined income just above $32,000 and singles with income just above $25,000 are now taxed on less than a full 50 percent of their benefits.)

The final option would keep the current-law income threshold of $32,000 for couples and $25,000 for individuals, while including up to 85 percent of benefits for all taxpayers above that threshold. The option would raise $4 billion from 1996 through 2000. It would, moreover, almost exclusively affect couples with combined income between $32,000 and $44,000, and individuals with income between $25,000 and $34,000.

Increased taxation of Social Security benefits is one way to apply some type of means test to those benefits. As an alternative to expanding taxation, the government can reduce benefits from those programs by changing the benefit formula (see ENT-59 through ENT-62), reducing cost-of-living adjustments (see ENT-67), or including benefits in a broadly based means test of multiple entitlement programs (see ENT-68).

REV-16 TAX INVESTMENT INCOME FROM LIFE INSURANCE AND ALL ANNUITIES

	Annual Added Revenues (Billions of dollars)					Cumulative Five-Year Addition
	1996	1997	1998	1999	2000	
Addition to Current-Law Revenues	4.5	12.9	16.8	20.6	23.2	78.0

SOURCE: Joint Committee on Taxation.

Life insurance policies often combine features of both insurance and tax-favored savings accounts. In the early years of whole life insurance and similar policies, annual premiums exceed the annual cost of insurance. As the excess premiums accumulate, they earn investment income, which is then available to pay the cost of future insurance, provide part of a death benefit, or provide a disbursement to the policyholder if the policy is voluntarily canceled.

The investment income, sometimes called "inside buildup," receives special tax treatment under current law compared with the interest income from other investments. It is exempt from taxation when used to pay the cost of future life insurance. It is also tax-exempt to the beneficiary or, with some tax planning, to the estate of the insured person when it is paid as part of a death benefit. The accumulated investment income is taxable to the policyholder when he or she voluntarily cancels a policy and receives a disbursement. Even when the investment income is ultimately taxable, however, the tax deferral can be favorable to the policyholder. The interest income from other investments, such as taxable bonds, is subject to tax as it accrues, even when interest is not paid to the investor until the bond matures.

Life insurance companies also sell annuities, which likewise have features of both insurance and tax-favored savings accounts. Life annuities promise periodic payments to the annuitant as long as he or she lives. Those payments provide insurance against the possibility that the annuitant will outlive his or her assets. By nature, however, annuities are also saving vehicles because annuity premiums are paid in return for annuity benefits received at a later date. Because premiums are often paid long before benefits are received, the benefits must include a return on investment in order for an annuity to be financially attractive.

For tax purposes, annuity benefits are divided into two parts--a return of principal and investment income. Only the investment income is subject to tax. Although investment accrues over the life of a contract, it is not included in taxable income until benefits are paid. As with whole life insurance and other similar policies, such tax deferral can increase the after-tax return to the investor significantly compared with alternative investments such as taxable bonds and certificates of deposit, from which interest income is taxable as it accrues.

Tax Investment Income Annually. Under this option, policyholders would include the investment income from life insurance policies and annuities in taxable income as it accrued. Insurance companies would report the accrued investment income to a policyholder or annuitant annually. Life insurance disbursements and annuity benefits would no longer be taxable as they were paid. Investment income from annuities purchased as part of a qualified pension plan or qualified individual retirement account would still be tax-deferred until benefits were paid. Making the investment income taxable in that way would raise $78 billion in 1996 through 2000.

Taxing the investment income from life insurance and annuities would equalize their tax treatment with the tax treatment of similar investments. The investment income from life insurance and annuities is tax-deferred, but the income from an ordinary savings account or taxable bond is taxed as it accrues. Alternatively, the tax deferral for life insurance and annuities is consistent with the tax deferral currently allowed for capital gains income.

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

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

A More Limited Option. Some annuity contracts sold by life insurers provide little or no insurance against outliving assets. For example, a contract may guarantee to pay a minimum total benefit regardless of how long the annuitant lives. Other annuities simply make predetermined benefit payments over a fixed term. Such "term-certain" annuities are simply investments and are essentially identical to bonds, bank certificates of deposit, or money market mutual funds.

Under a more limited option, an individual's taxable income would include the annual accrual of investment income only from annuity benefits that are guaranteed to exceed a certain amount or to be paid over a fixed period, regardless of how long the annuitant lives. The insurance companies would annually report to individuals the amounts to be included as taxable income. To lessen the burden of compliance, however, no reporting or accrual taxation would be required when the term-certain portion of the value of an annuity accounted for less than one-third of its value. Annuities purchased as part of a qualified pension plan or qualified individual retirement account would also be exempted. This option is similar to a proposal by the Bush Administration in its 1993 budget. An estimate of the option's budgetary effect is not currently available.

REV-17 TAX A PORTION OF THE INSURANCE VALUE OF MEDICARE BENEFITS

Addition to Current-Law Revenues	Annual Added Revenues (Billions of dollars) 1996	1997	1998	1999	2000	Cumulative Five-Year Addition
			With Income Thresholds			
Tax Hospital Insurance Only	1.9	5.0	5.7	6.4	7.2	26.2
Tax Supplementary Medical Insurance Only	1.0	2.8	3.3	3.9	4.5	15.5
Tax Both	3.2	8.4	9.7	11.1	12.8	45.2
			Without Income Thresholds			
Tax Hospital Insurance Only	2.7	9.3	10.2	11.2	12.3	45.7
Tax Supplementary Medical Insurance Only	1.4	4.8	5.6	6.4	7.3	25.5
Tax Both	4.5	15.6	17.4	19.5	21.8	78.8

SOURCE: Joint Committee on Taxation.

Like Social Security, Hospital Insurance (HI) benefits under Medicare are financed by payroll taxes that are earmarked for a trust fund. Social Security benefits, however, are partially taxable for higher-income people, whereas the value of HI benefits is not subject to tax. In addition, the Supplementary Medical Insurance (SMI) component of Medicare is heavily subsidized; premiums cover only about 25 percent of the benefits paid. This option would tax HI the same way Social Security is taxed under current law or under the tax option in REV-15 and would partially tax SMI.

The first option would treat the insurance value of Medicare like Social Security benefits, although the tax would be imposed on the average insurance value of in-kind Medicare benefits, not on the dollar value of benefits actually received. In this option, 85 percent of the value of HI and 75 percent of the value of SMI would be included in adjusted gross income (AGI) for taxpayers with combined income (AGI plus nontaxable interest income plus one-half of Social Security, Railroad Retirement, and Medicare benefits) over $34,000 for single returns and $44,000 for joint returns. For taxpayers with combined income below those thresholds but above $25,000 (single) and $32,000 (joint), 50 percent of the insurance value of both HI and SMI would be included in AGI. Taxpayers with lower income would have no additional tax liability. Because the thresholds are fixed, inflation would cause a larger fraction of Medicare insurance benefits to become taxable over time.

With those income thresholds, the HI tax alone would increase federal revenues by about $26 billion from 1996 through 2000. The SMI tax alone would yield about $16 billion over the five-year period. If both taxes were imposed simultaneously, revenues would be about $45 billion higher over five years. The combined tax would generate more revenues than the sum of the HI and SMI taxes because some taxpayers would be subject to higher tax rates as a result of the increase in AGI. In addition, more enrollees would have income above the threshold when both components are included.

The second option would include 85 percent of the insurance value of HI benefits and the subsidy component of SMI (about 75 percent) in AGI for all taxpayers. Without an income threshold, the HI tax alone would increase federal revenues by about $46 billion over the 1996-2000 period. Revenues from the SMI tax alone would be about $25 billion over the five-year period. If both taxes were imposed simultaneously, revenues would be nearly $79 billion higher over the five-year period.

Earmarking revenues from taxing HI benefits for the HI trust fund would delay the projected deficit of the trust fund in 2003. A tax on SMI benefits would shift some SMI costs from taxpayers to enrollees. If income thresholds were used, lower-income enrollees would not be affected. In fact, this proposal would affect only about 57 percent of enrollees in 1996 even if no income thresholds were used. Furthermore, since this option would use the mechanism already in place for taxing Social Security benefits, it would be straightforward to administer.

Unlike the tax on Social Security benefits, this tax would be imposed on the insurance value of in-kind benefits rather than on the dollar benefits actually received. Some people might object that the additional income does not generate cash with which to pay the tax liability. (There would be little to recommend basing the tax on actual benefits received, however, because it would then be directly related to enrollees' health care costs. Such a tax would reduce the insurance protection Medicare is intended to provide.) In addition, the actual value of insurance provided under Medicare varies among households based on age, health status, and whether they have other health insurance.

Thus, including a fixed imputed HI premium in income might be viewed as unfair. The approximately 13 percent of enrollees in or above the 28 percent tax bracket would face a tax increase averaging about $1,250 in 1996 for individuals and about $2,520 for couples with two enrollees, assuming the combined tax was imposed with no income thresholds. In addition, more households would have to pay tax on Social Security benefits if the definition of combined income was expanded to include Medicare benefits.

REV-18 EXPAND MEDICARE AND SOCIAL SECURITY COVERAGE

Addition to Current-Law Revenues	Annual Added Revenues (Billions of dollars) 1996	1997	1998	1999	2000	Cumulative Five-Year Addition
Expand Medicare Coverage to Include State and Local Government Employees Not Now Covered	1.1	1.6	1.5	1.5	1.4	7.1
Expand Social Security Coverage to Include All New State and Local Government Employees	0.3	1.0	1.8	2.7	3.5	9.3

SOURCE: Congressional Budget Office.

NOTE: These estimates do not include the effect of any increases in benefit payments that would result from the option. They would be small over this five-year period. Estimates are net of reduced income tax revenues.

Certain groups of federal, state, and local government workers are not covered under the Medicare and Social Security programs, despite recently expanded coverage. Legislation in the past decade required all federal workers to pay Medicare payroll taxes beginning in 1983 and required federal employees who began work after December 31, 1983, to pay Social Security payroll taxes. Further legislation mandated that state and local workers who began employment after March 31, 1986, pay Medicare payroll taxes. The Omnibus Budget Reconciliation Act of 1990 expanded Social Security and Medicare coverage to include state and local government workers not covered by any retirement plan.

Under current law, many state and local employees will qualify for Social Security and Medicare benefits based on other employment in covered jobs or their spouse's employment. Those workers will thus receive benefits in return for a smaller amount of lifetime payroll taxes than are paid by people who work continuously in covered employment. That inequity is especially apparent for Medicare benefits: one out of six state and local employees is not covered through his or her employment, but 85 percent of those employees receive full Medicare benefits through their spouse or because of prior work in covered employment. Inequitable treatment is less of a problem in the case of Social Security benefits because the benefit formula is adjusted for retired government workers who have worked a substantial portion of their career in employment not covered by Social Security.

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

Expand Medicare Coverage to Include State and Local Government Workers Not Now Covered. Expanding Medicare coverage to include state and local government workers who began work before April 1, 1986, would raise $7.1 billion from 1996 through 2000. The annual revenue gain would decline gradually over time, coinciding with the number of workers who were hired before April 1986 and remained on payrolls of state and local governments. The Administration proposed this option in its health care reform package of 1993, and in recent years, the Congress has considered it during the budget reconciliation process.

Expand Social Security Coverage to Include All New State and Local Government Workers. Retirement coverage for state and local government workers may be provided by a public-employee program, the Social Security program, or a plan that integrates the two programs. Expanding Social Security coverage to include all new state and local government workers would raise $9.3 billion from 1996 through 2000, although in the long run higher Social Security benefit payments would offset a portion of the extra revenue. The annual revenue gain would grow rapidly--to $3.5 billion by 2000--because the pool of new employees would grow rapidly.

How states and localities revised their pension plans in response to mandatory coverage would determine which workers gained and lost from this change, but requiring coverage of new state and local government workers would be likely to benefit many workers who spent only part of their career in the government sector. First, because of the portability of coverage, newly hired workers would find it easier to qualify for disability and survivors' benefits under Social Security than under many public-employee benefit programs. Second, Social Security eligibility is not lost if the state and local employees change jobs before they are vested. Third, Social Security benefits are calculated on the basis of indexed wages, whereas benefits from public pension plans are calculated on the basis of nominal wages for a given amount of covered wages. Consequently, workers who worked only when they were young would receive more generous retirement benefits from Social Security than from public pension plans.

State and local governments would have to pay the employer's share of Social Security taxes on new employees if coverage was made mandatory. Because state and local government participation in Social Security is now voluntary, those states with a low percentage of covered employees would bear more of the cost of expanded mandatory coverage, including the cost of setting up the system.

REV-19 CURTAIL TAX SUBSIDIES FOR EXPORTS

	Annual Added Revenues (Millions of dollars)					Cumulative Five-Year Addition
	1996	1997	1998	1999	2000	
Addition to Current-Law Revenues	2.5	4.2	4.5	4.8	5.2	21.2

SOURCE: Joint Committee on Taxation.

The tax code subsidizes U.S. exports in two important ways. First, the allocation of income between domestic and foreign business activities under the "title passage" rule routinely allows U.S. multinational companies to use excess foreign tax credits to offset about half of the U.S. tax on their export income by characterizing it as foreign-source income. Second, the tax rules for foreign sales corporations (FSCs) offer U.S. companies an opportunity to exempt about 15 percent of their export income from U.S. tax by characterizing it as income of a foreign subsidiary that is not effectively connected with U.S. trade or business.

Sourcing Rules for Sales of Inventory. U.S. companies generally pay U.S. tax on their worldwide income, but they may claim a foreign tax credit. The foreign tax credit reduces the tax that U.S. companies owe on foreign-source income by the amount of income tax they pay abroad. To prevent the foreign tax credit from offsetting domestic-source income, the tax code limits the credit to the amount of tax owed on foreign-source income. When foreign tax payments exceed the U.S. tax on foreign-source income, U.S. companies accrue excess foreign tax credits that they cannot currently use. U.S. companies retain those excess credits to offset taxes owed on future income from foreign sources, but only for five years. (One consequence of lowering corporate tax rates in the Tax Reform Act of 1986 is that more U.S. multinational companies are accumulating excess foreign tax credits that are likely to expire.)

In allocating worldwide income between domestic and foreign sources, sourcing rules determine how fully U.S. companies can use their foreign tax credits to reduce their U.S. tax liability. For example, when a corporation has excess foreign tax credits, treating a dollar of income as foreign-source income instead of domestic-source income allows the corporation to use excess credits that might otherwise expire to reduce the U.S. tax on its worldwide income by about 35 cents.

Sales income is classified for tax purposes as domestic or foreign source according to a complex set of sourcing rules that take account of the residence of the seller, the place of sale, the location of the seller's business activities, and the presence of any foreign tax on the sales income. Under a particular rule known as the "title passage" rule, the income of a U.S. company from the sale of inventory is sourced according to the place of sale. So when inventory is sold abroad, the income from the sale is deemed foreign-source income, regardless of where the inventory was purchased and regardless of whether the income was subject to foreign tax. When a U.S. company produces the inventory in the United States and markets it abroad, half of the income is typically classified as foreign source on the basis of the title passage rule and half is classified based on the location of the production activity. Assuming the company has excess foreign tax credits to offset the tax on its foreign-source income, the 50-50 allocation effectively exempts half of the export income from U.S. tax.

If the title passage rule allows a company with excess foreign tax credits to classify more of its export income as foreign source than it could justify solely on the basis of the location of its business activities, then the company receives an implicit export subsidy.

Foreign Sales Corporations. According to a decision by the governing council of the General Agreement on Tariffs and Trade (GATT), export income can be exempt from U.S. tax only if the economic activity that produces the income takes place outside the United States. In response to the GATT decision, the tax code was amended by the Congress to allow U.S. companies to charter FSCs in low-tax countries and either supply goods to the FSCs for resale abroad or pay commissions to FSCs on export sales. Although the FSCs are largely paper corporations with very few employees, the Congress believes that they have enough foreign presence and economic substance to meet GATT's requirements to exempt export income.

Under the tax code, when a U.S. company sells exports through an FSC, about 23 percent of the total income from production and marketing is attributed to the FSC and about 65 percent of the FSC's export income is exempt from U.S. tax. The exempt income, which is approximately 15 percent of the income from the sale, remains free from U.S. tax when the U.S. company receives it as a dividend from the FSC.

Economic Effects of Export Subsidies. Export subsidies increase investment and employment in export industries, but do not increase the overall levels of domestic investment and domestic employment. Stimulating exports increases the demand for U.S. dollars by foreigners, which raises the value of the dollar and lowers the cost of imports, causing imports to increase. In the long run, export subsidies increase imports as much as exports, which causes investment and employment in import-competing industries in the United States to decline about as much as they increased in the export industries.

Export subsidies reduce domestic welfare by distorting the allocation of economic resources at home and abroad. The subsidized production of export goods in the United States partially displaces the more efficient production of those goods abroad. Moreover, the subsidies increase the worldwide supply of goods that the United States exports and decrease the worldwide supply of goods that the United States imports. The shifts in supply lower the world price of U.S. exports and raise the price of U.S. imports. As a result, domestic welfare suffers because the United States receives fewer import goods in exchange for its export goods.

Curtailing the export subsidies provided by the title passage rule and the favorable tax treatment of FSCs would raise about $21 billion from 1996 through 2000. The option would curtail the export subsidy from the title passage rule by eliminating it and treating the income of U.S. companies from the sale of goods abroad as domestic-source income. An exception would be allowed, however, if a U.S. company had a place of business that was located outside the United States and was substantially involved in the export sale. Under the exception, income would be allocated between domestic and foreign sources based on the location of the business activities that produced the income. The option would curtail the subsidy from FSCs by treating them like other foreign subsidiaries. In general, all of the income repatriated from FSCs would be subject to U.S. tax, but some of it might be foreign-source income under the revised sourcing rule mentioned above. The tax on any income from the FSC that was deemed foreign-source income could be offset by unused foreign tax credits.