ISSUES INVOLVED IN POSSIBLE REVENUE OPTIONS TO REDUCE THE FEDERAL DEFICIT

Scheduled for a Hearing

Before the

SUBCOMMITTEE ON DEFICITS, DEBT MANAGEMENT, AND INTERNATIONAL DEBT

of the

SENATE COMMITTEE ON FINANCE

on June 5, 1992

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of the

JOINT COMMITTEE ON TAXATION

June 4, 1992

JCX-20-92

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INTRODUCTION

The Senate Finance Subcommittee on Deficits, Debt Management, and International Debt has scheduled a public hearing on June 5, 1992, to address the long-term economic implications of the Federal budget deficit.

This document,[1] prepared by the staff of the Joint Committee on Taxation in connection with the June 5 Subcommittee hearing, discusses why policy makers might be concerned about the deficit and examines several selected revenue raising options to illustrate both the magnitude of revenues that could be generated by the alternatives and the potential economic impact of enacting these alternatives. The discussion of economic effects is brief; however, this discussion attempts to highlight key economic concerns that policymakers should address. Among the economic issues covered are: the potential for economic inefficiency that could be caused by enactment of the alternative; the distributional consequences of the alternative (i.e., who in society actually would bear the burden of the alternative); and the administrative or transitional costs that would accompany enactment of the alternative. Discussion of possible expenditure reducing or cost saving options is not within the scope of this document.

Inclusion of particular revenue raising options in this document should not be construed as endorsement by the staff of the Joint Committee on Taxation.[2] These alternatives were selected as representative of the categories of alternatives which might be considered as part of a serious effort to reduce the Federal deficit by raising additional Federal revenues. The primary goal of these illustrative revenue raising alternatives is to provide information for policymakers to help evaluate the alternatives.

The document is organized as follows. Part I presents some data on the size of the Federal deficit and briefly discusses why policymakers are concerned about the deficit. Part II presents several alternative rate increases in the

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[1] This document may be cited as follows: Joint Committee on Taxation, Issues Involved in Possible Revenue Options to Reduce the Federal Deficit (JCX-20-92), June 4, 1992.

[2] Similarly, omission of a particular alternative should not be perceived as a statement of the preferences of the staff of the Joint Committee on Taxation. Time constraints in preparation of this document for the June 5 Subcommittee hearing precluded an in-depth analysis of various revenue options and limited as the number of alternatives discussed within each of the major categories.

context of the individual and corporate income taxes. Part III presents several income tax base broadeners for the individual and corporate income taxes. Finally, Part IV presents a number of excise and other consumption tax alternatives.

I. THE DEFICIT

During the past two decades large Federal budget deficits have become a central feature of public finance as practiced in the United States. Numerous commentators have warned of the dire long-term economic consequences of chronic Federal deficits.[3] Such widespread concern has drawn the attention of many policymakers. Virtually all agree that the problem of a large Federal deficit will not succumb to a simple solution. Rather, a concerted effort by citizens and their elected officials is needed in order to grapple with a deficit that exceeds $350 billion (over $1400 for every United States resident) in fiscal year 1992. The deficits have increased the national debt. The total interest bearing debt of the Federal government outstanding at the end of 1991 was approximately $3.8 trillion, or more than $15,000 per capita. A concerted effort to reduce the size of the deficit may require additional revenues and/or reductions in expenditures at the Federal level.

Federal deficit

The Federal deficit for the 1991 fiscal year totaled $268.7 billion and is estimated to be in excess of $300 billion for the 1992 and 1993 fiscal years.[4] For 1991, this figure represented more than 4.5 percent of the nation's gross domestic product (GDP).[5] The projected deficits for

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3 A sampling of these writings include: Richard Darman, "Director's Introduction," in President of the United States, Office of Management and Budget, Budget of the United States Government, Fiscal Year 1993, January 1992; Congressional Budget Office, Reducing the Deficit: Spending and Revenue Options, February 1992; General Accounting Office, Budget Policy: Prompt Action Necessary to Avert Long-term Damage to the Economy, May 1992; and Joint Committee on Taxation, Tax Policy and the Macroeconomy: Stabilization, Growth, and Income Distribution (JCS-18-91), December 12, 1991.

4 President of the United States, Office of Management and Budget, Budget of the United States Government, Fiscal Year 1993, January 1992. See, also, Congressional Budget Office, Analysis of the President's Budgetary Proposals for Fiscal Year 1993, March 1992. The Congressional Budget Office (CBO) estimates the budget deficit to be $368 billion for fiscal year 1992 and $336 billion for fiscal year 1992.

5 Gross Domestic Product (GDP) of a country is the value of all marketed goods and services produced in that country. Gross National Product (GNP) is GDP plus the net factor income received by residents of that country from abroad.
(Footnote continued)

1992 and 1993 are estimated to represent more than six percent of GDP in 1992 and more than five percent of GDP in 1993.[6] While deficits of $200 billion or more represent large numbers, they are smaller in comparison to the size of the economy than some previous deficits incurred by the Federal Government. Figure 1 presents the Federal deficit as a percentage of real gross national product (GNP) from 1970 through 1991. Relative to the size of the economy, the deficit was larger from 1982 through 1987 than it is today. During the World War II, the Federal deficit exceeded 20 percent of GNP. However, between the end of the World War II and 1982, the Federal deficit only rarely exceeded 2.5 percent of GNP.

What does the deficit measure?

Overview.--The reported deficit measures the difference between current year Federal receipts and outlays. This measure has been subjected to criticisms on several grounds by accountants, economists, budget analysts, and policymakers. A common theme of the criticisms is that the measured deficit is an inadequate guide for policymakers to use in a number of situations and should not be relied upon to the exclusion of all other measures. Below is a nonexhaustive list of these criticisms.

Full-employment deficit.--Many observers argue that the actual size of the Federal deficit provides an inaccurate measure of government stimulus of aggregate demand. Even with no change in government policy the size of the deficit will change in a recession as the economic downturn reduces tax revenues and increases counter cyclical spending (e.g., unemployment benefits). These observers argue that for purposes of assessing macroeconomic policy, the deficit should be measured relative to full employment.[7] For example, a deficit of $100 billion when the economy is experiencing eight percent unemployment might be reduced to $25 billion if

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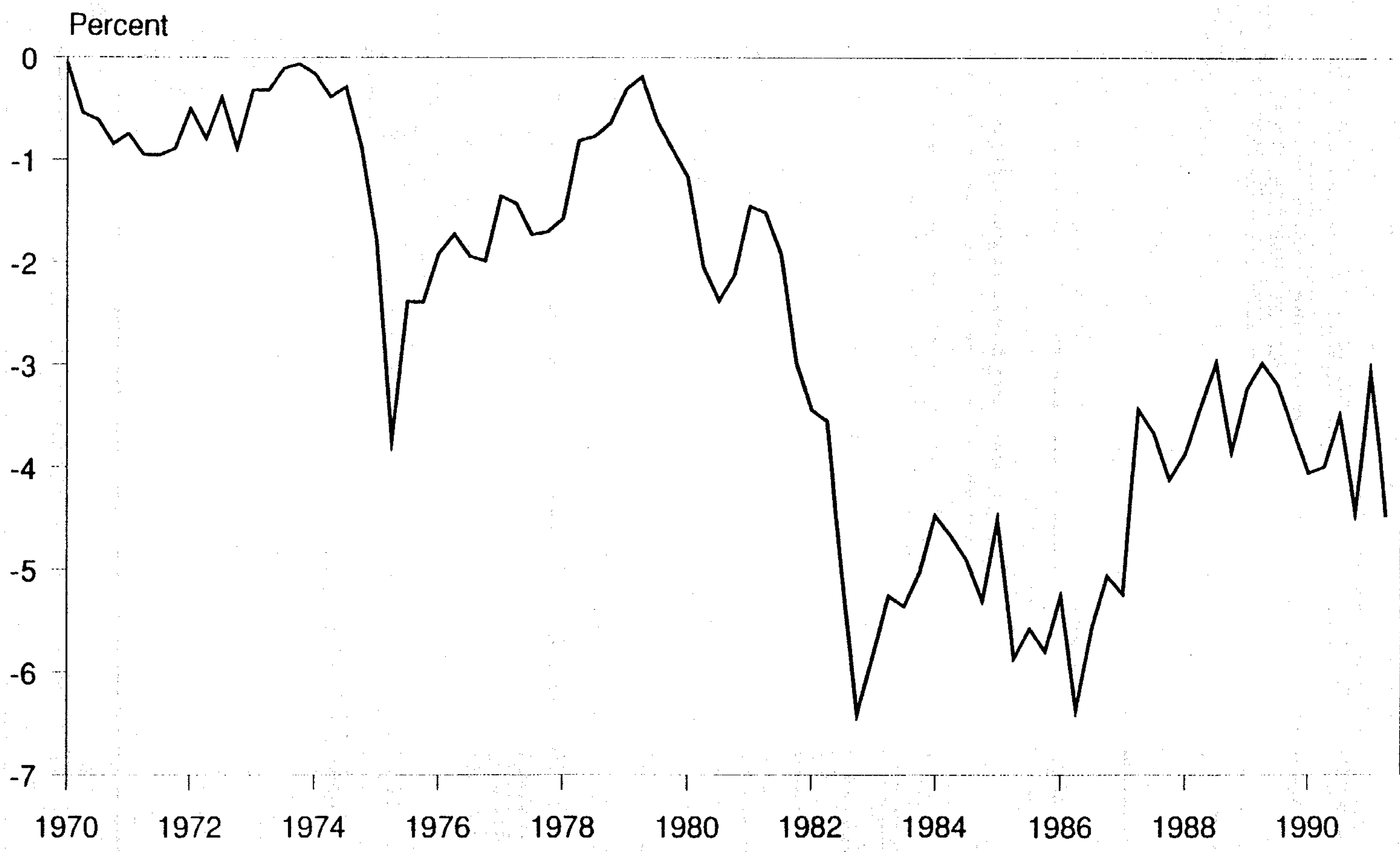
[5] (continued)
Thus wages earned by a United States resident from temporary work abroad constitutes part of GNP but not GDP. Similarly, the returns from investment abroad constitute part of GNP but not GDP. Empirically, the difference between GDP and GNP is small for the United States.

[6] Congressional Budget Office, Analysis of the President's Budgetary Proposals for Fiscal Year 1993.

[7] By full employment, economists do not mean an unemployment rate of zero, but rather some larger number to reflect the normal quitting and search process of labor markets. There is debate about the "correct" measure of full employment for the United States economy.

Figure 1

Federal Deficit as a Percentage of Real GNP, 1970-1991



Department of Commerce,
Bureau of Economic Analysis

the economy were at full employment. The concept of the full-employment deficit is meant to measure the net fiscal stimulus the government is adding to the economy.

Accrual rather than cash accounting.--Some economists have commented that neither the actual nor the full-employment deficit is an accurate measure of Federal fiscal policy. They argue that such measures of the deficit include outlays, the liability for which may have occurred earlier and that the actual timing of the outlay has no real effect on the economy. An example in the current economic context would be the expansion in the actual Federal deficit incurred to cover insured deposits in the thrift and banking industries. Such liabilities were incurred when it became apparent the financial institutions were insolvent which occurred prior to the current outlays. Similarly, the cash budget does not include the outlays or receipts from future years for which the liability is incurred by a policy enacted today. For this reason, certain increases or decreases in the cash deficit may not accurately represent changes in government fiscal policy. On the other hand, it is often difficult to determine the proper amount of income to accrue under an accrual accounting system. For example, In the case of deposit insurance, it is not clear at what point liabilities should have been determined to have accrued.

Capital expenditure and trust fund budgeting.--Some analysts object to lumping together expenditures on capital goods with current expenditures on nondurable goods. They observe that capital expenditures, such as for the construction of a bridge, provide services to the public for many years while non-capital spending may finance current consumption (e.g., transfer payments). They argue it is therefore appropriate to borrow to fund capital expenditures because borrowing and servicing the debt better matches the benefits and costs on an annual basis. To the extent that a deficit exists to finance capital expenditures, these analysts would argue the deficit should be no cause for concern. Similarly, these analysts argue that the budget should report separately capital expenditures and operating expenditures. This is the budget reporting practice of many States and local governments.

Similarly, others argue that where earmarked revenues have been provided to trust funds, separate accounting should be given to each trust fund. They argue that separate trust fund accounting would help policymakers better assess the costs and benefits associated with specific government programs.

Changes in values of government assets.--Another criticism of current deficit measures is that they do not account for the changing real value of government assets.[8] For example, the value of the national debt has been substantially reduced by inflation over the past two decades. Similarly, the real value of mineral rights on Federal lands has increased substantially. The reduction in the value of the debt and the increase in the value of mineral rights are like additional revenue to the government. In the case of debt, the government will now require fewer real resources to service the existing debt. In the case of mineral rights, the government in the future could auction such rights for greater revenues. To the extent that measures of current receipts and outlays omit changes in values of assets, the measured deficit need not tell policy makers anything about the current net income position of the government.

Policy concerns relating to large deficits

Constraints on current expenditures

Some policymakers are concerned about the size of the budget deficit because of the indirect effect it has on the level of current government expenditures for goods and services. By adding to the stock of the national debt, large budget deficits increase required outlays to meet interest expense on the national debt. If policy makers have agreed to limit the size of aggregate government expenditures, an increase in expenditures for interest reduces resources available for other purposes.

Potential "crowding out" of the private sector in the credit markets

Effect on investment and purchases of consumer durables.--Federal government spending that is financed with increased issuance of government bonds may increase the rate of interest in the Treasury bond markets. This rise in the Treasury bond rate in turn will raise rates for bonds issued by corporations and State and local governments as well as rates for consumer, mortgage, and business loans and may cause the rationing of credit. Such a tightening of credit markets can reduce business investment and personal consumption expenditures. This especially may be true for interest-sensitive sectors such as housing and consumer durables and for capital goods purchased by businesses that may have difficulty in obtaining credit. The Federal deficit is said to "crowd out" private investment and consumption.

Alternatively stated, by raising real borrowing costs, the cost of capital (the rate of return that investments must earn to be profitable) is increased. This makes many

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8 Robert Eisner and Paul J. Pieper, "How to Make Sense of the Deficit," Public Interest, vol. 78, Winter 1985, pp. 101-118.

investment projects less attractive and aggregate investment falls as fewer investment projects are undertaken. Rates of investment are important because when an economy's rate of net investment (gross investment less depreciation) increases, the economy's stock of capital increases. A larger capital stock permits a fixed amount of labor to produce more goods and services. The larger a country's capital stock, the more productive its workers and generally, the higher its real wages and salaries. Thus, increases in investment tend to cause future increases in a nation's standard of living. Many policy makers are concerned that continued large deficits will continue the trend of low growth of wages and per capita GDP experienced by the United States for the past twenty years.[9]

Effect on trade.--Besides the contractionary effects of higher interest rates on consumer durables and investment goods, higher interest rates may also have a negative effect on net exports. Higher domestic interest rates attract foreign investment which drives up the value of the dollar. An appreciation of the dollar reduces the cost of imports to U.S. residents and raises the price of U.S. exports in foreign markets. As the price of imported goods falls relative to domestically produced goods, United States residents may substitute imported goods for domestically produced goods to the detriment of trade sensitive industries. If these price changes result in a reduction in net exports (or an increase in net imports), there would be a contraction in the aggregate demand for U.S. goods and services.

Dearth of saving.--The effect on investment and on trade is exacerbated by the low rate of saving in the United States. Either domestic saving or borrowing from abroad funds private investment and government deficits.[10] The United States national saving rate is low when compared to that of other developed nations.[11] With saving rates lower and deficits larger than those that prevailed in the late

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9 For more discussion of long-term economic performance, see, Joint Committee on Taxation, Tax Policy and the Macroeconomy: Stabilization, Growth, and Income Distribution (JCS-18-91), December 12, 1991.

10 For a more detailed discussion of saving, investment, and foreign borrowing, see Joint Committee on Taxation, Factors Affecting the International Competitiveness of the United States (JCS-6-91), May 30, 1991.

11 See Joint Committee on Taxation, Factors Affecting the International Competitiveness of the United States, for more data and discussion on this point.

1960s, the share of national income devoted to investment must decline unless funds are borrowed from abroad.

Table 1 presents United States net saving by component as a percentage of gross national product. National saving is divided into private saving and public saving. Private saving comprises household or personal saving and business saving. Households save by not spending all of their disposable (i.e., after-tax) income. Businesses save by retaining some of their after-tax earnings. Public saving reflects the extent to which the Federal, State, and local governments run budget surpluses. As Table 1 demonstrates, net business saving,[12] net personal saving, and public saving were all lower during the 1980s than in any of the three previous decades. Though private saving remained positive, it fell during the 1980s. Moreover, public saving was consistently negative during the 1980s as the result of Federal deficits. The magnitude of public dissaving generally was larger relative to GNP in the 1980s than in earlier years. As the table indicates, net national saving is lower after 1981 than at any time in the post-World War II era. In 1983, 1985, 1986, and 1987 aggregate governmental dissaving consumed all, or more than all, of personal saving.

Table 1.--Components of United States Net National Savings as a Percentage of GNP, Selected Years, 1929-1990

Year	Net personal saving	Net business saving	Total net private saving	public saving	Total net national saving
1929	2.5	2.3	4.8	1.0	5.8
1939	2.0	0.3	2.3	-2.4	-0.1
1949	2.8	4.0	6.9	-1.3	5.6
1954	4.4	2.6	7.0	-1.9	5.1
1959	4.4	3.2	7.6	-0.3	7.2
1964	4.8	3.9	8.8	-0.4	8.4
1969	4.4	2.6	7.0	1.0	8.0
1974	6.6	1.4	7.9	-0.3	7.6
1975	6.5	2.3	8.9	-4.1	4.8
1976	5.4	2.6	8.0	-2.2	5.8

12 Table 1 presents net saving, which equals gross saving less capital consumption (depreciation).

1977	4.6	3.1	7.7	-1.0	6.7
1978	4.9	3.1	8.0	0.0	7.9
1979	4.7	2.5	7.2	0.5	7.6
1980	5.0	1.4	6.4	-1.3	5.1
1981	5.2	1.4	6.6	-1.0	5.7
1982	4.9	0.6	5.5	-3.5	2.0
1983	3.8	1.9	5.7	-3.8	2.0
1984	4.4	2.5	6.8	-2.8	4.1
1985	3.1	2.6	5.7	-3.3	2.4
1986	3.0	2.0	4.9	-3.4	1.5
1987	2.0	1.8	3.9	-2.4	1.5
1988	3.0	1.9	4.9	-2.0	2.9
1989	3.3	1.0	4.3	-1.7	2.6
1990	3.3	0.5	3.8	-2.3	1.5
Average 1950-59	4.7	2.8	7.5	-0.1	7.4
Average 1960-69	4.6	3.5	8.1	-0.3	7.9
Average 1970-79	5.6	2.4	8.0	-1.0	7.1
Average 1980-89	3.8	1.7	5.5	-2.5	3.0

Source: Department of Commerce, Bureau of Economic Analysis

Potential "accommodation" by the Federal Reserve

An additional concern caused by large Federal deficits is that Federal Reserve may "monetize" the debt. Expansionary monetary policy could keep interest rates low and credit abundant despite increased demand for money and loanable funds. This type of accommodating monetary policy may alleviate any tightening of credit, especially in the short run. However, many economists believe that, whatever improvements in credit conditions are provided by expansionary monetary policy, they are not sustained in the long run and are earned only at the cost of a higher rate of inflation.[13]

[13] Milton Friedman, "The Role of Monetary Policy," American Economic Review, vol. 58 (March 1968), pp. 1-17.

Intergenerational equity

Overview.--Policymakers have long argued whether deficit finance is fair to future generations. The simple analysis is that borrowing to fund current expenditures necessitates future taxes to service the debt obligation. The benefit of the expenditure may be received by current generations, while the debt is serviced by future generations. Historically, prior to the last twenty years, most debt incurred by the Federal government has been related to war finance. Arguably, the benefits of insuring freedom are valuable to all future generations. Many analysts have noted that the recent sizeable additions to the national debt have not been war related, although they may, in part, be related to increased defense expenditures.

The discussion of alternative deficit measures suggested that the simple analysis of current expenditures leading to current benefits is not always accurate.[14] There is, however, a popular perception that the national debt is a burden on future generations and that large increases to that burden may represent a shifting of a portion of the burden from one generation to the next.

Generational accounts.--Recently, the notion of "generational accounting" has been developed to attempt to address the shortcomings of the deficit as a measure of intergenerational wealth transfers.[15] The goal of generational accounting is to calculate the present value over many years of the benefits and costs of government programs and assign the net value to various age cohorts of the current population as well as to cohorts yet unborn. For example, generational accounting would compute the present value of social security benefits that each individual might expect to receive during his or her lifetime and the present value of the same individual's payroll tax liability. In theory, generational accounts would reflect not only the burdens of taxes and the benefits from expenditure programs, but also the burdens and benefits of regulatory policies. Because the concept of generational accounting requires estimates of future economic activity such calculations are only suggestive. Accepting these caveats, one exercise in

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14 Discussion below introduces the economic concept of "Ricardian equivalence" which suggests that the debt service obligation may not create a burden for future generations.

15 See Alan J. Auerbach, Jagadeesh Gokhale, and Laurence J. Kotlikoff, "Generational Accounts: A Meaningful Alternative to Deficit Accounting," in David Bradford, ed., Tax Policy and the Economy, vol. 5 (Cambridge: MIT Press for the National Bureau of Economic Research), 1991.

generational accounting has estimated that future generations will pay 79 percent more in taxes (net of transfers) than the generation of people who have just been born.[16]

Do deficits matter?

Even if there is no crowding out in the credit markets, some economists believe that increases in deficits do not matter to the aggregate economy. According to this school of thought, changes in fiscal policy provide no net stimulus because individuals receiving a tax cut or the income from increased government expenditures recognize that additional disposable income realized today will be offset by tax increases in the future that will be assessed to support the current increase in the deficit.[17] For example, it is widely believed that consumption is a function of consumers' wealth, which includes the current value of assets net of debt obligations plus the present value of future after-tax earnings. Because cuts in capital taxes increase the value of capital and cuts in wage taxes increase the present value of future earnings, tax cuts, especially permanent tax cuts, are believed to increase wealth and therefore increase consumption. However, many economists would argue that wealth is really not increased when increased future tax obligations (necessary to fund the current debt) are taken into account.

It may be improbable that all consumers fully take into account increased future tax obligations that result from an increase in the current government deficit. However, it does seem plausible that an increase in personal wealth resulting from a tax cut financed by an increase in public debt is less stimulative than a real increase in wealth resulting from

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16 This calculation combines the taxes and transfers of all levels of government, not solely the Federal Government. See, President of the United States, Budget of the United states Government, Fiscal Year 1993.

17 This proposition is known as the "Ricardian equivalence" theorem. For more discussion, see Robert Barro, "Are Government Bonds Net Wealth?" Journal of Political Economy, vol. 82, November-December 1974. Ricardian equivalence does not necessarily hold in an economy where consumers and businesses are unable to obtain sufficient credit to meet their demands. In that case, when the government borrows to put cash in the hands of its citizens through lower taxes or increased spending it is, in effect, borrowing on their behalf. Accordingly, government borrowing may have some impact on output even though consumers perceive the future tax liability because in effect they get a loan for consumption through the government that they would not otherwise be able to obtain at the same cost.

higher pre-tax (and after-tax) income.

II. POSSIBLE INCOME TAX RATE INCREASES

A. Individual Income Tax Rate Increases

1. Create a 35-percent rate bracket for taxable incomes above $135,000 (unmarried individuals filing separate returns), $150,000 (unmarried individuals filing as heads of households), $200,000 (married individuals filing joint returns), and $100,000 (married individuals filing separate returns).

2. Impose a 10-percent surtax on individuals with taxable income over $1,000,000 ($500,000 for married taxpayers filing separate returns).

These proposals would be effective for taxable years beginning after December 31, 1992.

	Revenue effects (billions of dollars)					
	1993	1994	1995	1996	1997	1993-97
1. 35-percent rate for higher-income taxpayers	3.9	7.1	7.5	7.4	7.4	33.3
2. Surtax on taxable income over $1,000,000	0.9	1.6	1.8	1.9	2.0	8.2

Proposals similar to these two alternatives were included in H.R. 4210, which was passed by the Congress on March 20, 1992, and vetoed by the President. Capital gains income would continue to be taxed at a maximum rate of 28 percent, as under present law. The thresholds for the 35-percent bracket would be indexed for inflation in the same manner as present law. The surtax would equal 10 percent of otherwise computed tax liability multiplied by the ratio of taxable income in excess of $1,000,000 to total taxable income. The effect of the surtax is that the more taxable income exceeds $1,000,000, the closer the surtax approaches a 10-percent increase in total tax liability. For alternative minimum tax purposes, the surtax would be implemented by increasing the tentative minimum tax by 2.4 percent of the amount by which alternative minimum taxable income exceeds $1,000,000.

The burden of these rate increases would be concentrated among those taxpayers with the highest incomes. This could result in an increase in the progressivity of the individual income tax system. It can be argued that this tax increase provides a disincentive to labor supply. To the extent that the highest income people in society are the most productive, this tax rate increase may have some effect on overall output by discouraging labor supply from these members of society. To the extent that high incomes are primarily the result of random events and not due to extraordinarily high productivity, the effect on overall output will be smaller and perhaps negligible. Similarly, this tax rate increase will act to reduce the after-tax return to saving by affected individuals, perhaps discouraging these taxpayers from undertaking saving and encouraging consumption.

The proposed rate increase would widen the gap between the tax rate on ordinary income and the tax rate on capital gains income. This would provide additional incentive for individuals to attempt to convert ordinary income into tax-favored capital gains income.

B. Corporate Income Tax Rate Increases

Raise the top marginal income tax rate for corporations from 34 percent to 35 percent, effective for taxable years beginning after December 31, 1992.

	Revenue effects (billions of dollars)					
	1993	1994	1995	1996	1997	1993-97
35-percent top rate on corporate taxable income	1.7	2.8	2.8	2.9	3.1	13.3

This tax rate increase would affect approximately 10 percent of corporate taxpayers; these corporations earn approximately 90 percent of corporate taxable income. An increase in the top corporate rate would increase the tax difference between firms that organize as corporations and those that choose other organizational forms (e.g., sole proprietorships, partnerships or subchapter S corporations). This could provide a tax disincentive to organize as a corporation, even when there are valid business reasons for favoring the corporate form of organization. Moreover, this increase could provide an incentive for existing investment to shift from corporate form to other organizational forms.

Increasing the top tax rate on corporations might increase the burden on investment activity done in the corporate form. If this resulted in a reduced after-tax return to these investments, fewer of these investments would be made. This effect might lower overall output by reducing investment.

To the extent the burden of a corporate income tax rate increase is borne by the owners of corporate shares, this proposal could result in a windfall loss to current shareholders. This would occur as the price of corporate shares decreases to equate the after-tax rate of return to these investments with the after-tax rate of return of investments of comparable risk. To the extent the burden of the corporate income tax is borne by all capital (rather than just corporate shares), there would be a similar windfall loss to all owners of existing (or "old") capital.

III. POSSIBLE INCOME TAX BASE BROADENING OPTIONS

A. Limit Individual Exclusion for Fringe Benefits

The proposal would limit the exclusion from gross income for employer-provided health insurance to $335 per month for family coverage and $135 per month for individual coverage (these amounts are expressed in 1993 dollars and would be indexed for inflation). In addition, the proposal would limit the benefits payable under a defined benefit pension plan to the Social Security wage base ($55,500 in 1992 dollars), with commensurate reductions in the limits on contributions for defined contribution pension plans. The proposal would be effective for years beginning after December 31, 1992.

	Revenue effects (billions of dollars)					
	1993	1994	1995	1996	1997	1993-97
Limit on exclusion for employer-paid health insurance	11.6	19.4	24.1	29.5	35.5	120.1
Decrease limits on defined benefit pension plans to the Social Security wage base (with commensurate reduction for defined contribution plans)	1.3	3.7	4.1	4.5	4.5	18.1

Under present law, amounts contributed by employers for employee health and pension benefits generally are excluded from the employee's gross income. The proposal would limit the amount of health and pension benefits that may be excluded.

Because the tax rate on health benefits is less than that on cash wages, employees and employers have an incentive to fashion compensation packages to include more health benefits than they would if there were no difference in tax treatment. An employee would prefer to be compensated with health benefits as long as the value of a dollar of health benefits is worth at least (1 - employee's marginal tax rate) dollars in cash wages to the employee. This incentive for overconsumption of health benefits could be reduced if the value of an extra dollar of health benefits would be equal to that of a dollar of cash wages.

The tax treatment of pension benefits creates a similar bias in favor of compensation in the form of pension contributions. Subject to annual contribution limits, pensions are taxed under consumption tax principles: an exclusion is allowed for contributions, no tax is imposed on accruing earnings, and all proceeds are taxed when distributed. Such treatment allows tax-free accrual of returns and is more favorable than the tax treatment allowed under income tax principals. Limiting the exclusion would make saving for retirement more expensive; the net effect on the amount of saving is uncertain because of competing substitution and income effects. If saving for retirement is reduced by the proposal, then the Government may be induced to increase payments to future elderly generations, which would require additional outlays.

In general, lower-income individuals receive fewer health and pension benefits than do high-income individuals. Limitations on the benefits may thus increase progressivity.

B. Limit Home Mortgage Interest Deduction

The proposal would alternatively eliminate the deduction for mortgage interest (including home equity loans) or reduce the maximum amount of home mortgage indebtedness that qualifies for interest deduction to $300,000. Under the latter alternative, there would be no grandfathering of existing mortgages. The proposal would be effective for taxable years beginning after December 31, 1992.

	Revenue effects (billions of dollars)					
	1993	1994	1995	1996	1997	1993-97
Eliminate mortgage interest deductions	31.0	52.8	54.7	56.6	58.6	253.6
$300,000 limit on home mortgage indebtedness that qualifies for interest deductions	1.0	2.6	3.2	3.7	4.2	14.7

Under present law, taxpayers who choose to itemize deductions may claim a deduction for interest paid on home mortgage and home equity indebtedness. The amount of home mortgage indebtedness that may qualify for interest deductions is limited to $1,000,000. The amount of home equity interest that may qualify for interest deductions is limited to the lesser of $100,000 or the amount of equity in the house.

To the extent that the deductibility of mortgage interest subsidizes owner-occupied housing, this proposal reduces the subsidy. This reduction in the subsidy could improve equity, since the value of the subsidy is larger for those taxpayers in higher marginal tax brackets. Yet the main subsidy to owner-occupied housing is not the deductibility of mortgage interest but the absence of taxation on the flow of housing services the house provides.[18] Under the proposal, this underlying benefit of

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18 To illustrate this point, consider a taxpayer with $80,000 in assets who wants to live in an $80,000 house. Assume that the rate of return on all capital (including housing) is 10 percent. The taxpayer has a choice of renting an $80,000 house (for which the annual rent would be $8,000 (10 percent of the house's value)), buying an $80,000 house for cash, or borrowing $80,000 (at 10 percent interest) in

(Footnote continued)

untaxed flows of services will continue to be worth more for taxpayers in higher brackets.

Denial of the deduction for mortgage interest may put otherwise similar renters and mortgagee owners on an equal footing (the renter gets no deduction for rent payments and the mortgagee gets no interest deduction). But taxpayers who are able to buy their homes outright are advantaged relative to mortgagee owners because the return to their investment in owner-occupied housing is untaxed.[19]

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18 (continued)
order to buy a house. In all three cases, the taxpayer receives an identical amount of housing services; only the tax treatment differs across the choices.

If the taxpayer rents, he can invest his $80,000 to yield taxable dividends of $8,000. What remains after tax can be used to pay some of the $8,000 rent. He has taxable income of $8,000 on the transaction.

If the taxpayer purchases the home for cash, he has no taxable income on the transaction.

Under present law, if the taxpayer borrows $80,000 to purchase the house, he can invest his own $80,000 to yield dividends of $8,000 sufficient to pay the interest on his mortgage. Because the mortgage interest is deductible, it offsets his dividend income, leaving him with no taxable income on the transaction. Thus, under present law, homeowners are benefitted relative to renters regardless of whether they have a mortgage or not.

19 Return to the example from the previous footnote. Under the proposal to eliminate the deduction for mortgage interest, if the taxpayer borrows $80,000 to purchase the house, he can no longer offset the $8,000 of dividend income with mortgage interest. He is in the same situation as if he rented.

C. Limit Benefits of Itemized Deductions to 15 Percent

The proposal would limit the benefit of itemized deductions by in effect converting them into tax credits equal to 15 percent of the amount of itemized deductions. For taxpayers in the 15-percent marginal tax bracket, the provision would result in no change from present law. For taxpayers in higher marginal tax brackets, the value of the itemized deductions would be reduced. The proposal would be effective for taxable years beginning after December 31, 1992.

	Revenue effects (billions of dollars)					
	1993	1994	1995	1996	1997	1993-97
Limit tax benefit of itemized deductions to 15 percent	26.8	61.6	66.2	72.4	79.4	306.4

Taxpayers may claim either a standard deduction or itemized deductions from adjusted gross income. The value of itemized deductions to a taxpayer depends upon the taxpayer's marginal tax rate. By limiting the benefit of itemized deductions to 15 percent of the amount deducted, the proposal would make the value of itemized deductions the same for all taxpayers who choose to itemize.

The proposal may increase equity by allowing the same value of itemized deductions to all taxpayers. But to the extent that itemized deductions are allowed to reflect reduced ability to pay (for example, in the case of medical expenses), then the proposal would result in higher taxes for those taxpayers less able to pay. Also, the proposal would lead to income mismeasurement by reducing the value of deductions such as those for casualty losses and miscellaneous employee expenses.

D. Reduce Deductibility of Business Meals and Entertainment

The proposal would allow taxpayers to deduct only 50 percent of the cost of meals and entertainment expenses incurred in connection with business activity. The proposal would be effective for taxable years beginning after December 31, 1992.

	Revenue effects (billions of dollars)					
	1993	1994	1995	1996	1997	1993-97
Reduce deduction for business meals and entertainment to 50 percent	1.6	3.4	3.4	3.5	3.6	15.5

Under present law, taxpayers may deduct 80 percent of the cost of meals and entertainment expenses incurred in connection with business activity.

Businesses are allowed to deduct from gross income the ordinary and necessary expenses of generating such income. To the extent that some part of the expenditure on business meals and entertainment represents consumption and not a cost of generating income, the deduction should be limited. There is not, however, a clear delineation of what fraction of such expenditures represent consumption.

E. Include Capital Gains in the Last Tax Return at Death

Under present law, at the death of an individual who holds appreciated capital assets the basis of such assets is stepped up to the fair market value at the time of the death. Thus heirs who later sell such assets are liable for tax only on capital gains since the death of the previous holder. Any capital gains on the asset prior to the death of the holder are untaxed. The proposal would include the capital gains prior to the death of the holder in the decedent's last tax return. The proposal would be effective for taxable years beginning after December 31, 1992.

	Revenue effects (billions of dollars)					
	1993	1994	1995	1996	1997	1993-97
Tax capital gains at death	*	3.2	3.9	4.6	5.3	17.0

* Less than $50 million

Because holding appreciated capital assets until death results in an effective tax rate of zero on these capital gains, taxpayers have an incentive to hold on to such assets until death. This incentive is a major contributor to the so-called "lock-in effect" of capital gain taxation rules. Investors may forego higher before-tax returns that could be earned on another asset because selling the appreciated capital asset to purchase the new asset would result in a lower after-tax return. Eliminating the step-up in basis as death would reduce the lock-in effect. On the other hand, taxing the appreciation of an asset at death will reduce the after-tax return to these assets, compared to current law. This may act to discourage saving, where the intent is to pass assets on to one's heirs.

F. Increase the Portion of Social Security Benefits Subject to Income Tax

Under present law, a portion of Social Security and tier 1 railroad retirement benefits is included in taxable income for taxpayers whose combined income, defined as adjusted gross income (AGI) plus (1) interest on tax-exempt bonds and (2) 50 percent of Social Security and tier 1 railroad retirement benefits, exceeds a threshold amount. The threshold amount is $32,000 for married taxpayers filing joint returns and $25,000 for unmarried taxpayers. The amount of benefits included in taxable income is the lesser of (1) 50 percent of Social Security and tier 1 railroad retirement benefits, or (2) 50 percent of the excess of the taxpayer's combined income over the threshold amount. The proposal would increase the maximum portion of Social Security and tier 1 railroad retirement benefits included in gross income from 50 percent to 85 percent. The alternative would be effective for taxable years beginning after December 31, 1992.

	Revenue effects (billions of dollars)					
	1993	1994	1995	1996	1997	1993-97
Increase maximum portion of Social Security benefits in taxable income from 50 percent to 85 percent	2.7	5.6	6.2	6.9	7.7	29.1

This proposal would increase the individual income tax liabilities of those Social Security and railroad retirement recipients with combined incomes above the applicable threshold. Thus, the proposal would primarily affect older taxpayers with incomes above the median for elderly households. A large percentage of any current Social Security recipient's benefits does not constitute a return of the original contribution made with after-tax dollars. Rather, the bulk of benefits received consists of the employer's contribution plus the implicit earnings on these contributions. The Social Security Administration has estimated that, for individuals retiring between 2025 and 2030, the lifetime aggregate employee contributions will, on average, equal approximately 7 percent of aggregate benefits. Similarly, CBO has estimated that the highest corresponding figure for single males earning the maximum Social Security taxable wage base is 15 percent. These estimates indicate that the 85-percent inclusion figure used in this proposal is a reasonable estimate of the portion of benefits received that represents amounts other than employee contributions made with previously taxed dollars.

G. Repeal Percentage Depletion for Extractive Industries

Under present law, a specified percentage of a property's gross income may be deducted in determining taxable income, regardless of the actual capitalized costs of the property. The proposal would eliminate the availability of percentage depletion deductions for all extractive industries, while retaining the availability of cost depletion. The proposal would be effective for taxable years beginning after December 31, 1992.

	Revenue effects (billions of dollars)					
	1993	1994	1995	1996	1997	1993-97
Repeal percentage depletion	0.5	0.9	1.0	1.0	1.0	4.5

Percentage depletion deduction is claimed when the amount is larger than the deduction under cost depletion, which permits a ratable deduction of the capitalized costs of the property. In particular, percentage depletion deductions are available for properties where the adjusted basis (essentially the cost of the property less any depreciation or depletion claimed) is small or zero. Thus, percentage depletion deductions may result in a mismeasurement of net income from a property. In the long run, the burden of any tax increase resulting from this alternative would generally fall on the owner of the mineral rights to the property, since this would ordinarily be the least mobile factor of production. In the short run, the burden of the tax may fall on other parties (e.g., operators of the production facility, workers in the production facility, consumers of the product), since there may be fixed or contractual relationships that cannot be altered in the short run.

H. Repeal the Possessions Tax Credit

A United States corporation operating in Puerto Rico or any U.S. possession may claim the possessions tax credit instead of the foreign tax credit (the possessions tax credit is referred to as the Section 936 credit). The possessions tax credit effectively exempts income sourced by a U.S. corporation to Puerto Rico or another U.S. possession from U.S. corporate income tax. This alternative would repeal the possessions tax credit for taxable years beginning after December 31, 1992.

	Revenue effects (billions of dollars)					
	1993	1994	1995	1996	1997	1993-97
Repeal possessions tax credit	1.7	3.1	3.3	3.4	3.6	15.0

A U.S. corporation may elect to claim the possessions tax credit if at least 80 percent of its gross income for the last three years is sourced to Puerto Rico or another U.S. possession and at least 75 percent of this income is from the active conduct of a trade or business. The possessions tax credit is intended to promote employment in Puerto Rico and other U.S. possessions, and studies indicate that a substantial fraction of all manufacturing employment in Puerto Rico takes place in corporations claiming the possession tax credit.[20] However, one effect of the possessions tax credit appears to be the encouragement of the reallocation of income generated by intangible assets (e.g., patents) to sources located in U.S. possessions. This artificial reallocation of income does not, by itself, promote employment in the possessions, and may be viewed as an inefficient use of society's resources. When viewed in the context of revenue foregone per job created, the possessions tax credit is sometimes considered an expensive economic development tool. For instance, a recent report by the General Accounting Office has estimated that the average amount of tax benefits received by firms in the drug industry (a major user of the possession tax credit) in 1989 was over $70,000 per job created.[21]

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20 For example, see Internal Revenue Service, U.S. Possessions Corporation Returns--1987, _Statistics of Income Bulletin_, Summer 1991.

21 General Accounting Office, _Pharmaceutical Industry: Tax Benefits of Operating in Puerto Rico_, GAO/GGD-92-72BR, May 1992.

IV. POSSIBLE CONSUMPTION TAX INCREASES

A. Impose a Narrow-Based Federal Value-Added Tax

The proposal would impose a 5-percent value-added tax on consumption, with exemptions for food, housing, and medical care. The proposal would be effective as of January 1, 1994, due to the lead time needed to implement a Federal value-added tax.

	Revenue effects (billions of dollars)					
	1993	1994	1995	1996	1997	1993-97
5-percent value-added tax on narrow consumption base	--	47.0	70.7	73.0	77.0	267.0

A Federal value-added tax has approximately the same economic effect as a national level retail sales tax. This means that a value-added tax would discourage consumption of the affected goods and services, and generally would encourage saving over current consumption. The burden of this tax is generally believed to fall on those individuals purchasing taxed goods and services. When compared to annual income, a value-added tax is regressive, since the relative burden is larger for those who consume all, or nearly all, of their annual income. When compared to a measure of lifetime income, a value-added tax is more nearly proportional, since nearly all taxpayers consume the vast bulk of their lifetime income.[22] Imposition of a value-added tax would be expected to cause a one-time increase in consumer prices, and hence, measured inflation. However, assuming the Federal Reserve reacted to accommodate this price increase, there would not be an acceleration in ongoing inflation. Most countries have chosen to implement a value-added tax instead of a national level sales tax (even though both have very similar economic effects) since there is less scope for tax evasion under the multi-stage collection procedures inherent in a value-added tax. However, the administrative costs of starting a new tax system would be substantial. Accordingly, conventional wisdom is that if a value-added tax is adopted, the rate should be sufficiently high (say, 5 percent) to offset the initially large start-up costs.

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[22] See, for example, Congressional Budget Office, Effects of Adopting a Value-Added Tax, February 1992.

B. Impose a Broad-Based Energy Tax

The proposal would impose a 5-percent ad valorem excise tax on a broad class of energy purchases. Conceptually, this tax would be a retail level tax on all consumption of energy (e.g., coal, petroleum, natural gas, electricity). The tax would apply to all energy purchases on or after October 1, 1992.

	Revenue effects (billions of dollars)					
	1993	1994	1995	1996	1997	1993-97
5-percent ad valorem tax on all energy consumption	13.4	16.6	17.4	18.2	19.0	84.6

A broad-based energy tax could be justified as correcting the externality caused by the market price of energy being below its social cost (e.g., social costs due to pollution caused by energy consumption). The proposed excise tax would make energy purchases more costly in relative terms than other types of consumption. This would encourage conservation of all forms of energy, potentially limiting emissions of carbon dioxide, often cited as a "greenhouse gas". To the extent the tax is borne by firms that consume energy in the production process, U.S. manufacturers may be put at a competitive disadvantage relative to foreign firms that operate in jurisdictions without such energy taxes. Mitigating this potential effect, though, is the observation that almost all other countries tax energy consumption more heavily than does the United States.

Generally, it is believed that much of the burden of an excise tax on energy consumption would be passed forward in the form of higher prices to consumers of energy. To the extent that energy consumption increases less than proportionately with income, this excise tax would be regressive with respect to annual income. This larger relative consumption of energy among lower-income individuals could be the case if these individuals are unable to easily shift to more energy-efficient heaters, automobiles, and/or appliances.

This excise tax could be imposed as a retail level tax on all energy sales. Such a point of imposition would have the beneficial effect of not altering relative prices for different energy sources, thereby minimizing market distortions. However, a retail level tax would entail many more taxpayers being brought into the excise tax system than if the tax were imposed at the producer level. In this case, administrative costs must be weighed against efficiency costs in choosing the point where the tax is levied.

C. Increase Motor Fuel Excise Taxes

The excise taxes on motor fuels (currently 14.1 cents per gallon for gasoline and 20.1 cents per gallon for diesel fuel) could be increased by 12 cents per gallon. The proposal would be effective on October 1, 1992.

	Revenue effects (billions of dollars)					
	1993	1994	1995	1996	1997	1993-97
Increase motor fuels taxes by 12 cents per gallon	10.9	11.0	10.8	10.9	11.2	54.8

More than 25 percent of total energy consumption in the United States is attributed to transportation, the bulk of which is motor fuels consumption. Increasing the excise taxes on motor fuels would provide encouragement for conservation of these energy sources, reducing U.S. dependence on imported petroleum.

Generally, it is believed that much of the burden the motor fuels excise tax is passed forward in the form of higher prices to consumers. To the extent that motor fuels consumption increases less than proportionately with income, this excise tax will be regressive with respect to annual income. This larger relative consumption of motor fuels among lower-income individuals could be the case if these individuals drive less energy-efficient automobiles. To the extent that consumption of motor fuels is larger in some regions of the country than others, this proposal might be considered regionally non-neutral. For example, it is often asserted that residents of western States drive much greater distances than do residents of more densely populated eastern States.

An increase in the tax rates for motor fuels that is intended to promote conservation might have its effect blunted somewhat if the various exemptions for motor fuels taxation are maintained. For instance, State and local government use of motor fuels is tax-exempt, as is off-road use (e.g., farming). It might be appropriate to extend the increase in motor fuels taxes to these currently exempt uses.

D. Increase Excise Tax Rates on Alcoholic Beverages

The proposal would increase all alcoholic beverage excise taxes to the equivalent of $16.00 per proof gallon, effective on October 1, 1992.

	Revenue effects (billions of dollars)					
	1993	1994	1995	1996	1997	1993-97
Increase excise tax rates on all alcoholic beverages to $16.00 per proof gallon equivalent	5.0	4.9	4.9	4.9	5.0	23.5

Current Federal excise taxes on beer and wine are significantly lower than the tax on distilled spirits on an equivalent alcohol content basis. The current tax on distilled spirits of $13.50 per proof gallon is a tax of about 21 cents per ounce of alcohol. This compares to a tax rate of about 10 cents per ounce of alcohol for beer (assuming an average alcoholic content of 4.5 percent for beer) and a tax rate of about 8 cents per ounce of alcohol for table wine (assuming an average alcoholic content of 11 percent for table wine). A tax of $16.00 per proof gallon on all alcoholic beverages would result in a tax of about 25 cents per ounce of alcohol.

Studies have indicated that the direct and indirect social costs ("external costs") from alcohol consumption are much higher than the revenues currently generated from alcohol excise taxes.[23] Increasing the alcoholic beverage taxes could help discourage consumption of alcoholic beverages and reduce some of the external costs of alcohol consumption.[24]

Although excise taxes are generally viewed as regressive, the alcoholic beverage taxes are imposed on discretionary purchases as compared to necessities for lower-income persons. From a public policy perspective, it could be argued that alcoholic beverage taxes should be

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23 W. Manning, E. Keeler, J. Newhouse, E. Sloss, and J. Wasserman, "The Taxes of Sin: Do Smokers and Drinkers Pay Their Way?", Journal of the American Medical Association, Vol. 261, No. 11, March 17, 1989.

24 Philip Cook and George Tauchen, "The Effect of Liquor Taxes on Heavy Drinking", Bell Journal of Economics, Vol. 13, No. 2, Autumn 1982.

imposed at equivalent rates based on alcohol content, since the major types of alcoholic beverages often are substitutes for each other.

In addition, the excise tax on alcoholic beverages could be indexed for future inflation. This alternative proposal is not reflected in the above revenue estimates.

E. Increase Excise Tax on Cigarettes

The proposal would increase the scheduled excise tax rate for cigarettes on January 1, 1993, from 24 cents per pack (of 20 cigarettes) to 48 cents per pack. (The current law tax is scheduled to increase from 20 cents to 24 cents per pack on January 1, 1993.)

	Revenue effects (billions of dollars)					
	1993	1994	1995	1996	1997	1993-97
Increase excise tax on cigarettes to 48 cents per pack	2.9	3.9	3.8	3.8	3.7	18.1

The current Federal cigarette excise tax rate is imposed at a flat rate per unit, rather than being adjusted to reflect inflation. Although the cigarette tax rate was increased from 16 cents to 20 cents per pack on January 1, 1991, and is scheduled to be increased further to 24 cents per pack on January 1, 1993, the effective rate (in real terms) is still much lower than it was in 1951 (the excise tax rate for 1951 translated to 1992 dollars would be approximately 42 cents per pack).

Studies have indicated that there are significant direct and indirect social costs ("external costs") associated with cigarette smoking as well as governmental health expenditures attributable to cigarette-related diseases.[25] Increasing cigarette excise taxes could discourage consumption and might prevent people from starting to smoke, which would reduce long-term health costs and premature deaths associated with smoking.

While excise taxes generally are viewed as regressive, cigarette excise taxes are imposed on discretionary purchases rather than necessities for lower-income persons. This may ameliorate the concern with the regressive nature of this proposal.

In addition, the excise tax on cigarettes could be indexed for future inflation. This alternative proposal is not reflected in the above revenue estimate.

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25 Manning, et al, "The Taxes of Sin: Do Smokers and Drinkers Pay Their Way?".