ESTIMATES OF FEDERAL TAX EXPENDITURES

PREPARED FOR THE

COMMITTEE ON WAYS AND MEANS

AND THE

COMMITTEE ON FINANCE

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OF THE

TREASURY DEPARTMENT

AND

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

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TAX EXPENDITURES

INTRODUCTION

This is the third report on tax expenditures prepared by the staff of the Joint Committee on Internal Revenue Taxation. Each of these reports has been prepared with cooperation by the staff of the Treasury Department in estimating the revenue loss from each of the enumerated tax provisions.

The staffs of the Treasury Department and the Joint Committee on Internal Revenue Taxation prepared two earlier reports[1] for the Committees on Ways and Means and Finance following a statement by the conferees on the Revenue Act of 1971 that the conference committee understood tax expenditure data would be submitted regularly to Congress.

An earlier version of this report was prepared to conform with the requirements of the Congressional Budget Act of 1974, and that report was included in the report to the Committees on the Budget by a special staff working group.

THE CONCEPT OF TAX EXPENDITURES

Tax expenditure data are intended to show the cost to the Federal Government, in terms of revenues it has foregone, of tax provisions that either have been enacted as incentives for the private sector of the economy or have that effect even though initially having a different objective. The tax incentives usually are designed to encourage certain kinds of economic behavior instead of employing direct expeditures or loan programs to achieve the same or similar objectives. These provisions take the form of exclusions, deductions, credits, preferential tax rates, or deferrals of tax liability.

Widely different point of view exist about the tax expenditure concept.[2] They range from views that merely list a series of tax provisions that are alternatives to direct expenditures and loan programs to those which view as tax expenditures any departure from a definition of a comprehensive tax base or departures from a definition of net income that only permits deduction of the business costs of earning net income. Alternatively, a concept of "normal" tax structure also has been mentioned as an appropriate base for determining tax expenditures.

The staff has not attempted to make its own determination of what should be classified as tax expenditures. Instead, in this report it includes as tax expenditures virtually all of those categories which under

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[1] Committee on Ways and Means, *Estimates of Federal Tax Expenditures*, October 4, 1972, and June 1, 1973.

[2] See the article and response on the subject in the *National Tax Journal*, vol. XXII: Bittker, "Accounting for Federal Tax Subsidies in the National Budget," pp. 244–261, and Surrey and Hellmuth, "The Tax Expenditure Budget—Response to Professor Bittker," pp. 528–537. The General Accounting Office soon will publish a report on the concept and measurement of tax expenditures.

almost any of the prior listings have been characterized as tax expenditures. As a result, in this report a broad view is taken of what constitutes tax expenditures. Listing an item as a tax expenditure here can be viewed as merely part of a process of providing information. As a result the listing becomes a catalog of past public policy decisions accompanied by estimates of their effects upon budget receipts. No judgment is made about the desirability of any specific provision as public policy or about the effectiveness of the tax approach relative to other methods of carrying out the particular public policy goals affected.

In this report, essentially a tax expenditure is described as a tax incentive that departs from simply allowing deductions from gross income of the costs incurred in earning net income. This allows deductions for current expenditures directly related to the process of earning income, and therefore these expenditures are not treated as tax expenditures. These deductions are treated as business costs, and they are deducted on returns filed by corporations, partnerships and individual proprietorships. On these returns, capital costs create complications because by their nature they are not incurred entirely in one year. The basic tax provision allows depreciation ratably (i.e., straight-line depreciation) over the useful life of the asset, but tax law also permits accelerated depreciation to allow faster capital recovery through shorter lives and/or faster rates of depreciation. Such faster tax treatment of capital costs is classified as a tax expenditure; in this report, those items appear as accelerated depreciation, asset depreciation range (ADR), percentage depletion allowances (in excess of cost depletion), and current expensing of costs that otherwise would be capitalized.

Individuals who are employees rather than carrying on their own business have analogous business-type deductions which also are not classified in this report as tax expenditures. The expenses referred to are those which are incurred in earning net income, e.g., the cost of his tools that a mechanic uses. Most other deductions which individuals take on their tax returns represent personal consumption expenditures. They reflect public policy decisions not to tax income needed for basic living expenses or to facilitate specific types of consumption spending and are therefore generally classified here as tax expenditures. (As noted below an exception to this rule is made for personal exemptions and the minimum standard deduction.) Individual tax expenditures also include various kinds of income, e.g., social security payments to the aged, dependents and survivors, which are tax-exempt income but would become components of adjusted gross income from which taxable income is derived in the absence of the provision for tax exemption.

Tax expenditures enumerated in this report and in Special Analysis F of the Budget for Fiscal Year 1976 [3] generally coincide with the items covered in the earlier reports by the Joint Committee staff. This report also includes ADR and deferral of income of controlled foreign corporations which were omitted from the special analysis but were included in the earlier reports by the Joint Committee staff. In addition,

[3] "Tax Expenditures," Special Analysis F, *Special Analyses of the Budget of the United States Government for Fiscal Year 1976*, pp. 101–117.

this report includes two items omitted from all the earlier reports, namely, the 50 percent maximum tax on earned income and the taxation of accrued capital gains at death.

Asset depreciation range (ADR) is a form of accelerated depreciation that enables the taxpayer to recapture the costs of personal property over a shorter period of time than is permitted with existing guidelines lives. ADR differs in form rather than in concept from accelerated depreciation which allows higher rates of depreciation in the earlier years of an asset's useful life (than is possible using straight-line depreciation).

Usually it is suggested income of controlled foreign corporations is deferred for tax purposes in order to permit U.S. corporate subsidiaries to compete as tax equals in foreign countries without the disadvantage of having additional taxes imposed by the U.S. Government. Income earned abroad by individuals that exceeds a specified exclusion is taxed. The exclusion is favored by the proponents of the provision as a way to encourage individuals to work abroad in subsidiaries of U.S. corporations. To some extent the income of foreign corporations is taxed currently in subpart F, and in a similar way foreign personal holding companies also are taxed currently. Of course, dividends from foreign subsidiaries generally are also taxed when received by the U.S. shareholder, but this may be much later than when the income is earned. (See the section below, on the Tax Reduction Act of 1975 for permanent changes in the foreign tax area.)

The maximum tax (50 percent) on earned income is a preferential rate of tax that was enacted in the Tax Reform Act of 1969 (fully effective in 1972) to encourage high income individuals not to resort to tax shelter schemes in order to reduce their average rate of taxation. The preferential rate (20 percentage points below the highest marginal tax rate of 70 percent) was designed to offset some of the advantages of using tax shelters and to decrease the amount of income subject to loss in risky tax shelters.

Capital gains accrued on assets up to the time of death are not taxed even though the assets are passed on to the heirs. At the time of the transfer, the heirs receive the assets with a step-up in basis, that is, their basis is the valuation of the asset at approximately the time they take possession. When the heir assumes possession of the asset with a current basis, he is in the same position for tax purposes as he would have been had he purchased the asset at the current market price. It could be argued that unrealized capital gains generally should be included in tax expenditures in a recognition of the deferral of tax that is occurring, but they are not so included in this report. However, capital gains at death are included since the absence of any tax on the gains at death (and the provision for a step-up in basis at that time) converts the deferral into a permanent exemption from taxation. On the other hand it is recognized that many view the estate tax which is imposed at the time of death as a substitute for the tax on capital gains at death. The estimate of the capital gains at death is based on the assumption that the income tax, including the capital gains tax, is paid before the estate tax and reduces the estate tax base.

A number of tax provisions are not treated as tax expenditure items which many may believe should be so classified. One such item is the structure of graduated tax rates and taxable income brackets in the individual income tax and separate tax structures for single persons, married persons filing separately, heads-of-households and income splitting for married persons. Other such items are the personal exemption—one per taxpayer and dependent—and the minimum standard deduction. On the other hand included as tax expenditures are the additional personal exemptions for the aged and blind, itemized personal deductions, and the excess of the percentage standard deduction over the minimum standard deduction.

In the business tax area, the combined corporate normal and surtax tax rate is not classified as a tax expenditure. The surtax exemption is treated as a departure designed to foster small corporations and therefore is treated as a tax expenditure.

There is no provision for negative tax expenditures, and no provisions are classified as disincentives. Thus, the corporate surtax rate is treated as the basic provision and not a departure from the normal tax. The limitation on the deduction of a net long-term capital loss is a limit to the incentive made available through the special treatment for capital gains.

Imputations of income in kind received from the services of durable assets are not treated as income in the tax code and are not here classified as tax expenditures. They might be considered as income under other concepts of income for tax purposes. Measurement of the imputed income-in-kind would be a formidable task. The imputed income from an owner-occupied home is the most prominent of these items, and among the others are the income that could be imputed to household furniture and appliances, books and art collections and automobiles.

Foreign tax credits are not classified here as tax expenditures since they are generally considered as the way of taking into account the interrelationship of domestic and foreign tax systems. In addition this analysis does not attempt to go behind the current legal acceptance and attribution of payments by U.S. corporations to foreign governments as taxes (e.g., it does not attempt to treat any as royalties as in the case of oil income), when the payments are designed in that way by those governments. Treating credits for some of these payments as tax expenditures might be appropriate, but they would be difficult to measure.

MEASUREMENT OF TAX EXPENDITURES

Estimates of tax expenditures are difficult to determine and are subject to important limitations.

Each tax expenditure is measured in isolation. The amount of the deduction is added back in the calculation of taxable income, which raises the level of taxable income. The difference in tax liabilities between the existing structure of tax rates and this new higher level of tax liabilities is taken as the amount of the tax expenditure. For this computation, it is assumed that nothing else changes: neither the behavior of the taxpayer, nor the economic variables that might signal an adjustment in business behavior, nor tax, fiscal or monetary policies.

There are other limitations to this kind of analysis.

First, if two or more items were to be eliminated, the result of the combination of changes being made at the same time might produce a lesser or greater revenue effect than the sum of the amounts shown for each item individual. This means that the addition of the various tax expenditure items is of limited usefulness. This is why totals are not shown for table 1, except in a footnate.

Second, the estimates for the various tax expenditure items do not take into account any effects that the removal of one or more of the items might have on investment patterns, consumption, or other aspects of economic activity. In other words, the estimates shown do not take into account the induced effects of changing the provisions. Repeal of a provision, therefore, would not necessarily raise the revenue associated with removal of that provision.

Third, in some cases if a tax expenditure item were to be eliminated, it is probable that Congress would, at least to some extent, desire to deal with the underlying problem by a direct expenditure or loan program. The effect of any such program is not taken into account in the estimates shown. A direct expenditure could become a tax expenditure if it takes the form of a payment to an individual or business that is not included in income subject to taxation. In addition, if some of these provisions were removed from the tax laws, this removal might be accompanied by revisions in tax rates, personal exemptions or the minimum standard deduction, as has happened in the past. Other fiscal and monetary policies might be adopted to offset a tax change. This has not been taken into account in the estimates.

Fourth, tax expenditure items which have been added to the tax law recently do not become fully effective until the lapse of several years. As a result, the eventual annual cost of some items is not fully reflected until some time in the future. Conversely, if various items now in the law were to be eliminated, it is unlikely, in many cases, that the full revenue effects shown would be realized until an extended period of years had passed.

Fifth, differences in personal income levels and corporate profits can also account for differences in the cost of tax expenditure items from year to year. Also, some tax expenditure items themselves may be larger or smaller from year to year, wholly independent of tax considerations.

Sixth, in the case of many of the items, especially those for which information is not available on tax returns, the lack of data makes estimates quite tenuous. Where information is not available on tax returns, it is necessary to obtain information from whatever sources are available and, when sources are limited, to make assumptions on which to base the estimates.

TAX EXPENDITURES BY FUNCTIONAL CATEGORY

To aid analysis of the economic benefits provided through the tax laws to various sectors of the economy, the costs (tax expenditures) and beneficiaries (in terms of area of activity) are grouped in table 1 in the same functional categories as outlays in the Federal budget. Where possible and relevant, estimates are shown separately for individuals and corporations. Tax expenditures which do not fit into any of the budget functional categories have been placed in three functional categories added to those in the budget: business investment, personal investment and other tax expenditures.

The staff of the Joint Committee had hoped to show the benefits conveyed to individuals by several of the tax expenditures in frequency distributions according to adjusted gross income class, but it has not been possible to compile the statistical data within present time requirements. It is hoped that in subsequent pamphlets on tax expenditures, it will be possible to classify tax expenditures by income levels.

TAX EXPENDITURE EFFECTS OF THE TAX REDUCTION ACT OF 1975 (P.L. 94–12)

The Tax Reduction Act of 1975 contained both temporary and permanent changes in tax law which change the estimates of tax expenditures for the fiscal years 1975 and 1976. In the characterization of items as tax expenditures no distinction was made between those changes which were temporary and those which were permanent. The provisions that are considered to be tax expenditures are summarized in the text below and in table 2. In several cases, tax expenditure estimates are grouped because separate estimates for each provision are not available.

Changes affecting individuals

The percentage standard deduction was increased from 15 percent of adjusted gross income (AGI) with a maximum deduction of $2,000 to 16 percent of AGI with a maximum deduction of $2,300 for single persons and $2,600 for married persons ($1,300 for married persons filing separate returns). The increase is temporary and applies to taxable years ending during calendar year 1975. Its induced effects on other tax expenditure items was not estimated, e.g., a smaller total of deductions for mortgage interest (or property tax) payments on owner-occupied homes as some taxpayers find the higher standard deduction more valuable.

Low-income families with dependent children will receive a refundable tax credit of 10 percent of earned income (wages and self-employment income) up to $4,000. The maximum credit of $400 will phase out at the 10-percent rate on earned income between $4,000 and $8,000, falling to zero at $8,000. The credit will be available to married persons who file a joint return. The provision applies to taxable years that begin during 1975. This credit is classified as a tax expenditure.

A permanent amendment to the child and dependent care deduction raises the income limitation from $18,000 to $35,000. The maximum deduction of $4,800 a year now will be phased out completely at an AGI of $44,600. This is classified as a tax expenditure increase.

An individual who sells his principal residence and reinvests the proceeds in a second principal residence within 18 months (formerly one year) can defer the tax on his capital gain until he sells the second residence. Where the taxpayer constructs a new principal residence, the capital gains tax may be deferred if the newly constructed residence is purchased within 24 months (formerly 18 months) of the sale of the old residence. This is classified as a tax expenditure which slightly increases an existing tax expenditure. It applies to sales of residences after December 31, 1974.

For the purchase of a new principal residence, a taxpayer can receive a tax credit of 5 percent of the purchase price, to a maximum $2,000 credit. Generally, the credit applies to the purchase of a new principal residence after March 12, 1975, and before January 1, 1977. This is classified as a tax expenditure.

The work incentive (WIN) credit is modified for 1975 (after the date of enactment) to cover certain welfare recipients. This is classified as a tax expenditure.

Changes affecting business

The investment credit for purchases of machinery and equipment was increased to 10 percent for all investors, including public utilities. The increase applies to property placed in service before January 1, 1977, or to the portion of the property's basis constructed before that date. Public utilities, in addition to the increase from 4 percent to 10 percent, may offset 100 percent of tax liability with the credit in 1975 and 1976, and the limitation will decline by 10 percentage points each year beginning in 1977 and will revert to the generally applicable 50 percent limit in 1981. The limitation on the credit for investment in used property will increase to $100,000 for 1975 and 1976 and return to $50,000 in 1977. The foregoing are classified as changes in tax expenditures. Another new tax expenditure is the allowance of the investment credit on progress payments on property that requires at least 2 years for construction and has a useful life of 7 or more years. This is a permanent change.

The corporate surtax exemption is increased from $25,000 to $50,000, and the normal tax rate on the first $25,000 is reduced from 22 percent to 20 percent. The former is treated as a tax expenditure for 1975.

The accumulated earnings credit is increased permanently from $100,000 to $150,000 and is classified as a tax expenditure.

Percentage depletion for oil and gas is repealed for large producers. It is retained for small producers but is phased down. The exemption for small producers falls 200 barrels a day for 5 years (1976–1980), from 2,000 barrels a day to 1,000 barrels a day. The 22 percent depletion rate is maintained for those 5 years, and then falls to 15 percent by 2 percentage points a year from 1981 through 1984 when it reaches 15 percent. Analogous small producer exemptions are provided for natural gas. This is classified as a reduction in tax expenditures.

Undistributed income of foreign subsidiaries in tax haven operations will be subject to current taxation. This ends a deferral of taxation that was possible so long as certain minimum distribution requirements were met. This is classified as a reduction in tax expenditures that is effective after December 31, 1975.

The deferral of current taxation on tax haven income, if dividends are reinvested in a less developed country, also was repealed after December 31, 1975. This is classified as a reduction in tax expenditures.

The deferral of taxation on foreign shipping subsidiaries would be continued only to the extent the shipping profits are reinvested in shipping operations. This is classified as a reduction in tax expenditures effective after December 31, 1975.

Tax haven income will be taxed currently if it is equal to or greater than 10 percent of gross income. This is classified as a reduction in tax expenditures effective after December 31, 1975.

DISC benefits are repealed for export sales of natural resources, energy products and products subject to export control under the Export Administration Act of 1969. The repeal applies to sales after March 18, 1975, in taxable years ending after that date. This is classified as a reduction in tax expenditures.

The investment credit is repealed for drilling rigs used outside of the northern part of the Western Hemisphere. This is classified as a reduction in tax expenditures.

Estimates of the revenue effects of the Tax Reduction Act are included in table 1 and are noted.

TABLE 1.—TAX EXPENDITURE ESTIMATES, BY FUNCTION [1]

Fiscal years; [In millions of dollars]

Description	Corporations 1974	Corporations 1975	Corporations 1976	Individuals 1974	Individuals 1975	Individuals 1976
National defense:						
Exclusion of benefits and allowances to Armed Forces personnel				650	650	650
Exclusion of military disability pensions				65	75	85
International affairs:						
Exclusion of gross-up on dividends of LDC corporations	55	55	55			
Exclusion of certain income earned abroad by U.S. citizens				90	95	100
Deferral of income of domestic international sales corporations (DISC) [2]	870	1,061	1,288			
Special rate for Western Hemisphere trade corporations	50	50	50			
Deferral of income of controlled foreign corporations [2]	590	590	525	30	30	27
Agriculture:						
Expensing of certain capital outlays	170	145	155	580	480	495
Capital gain treatment of certain income	30	20	25	520	280	340
Natural resources, environment and energy:						
Expensing of exploration and development costs	750	950	1,235	80	100	130
Excess of percentage over cost depletion [2]	1,815	1,717	874	305	367	411
Capital gain treatment of royalties on coal and iron ore	5	15	20			
Timber: capital gain treatment of certain income	130	145	155	55	60	60
Pollution control: 5-year amortization	35	30	20			
Commerce and transportation:						
$25,000 corporate surtax exemption [2]	3,270	3,668	3,572			
Deferral of tax on shipping companies	35	35	40			
Railroad rolling stock: 5-year amortization	70	60	55			
Bad debt reserve of financial institutions in excess of actual	1,000	1,030	980			
Deductibility of nonbusiness State gasoline taxes				865	850	850
Community and regional development:						
Housing rehabilitation: 5-year amortization	35	45	35	50	70	60
Credit for purchasing new home [2]						625
Education, manpower and social services:						
Child care facilities: 5-year amortization	5	5	5			
Exclusion of scholarships and fellowships				195	210	190
Parental personal exemption for student age 19 and over				655	670	690
Deductibility of contributions to educational institutions	155	160	155	355	405	435
Deductibility of child and dependent care expenses [2]				230	240	260
Credit for employing public assistance recipients under work incentive (WIN) program [2]	5	5	5			1
Health:						
Exclusion of employer contributions to medical insurance premiums and medical care				2,940	3,340	3,745
Deductibility of medical expenses				2,125	2,375	2,630
Income security:						
Exclusion of social security benefits:						
Disability insurance benefits				235	260	280
OASI benefits for aged				2,530	2,655	2,940
Benefits for dependents and survivors				410	435	480
Exclusion of railroad retirement system benefits				160	170	180
Exclusion of sick pay				255	275	295
Exclusion of unemployment insurance benefits				1,050	2,370	3,830
Exclusion of workmen's compensation benefits				520	570	620
Exclusion of public assistance benefits				75	85	90
Net exclusion of pension contributions and earnings:						
Employer plans				4,790	5,200	5,740
Plans for self-employed and others				230	410	710
Exclusion of other employee benefits:						
Premiums on group term life insurance				680	740	805
Premiums on accident and accidental death insurance				40	45	50
Privately financed supplementary unemployment benefits				5	5	5
Meals and lodging				175	180	190
Exclusion of capital gains on house sales if over 65				10	10	10
Excess of percentage standard deduction over minimum standard deduction [2]				1,260	1,527	2,090
Additional exemption for the blind				15	15	15
Additional exemption for over 65				1,150	1,200	1,250
Retirement income credit				100	75	70
Earned income credit [2]						1,455
Veterans' benefits and services:						
Exclusion of veterans' disability compensation				485	525	550
Exclusion of veterans' pensions				25	30	35
Exclusion of GI bill benefits				290	255	250

TABLE 1.—TAX EXPENDITURE ESTIMATES, BY FUNCTION [1]—Continued

Fiscal years; [In millions of dollars]

Description	Corporations			Individuals		
	1974	1975	1976	1974	1975	197
General government:						
Credits and deductions for political contributions				10	25	50
Revenue sharing and general purpose fiscal assistance:						
Exclusion of interest on State and local debt	2, 8C5	3, 155	3, 505	1, 060	1, 160	1, 260
Exclusion of income earned in U.S. possessions	350	350	350	5	5	5
Deductibility of nonbusiness State and local taxes (other than on owner-occupied homes and gasoline)				6, 955	8, 820	9, 950
Business investment:						
Depreciation on rental housing in excess of straight line	105	115	120	375	405	420
Depreciation on buildings (other than rental housing) in excess of straight line	285	280	275	220	220	215
Expensing of research and development expenditures	605	630	660			
Capital gain: corporate (other than farming and timber)	745	595	755			
Investment credit [2]	3, 690	5, 006	7, 415	880	948	1, 392
Asset depreciation range	1, 135	1, 270	1, 440	125	140	150
Personal investment:						
Dividend exclusion				320	340	360
Capital gain: individual (other than farming and timber)				6, 150	3, 280	4, 165
Exclusion of capital gains at death				5, 000	4, 420	4, 550
Exclusion of interest on life insurance savings				1, 420	1, 620	1, 820
Deferral of capital gain on home sales				255	285	315
Deductibility of mortgage interest on owner-occupied homes				4, 870	5, 590	6, 500
Deductibility of property taxes on owner-occupied homes				4, 060	4, 660	5, 270
Deductibility of casualty losses				255	275	300
Other tax expenditures:						
Exemption of credit unions	105	115	125			
Deductibility of charitable contributions (other than education)	290	295	285	3, 820	4, 485	4, 840
Deductibility of interest on consumer credit				2, 435	2, 885	3, 460
Maximum tax on earned income				330	350	385

[1] All estimates are based on the provisions in the Internal Revenue Code as of Jan. 1, 1975.
[2] Includes effects in fiscal years 1975 and 1976 of the Tax Reduction Act of 1975. Separate estimates are pre:ented In table 2.

Note: Limitations on the use of totals are explained in the text. The totals (in millions of dollars) are:

Fiscal year	Total	Corporations	Individuals
1974	82, 015	19, 190	62, 825
1975	88, 844	21, 597	67; 247
1976	103, 310	24, 179	79, 131

TABLE 2.—TAX EXPENDITURE EFFECTS OF THE TAX REDUCTION ACT OF 1975, FOR FISCAL YEARS 1975 AND 1976

[In millions of dollars]

	Corporations		Individuals	
	1975	1976	1975	1976
Temporary increase in percentage standard deduction			157	670
5 percent new home credit				625
10 percent earned income credit				1, 455
Child care				−10
Investment credit	846	2, 995	43	442
Percentage depletion	−483	−1, 736	−3	−34
WIN				1
Reduce corporation normal tax rate to 20 percent	78	182		
Raise corporation surtax exemption to $50,000	360	840		
Modifying taxation of controlled foreign corporations:				
Repealing minimum distributions exception		−30		
Repealing reinvestment in less developed countries exception and modifying shipping income exception		−15		
Changing rule for classifying income of controlled foreign corporations		−23		
Denying DISC benefits for energy resources	−9	−32		