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THE PRESIDENT'S FISCAL YEAR 1979 TAX EXPENDITURE PROPOSALS

A Report to the
Senate and House
Committees on the Budget
—Supplement

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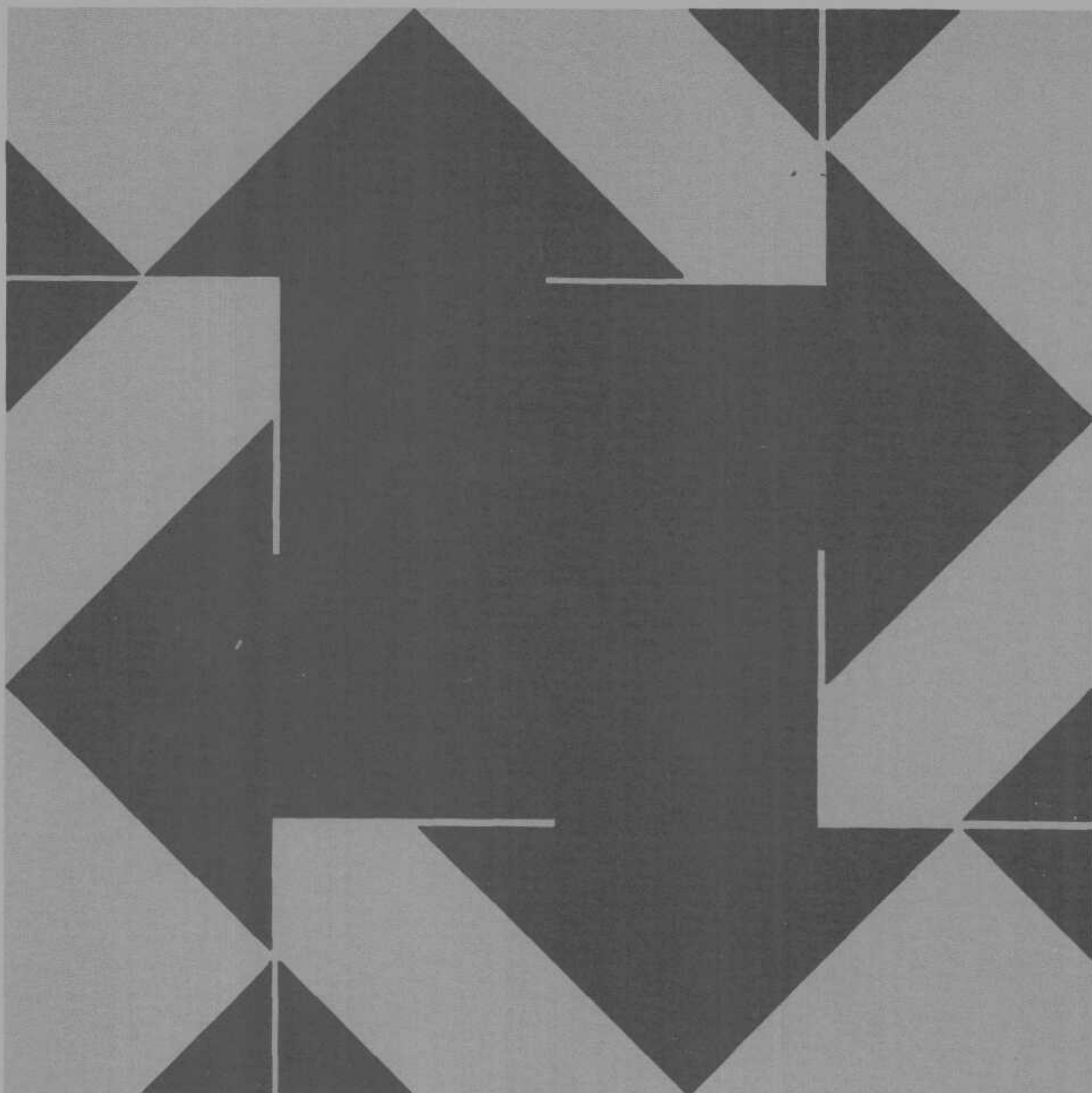

CONGRESS OF THE UNITED STATES

CONGRESSIONAL BUDGET OFFICE

THE PRESIDENT'S FISCAL YEAR 1979 TAX EXPENDITURE PROPOSALS

A Report to the Senate and House Committees on the Budget

The Congress of the United States
Congressional Budget Office

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PREFACE

In February 1978 CBO published Budget Strategies for Fiscal Years 1979-1983 as one of the documents prepared pursuant to section 202(f) of the Budget Act of 1974. This supplement to that report analyzes proposals for tax expenditures made by the President in The Budget of the U.S. Government for Fiscal Year 1979.

This report summarizes the effect of the President's proposed budget on the levels of tax expenditures. In accordance with CBO's mandate to provide objective analysis, the report offers no recommendations. It was prepared by Jonathan Bernstein of CBO's Tax Analysis Division.

Alice M. Rivlin
Director

April 1978

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INTRODUCTION

Tax expenditures are revenue losses from provisions of the tax law that provide special or selective tax relief. These revenue losses are called tax expenditures because they are very much like payments by the federal government, except that they are made through a reduction of taxes rather than by direct spending. If a business buys a machine costing $1,000, for example, the 10 percent investment tax credit allows the business to reduce its income tax by $100. Instead of allowing this credit, the government could collect this $100 as it does from other taxpayers, and then provide financial assistance by a government payment of $100.

A tax expenditure may provide tax relief in any of the following forms:

- Special exclusions, exemptions, and deductions, which reduce taxable income, and thus result in a lesser amount of tax (for example, tax-exempt municipal bond interest or the deduction of interest paid on consumer loans).

- Preferential rates, which reduce taxes by applying lower rates to part or all of a taxpayer's income (for example, the special 50 percent maximum tax rate on personal service income).

- Special credits, which are subtracted from the actual taxes due, rather than from the income on which the tax is figured (for example, the investment tax credit).

- Deferrals of tax, which generally result from allowing in the current year deductions that are properly attributable to a future year (for example, accelerated depreciation).

The tax relief offered by tax expenditure provisions is generally available to any taxpayer who meets the requirements of the tax law. Thus, a tax expenditure is analogous to an entitlement program on the spending side of the budget. The amount extended is not subject to any legislated limit but is dependent solely upon taxpayer response to the particular provision. In this respect, tax expenditures closely resemble spending programs that have no ceiling.

LEVELS OF TAX EXPENDITURES UNDER EXISTING LAW

There are 84 items in the fiscal year 1979 tax expenditure budget. 1/ As shown in Table 1, these provisions are expected to yield $101.8 billion in tax relief for individuals and $34.4 billion of tax savings for corporations in 1979 under existing law.

The President's budget proposals would reduce these levels by $16.6 billion for individuals and would raise them by $1.6 billion for corporations. He would achieve these results through a set of energy proposals first made in April 1977 and an extensive tax reform and reduction package submitted in January 1978. These proposals include both increases and reductions in the level of tax expenditures.

PROPOSALS INCREASING TAX EXPENDITURES

Energy Proposals

The April 1977 energy proposals had the dual purpose of stimulating production of fuel and conserving energy. The search for energy sources would be encouraged by reducing the tax burden on drilling activities. First, the President would permanently remove intangible drilling expenses from the minimum tax base. Second, the deduction for intangible drilling expenses would be expanded to include drilling for geothermal energy sources as well as for oil and gas.

1/ The Budget of the U.S. Government for Fiscal Year 1979, Special Analysis G, pp. 158-160 (Government Printing Office, Washington, D.C.)

TABLE 1. EFFECTS OF PRESIDENT'S TAX PROPOSALS ON THE LEVELS OF TAX EXPENDITURES IN FISCAL YEAR 1979: IN BILLIONS OF DOLLARS

	Individual	Corporate	Total a/
Level of Tax Expenditures Under Existing Law b/	101.8	34.4	136.2
Proposals Increasing Tax Expenditures			
Energy proposals	0.9	0.3	1.2
Investment tax credit changes	0.1	2.3	2.4
Proposals Decreasing Tax Expenditures			
Tax rate reductions	-13.3	-0.6	-13.9
Proposals to improve tax equity	- 0.2	-0.5	- 0.7
Proposals to improve tax simplification	- 4.1	--	- 4.1
Total Effect of President's Proposals	-16.6	+1.6	-15.0
Level of Tax Expenditures Under the President's Proposals a/	85.2	36.0	121.2

a/ Details may not add to totals because of rounding.

b/ All estimates are based on the tax code as of December 31, 1977.

Conservation of oil and gas fuels would be encouraged by a number of new tax credits. For individuals, tax credits were proposed for insulating residences and installing solar energy equipment. Businesses would benefit from an additional 10 percent investment tax credit for investment in equipment not using oil or gas, co-generation facilities, energy-conserving modifications of existing structures and equipment, and solar energy equipment.

Together, all of these recommendations would increase tax expenditures in fiscal year 1979 by $1.2 billion, with $900 million going to individuals and $325 million going to corporations.

Investment Tax Credit Changes

The new proposals in the January tax message were largely intended to stimulate the economy through a reduction of tax burdens. A part of the recommended reductions was focused on the capital goods sector by an expansion of the investment tax credit to cover industrial and utility structures. Under the proposal, the credit could offset 90 percent of a taxpayer's total tax liability, rather than 100 percent of the first $25,000 of tax liability and 50 percent of the remaining tax liability as is generally permitted under existing law. The full credit, instead of the existing one-half credit, would also be allowed on pollution-control facilities that are subject to rapid amortization. These changes in the investment tax credit would increase tax expenditures in fiscal years 1979 and 1983 by $2.4 billion and $2.6 billion, respectively. In 1979, individuals would receive $55 million of this special tax relief while corporations would gain $2.3 billion. By fiscal year 1983, the individual portion would rise to $82 million while the corporate share would be $2.5 billion.

PROPOSALS DECREASING TAX EXPENDITURES

In addition to the investment tax credit expansion, the President's January tax message proposed a number of broader tax measures to stimulate the economy. These more general measures include tax cuts to be achieved through tax rate reductions for both individuals and corporations. The revenue losses from these proposals were partially balanced by numerous equity and simplification proposals that would raise revenues selectively--largely by cutting back on tax expenditures.

Rate Reductions

General across-the-board rate reductions reduce tax expenditures. When rates are lower, the revenue loss from a special exclusion, deduction, rate, or deferral is less than it is under higher rates. For example, a $100 charitable contribution by a corporation paying the highest corporate rate would produce $48 of tax relief; if the top corporate rate were reduced to 44 percent as the Administration proposes, the tax benefit would be lowered to $44. The revenue loss associated with the charitable contribution thus would be reduced by $4, and the level of tax expenditures would be reduced even though the structure of the law and the tax expenditure provision had not been changed at all. General rate reductions are unusual in that they reduce both revenue and tax expenditures, while most provisions that reduce tax expenditures also raise revenue.

In fiscal year 1979, the recommended rate reductions would reduce revenues by $22.5 billion for individuals and by $4 billion for corporations. By fiscal year 1983, the revenue losses from rate reductions would be $38.5 billion for individuals and $10.3 billion for corporations. As shown in Table 1, however, these rate reductions would also result in reductions in the level of tax expenditures. In 1979, these rate reductions would reduce the level of tax expenditures by $13.3 billion for individuals and $0.6 billion for corporations.

Tax Equity and Simplification Proposals

Fourteen of the President's thirty new proposals in the January tax message were aimed at improving tax equity, and six of them were also intended to simplify the tax law significantly, largely for individuals. One of these proposals would cut back slightly on tax credits; one would remove a preferential tax rate; and the balance would reduce special deductions, exclusions, or deferrals.

Nearly all of these equity and simplification proposals would raise revenues, thereby balancing some of the revenue losses in other parts of the tax package. They are the only revenue-increasing proposals made by the President. All but two of the equity and simplification recommendations would reduce tax expenditures. 2/

As shown on Table 1, the President's proposals to improve tax equity would reduce tax expenditures by $.7 billion in 1979. They would raise $0.2 billion from individuals and $0.5 billion from corporations. The proposals to simplify the tax law would reduce tax expenditures by $4.1 billion in 1979. All of this would be raised from individuals.

OVERALL EFFECT

As shown in Table 1, under the President's proposals, individuals' tax expenditures would be reduced by $16.6 billion in 1979, while corporations' tax expenditures would b increased by about $1.6 billion. The greater part of the individual decreases is caused by the reduction in rates. Most of the balance results from the revenue-raising simplification proposals that would apply to deductions taken by individuals. Under the President's proposals, they would be fully effective on January 1, 1979.

In contrast to the proposed individual tax changes, the major revenue-raising reforms for corporations would be gradually phased in. Corporate rate reductions would also reduce tax expenditures. In fiscal year 1979, however, the effect of the corporate reforms and rate reductions on tax expenditures would be overwhelmed by the changes in the investment tax

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2/ The proposals dealing with entertainment expenses and with the taxation of certain annuity contracts do not affect the levels of identified tax expenditures.

credit, which would both increase corporate tax expenditures and be retroactive to January 1, 1978. In subsequent years, the rate of increase in corporate tax expenditures would decline as the reform provisions gradually became more stringent. Revenue gains from the individual provisions would not grow as rapidly because the gains would mainly stem from inflation and economic growth. Table 2 shows the revenue gain or loss associated with each tax expenditure proposal made by the President other than the proposals for rate reductions.

TABLE 2. EFFECT (+ OR -) OF EACH OF THE PRESIDENT'S TAX PROPOSALS FOR FISCAL YEAR 1979 (OTHER THAN RATE REDUCTIONS) ON TAX EXPENDITURE LEVELS: IN MILLIONS OF DOLLARS

	Individual	Corporation
Proposals Increasing Tax Expenditures		
Energy Proposals		
Residential thermal efficiency credit a/	+705	--
Residential solar energy credit	+100	--
Cogeneration credit	--	+ 60
Alternative energy credit	--	+ 10
Expensing of exploration and development cost for geothermal energy	--	+ 10
Business thermal efficiency credit	+ 95	+ 245
Subtotal	+900	+ 325
Investment Tax Credit Changes:		
Extension to structures	+ 55	+1,725
Increase limit to 90 percent	--	+ 397
Extension to pollution control equipment	--	+ 184
Subtotal	+ 55	+2,306

(continued)

TABLE 2. (Continued)

	Individual	Corporation
Proposals Decreasing Tax Expenditures		
Proposals To Improve Tax Equity		
Real estate tax shelters	- 9	- 18
Taxation of some unemployment compensation benefits	- 151	--
Changes in minimum tax b/	0	--
Taxable bond option	- 30	+ 7
Limit individual tax credits to 90% of tax before credits	- 7	--
Exclusion of qualified retirement plans	- 5	--
Corporate family farm accounting	--	- 18
Bad debt reserves		
Commercial banks	--	- 102
Mutual savings banks, savings & loans	--	- 17
Exemption of credit unions' income	--	- 10
Phase-out of DISC	--	- 249
Phase-out of deferral for controlled foreign corporations	--	- 40

(continued)

TABLE 2. (Continued)

	Individual	Corporation
At-risk rules	--	- 2
Group term life plans	--	- 14
Subtotal	- 202	- 463
Proposals To Improve Tax Simplification		
Repeal deduction for political contributions	- 1	--
Repeal alternative tax on capital gains	0	--
Repeal deductions for state and local gasoline taxes	- 603	--
Repeal deduction for state and local sales taxes	-1,734	--
Repeal deduction for miscellaneous taxes	- 398	--
Modify deduction for medical and casualty expenses	-1,336	--
Subtotal	-4,072	--
Grand Total	-3,319	+2,168

a/ The proposal would not apply to corporations.

b/ The proposal would affect individuals' tax expenditures in future years.