CBO PAPERS

AN ECONOMIC ANALYSIS OF THE REVENUE PROVISIONS OF OBRA-93

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CONGRESSIONAL BUDGET OFFICE

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SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

NOTE

The numbers in the text and tables of this paper may not add to totals because of rounding.

PREFACE

The Omnibus Budget Reconciliation Act of 1993 (OBRA-93) will increase federal tax revenues by $241 billion between 1994 and 1998. Major revenue-raising provisions in the act include raising marginal tax rates on the highest income individuals, increasing the taxation of Social Security benefits of middle- and upper-income retirees, raising taxes on transportation fuels, raising the top corporate income tax rate, and reducing a number of business deductions. These revenue gains are offset in part by revenue losses from provisions that expand the earned income tax credit for low-wage workers, extend a number of existing tax incentives, introduce some new tax preferences, and repeal some of the luxury excise taxes that were enacted in 1990. Overall, the tax changes in OBRA-93 will affect incentives to work, save, and invest; encourage some selected forms of economic activity; and alter the distribution of the tax burdens among income groups.

In this paper, the Congressional Budget Office (CBO) presents an economic analysis of the major revenue provisions of OBRA-93. The paper discusses how the act affects economic incentives, assesses some of the potential behavioral responses, provides estimates of changes in the distribution of the tax burden among taxpayers in different income and demographic groups, and discusses selected impacts of the act such as the effects on small business.

Eric Toder of CBO's Tax Analysis Division prepared the final draft of the paper, under the direction of Rosemary Marcuss. Mark Booth, Maureen Griffin, Matthew Melillo, Larry Ozanne, Linda Radey, Pearl Richardson, and David Weiner wrote sections of the paper on separate aspects of the legislation. Rick Kasten, Frank Sammartino, and David Weiner provided estimates of the distribution of the tax burden. James Blum, Leonard Burman, and Robert Dennis provided useful comments on earlier drafts of the paper.

Sherwood Kohn edited the manuscript and Christian Spoor provided editorial assistance. Simone Thomas prepared the paper for publication.

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CHAPTER I

INTRODUCTION

The Omnibus Budget Reconciliation Act of 1993 (OBRA-93) relies on tax increases for much of its reduction in the deficit. The Congressional Budget Office estimates that OBRA-93 will reduce the deficit by $433 billion between 1994 and 1998. Of this amount, $241 billion (56 percent) will come from increased tax revenues, $77 billion (18 percent) from cuts in mandatory spending, $69 billion (16 percent) from cuts in discretionary spending, and $47 billion (11 percent) from lower debt-service costs.

OBRA-93's changes in spending and taxation will reduce the amount of fiscal stimulus that the federal budget would otherwise supply. This tighter fiscal policy, unless offset by easier monetary policies, can slow the recovery in the short run by reducing demand for the economy's output by government and private consumers. At the same time, the reduced federal demand for private credit will keep interest rates lower than they would otherwise be and reduce the need to borrow from abroad. Lower interest rates and less foreign borrowing will increase both domestic investment and net exports. Ultimately, by increasing national saving and the accumulation of wealth, the lower deficits that OBRA-93 produces will increase U.S. living standards.

In addition to the macroeconomic effects of deficit reduction, the revenue provisions of OBRA-93 will change the distribution of tax burdens among income and demographic groups and alter incentives that affect work effort, saving, investment, and the composition of business activity. Through these incentives, the changes in the tax law will influence how efficiently the economy uses labor and capital.

The revenue provisions of OBRA-93 will raise $241 billion between 1994 and 1998 (see Table 1). This includes a $268 billion gain from provisions that raise revenue and a $28 billion revenue loss from other provisions. In addition, the expansion of the refundable portion of the earned income tax credit (EITC) increases mandatory spending by $19 billion in 1994-1998. Counting the full effect of the EITC, the tax reductions in OBRA-93 increase the deficit by $47 billion between 1994 and 1998, and all of the tax law changes combined reduce the deficit by $221 billion.[1]

1. Current budgetary procedures record the effects of the EITC in two places. The budget counts the part that offsets other tax liability as a reduction in revenue. But the budget counts the refundable portion--the amount of the credit that exceeds other tax liability for any taxpayer--as a budget outlay instead of a tax reduction. The budget convention is that no one pays a negative amount of taxes; net tax refunds are spending. The expansion of the EITC in OBRA-93 offsets other taxes by under $2 billion in the 1994-1998 period, but increases refundable credits by $19 billion.

TABLE 1. BUDGETARY SAVINGS FROM MAJOR TAX PROVISIONS OF OBRA-93
(By fiscal year, in billions of dollars)

	1994	1995	1996	1997	1998	Five-Year Total
Major Revenue-Increasing Provisions						
Increase tax rates paid by high-income individuals[a]	15.4	22.8	25.7	24.6	26.3	114.8
Repeal Hospital Insurance wage base cap	2.8	6.0	6.4	6.8	7.2	29.2
Increase taxable portion of Social Security benefits	1.9	4.6	5.3	6.0	6.7	24.6
Increase motor fuels tax by 4.3 cents per gallon	4.8	4.9	4.8	4.8	4.9	24.3
Increase corporate tax rate to 35 percent for taxable income above $10 million	4.4	2.8	2.9	3.0	3.2	16.4
Reduce deductible portion of business meals and entertainment expenses	1.8	3.1	3.3	3.4	3.6	15.3
Extend current 2.5 cents per gallon motor fuels tax	n.a.	n.a.	2.6	2.6	2.6	7.8
Extend and modify corporate estimated tax rules	2.1	0.4	0.1	4.3	0.9	7.8
Other revenue-increasing provisions	1.7	4.8	5.8	9.0	6.6	27.9
Total	34.9	49.4	56.9	64.7	62.1	268.0
Expansion and Simplification of the EITC						
Revenues	b	-0.2	-0.4	-0.5	-0.6	-1.7
Outlays	-0.2	-2.0	-4.4	-6.1	-6.4	-19.1
Total	-0.2	-2.2	-4.8	-6.7	-7.0	-20.8
Other Tax Incentive Provisions						
Extend low-income housing credit	-0.4	-0.6	-0.9	-1.3	-1.7	-4.9
Extend research and experimentation credit	-2.2	-1.2	-0.8	-0.4	-0.3	-4.9
Increase expensing amount for small business to $17,500	-2.3	-1.0	-0.7	-0.4	-0.2	-4.6
Eliminate ACE depreciation adjustment under corporate AMT	-0.3	-1.0	-1.1	-1.0	-0.9	-4.3
Provide passive loss relief for real estate professionals	-0.3	-0.5	-0.5	-0.6	-0.7	-2.6
Provide tax incentives for empowerment zones and enterprise communities	-0.3	-0.5	-0.5	-0.6	-0.6	-2.5

(Continued)

TABLE 1. CONTINUED

	1994	1995	1996	1997	1998	Five-Year Total
Other Tax Incentive Provisions (Continued)						
Extend mortgage revenue bonds and mortgage credit certificates	-0.1	-0.1	-0.2	-0.3	-0.3	-1.0
Other incentive provisions	-1.8	-0.7	-0.1	0.2	0.5	-1.9
Total	-7.6	-5.6	-4.9	-4.4	-4.2	-26.7
Other Revenue Provisions	-0.9	-0.2	-0.1	0.8	1.1	0.8
Summary of Revenue Changes						
Revenue-increasing provisions	34.9	49.4	56.9	64.7	62.1	268.0
Revenue loss from tax incentives	-7.6	-5.8	-5.3	-5.0	-4.8	-28.4
EITC	b	-0.2	-0.4	-0.5	-0.6	-1.7
Other tax incentives	-7.6	-5.6	-4.9	-4.4	-4.2	-26.7
Other revenue provisions	-0.9	-0.2	-0.1	0.8	1.1	0.8
Total revenue change	26.4	43.5	51.5	60.7	58.5	240.6
Increased Outlays from EITC	-0.2	-2.0	-4.4	-6.1	-6.4	-19.1
Net Budget Savings from Tax Law Provisions	26.2	41.5	47.1	54.6	52.1	221.5

SOURCE: Congressional Budget Office.

NOTE: OBRA-93 = Omnibus Budget Reconciliation Act of 1993; n.a. = not applicable; EITC = earned income tax credit; ACE = adjusted current earnings; AMT = alternative minimum tax.

a. Includes the imposition of new rate brackets of 36 percent and 39.6 percent; the increase in the tax rates and exemption amounts under the individual alternative minimum tax; and the extension of the itemized deduction limitation and personal exemption phaseout.

b. Less than $50 million.

Increases in income tax rates on high-income individuals are the largest single revenue item, producing about $115 billion in additional revenues between 1994 and 1998. OBRA-93 imposes new marginal income tax rates of 36 percent and 39.6 percent on high-income individuals, increases the tax rates under the alternative minimum tax (AMT) for individuals, and permanently extends the limitation on the use of itemized deductions and the phaseout of personal exemptions. Other major revenue-raising provisions repeal the cap on earnings subject to the Hospital Insurance payroll tax ($29 billion), increase the taxable portion of Social Security benefits for middle- and upper-income retirees ($25 billion), increase the motor fuels excise tax by 4.3 cents per gallon ($24 billion), increase the top corporate income tax rate to 35 percent ($16 billion), reduce the deductible portion of business meal and entertainment expenses ($15 billion), and extend the current 2.5 cents per gallon motor fuels tax beyond its scheduled expiration date of October 1, 1995 ($8 billion). Modification of the corporate estimated tax rules also raises $8 billion between 1994 and 1998, but this increase can be attributed to the one-time effect of advancing the timing of tax payments.

The largest single deficit-increasing tax provision is the expansion of the earned income tax credit for low-income workers ($21 billion, of which $19 billion is counted as an increase in outlays). The largest revenue-losing provisions are those that extend the low-income housing credit and the research and experimentation credit ($5 billion each), increase the annual amount of investment that small businesses can deduct immediately or "expense"--to $17,500 ($5 billion), eliminate the adjusted current earnings method of depreciation under the corporate alternative minimum tax ($4 billion), allow real estate professionals to claim passive losses ($3 billion), and introduce new tax incentives for investment and employment in empowerment zones and enterprise communities ($2 billion).

OBRA-93 includes many other provisions with smaller revenue consequences, but these provisions substantially affect some taxpayers and business decisions. The law extends several existing tax preferences that encourage selected forms of investment and employment, and eliminates or reduces other tax preferences and restricts deductions for some business expenses. It repeals the luxury tax on boats, aircraft, jewelry, and furs; indexes the luxury tax on automobiles for inflation; extends the 25 percent deduction for health insurance for self-employed individuals; and permanently removes gifts of appreciated property to charities from the AMT.

CHAPTER II

EFFECTS ON ECONOMIC INCENTIVES

The Omnibus Budget Reconciliation Act of 1993 substantially increases marginal tax rates on wages and ordinary income from capital (dividends, rent, interest, and business income) for high-income taxpayers. The changes affect incentives to work and save. OBRA-93 also includes provisions that encourage some investments and help some types of business organizations and activities.

CHANGES IN MARGINAL TAX RATES

Marginal tax rates determine how much the government claims on an additional dollar of ordinary taxable income or capital gains. Higher marginal tax rates reduce after-tax returns. As a result, they reduce incentives to work and save and increase incentives to take compensation in the form of tax-free fringe benefits, spend money on tax-deductible goods and services, shift savings to tax-exempt and tax-preferred assets, and defer realizations of capital gains. They also may reduce the amount of voluntary compliance with the tax law.[1] For very high income taxpayers, OBRA-93 increases marginal tax rates substantially on wages and ordinary income from capital, but only slightly on realized capital gains. On average, marginal tax rates remain the same or increase slightly on all three sources of income for all income groups with adjusted gross income (AGI) less than $200,000. Marginal tax rates on wages increase for some low-income taxpayers and decline for others.

Marginal Tax Rates on High-Income Taxpayers

The main provisions in OBRA-93 that change marginal tax rates for high-income taxpayers are the addition of two new tax brackets. OBRA-93 imposes a 36 percent marginal tax rate on joint taxpayers with taxable incomes over $140,000 and single taxpayers with taxable incomes over $115,000. It also imposes a 39.6 percent marginal tax rate on all taxpayers whose taxable incomes are over $250,000. Marginal tax rates for many high-income taxpayers are also increased by the permanent extension of the limitation on itemized deductions (called the Pease provision because it was originally proposed by Representative Donald Pease) and the phaseout of personal exemptions (PEP)

1. For a discussion of some of the behavioral responses to changes in tax policy, see papers in Joel Slemrod, ed., *Do Taxes Matter?* (Cambridge, Mass.: MIT Press, 1990).

in current law. Pease and PEP apply only to taxpayers above certain AGI levels. (These amounts are indexed to changes in the consumer price index.) In 1994, Pease raises the marginal rate for most taxpayers with AGI over $111,800; PEP raises the marginal rate for joint taxpayers with AGI between $167,700 and $292,700 and for single taxpayers with AGI between $111,800 and $236,800. For affected taxpayers in the 31 percent bracket, Pease raises the marginal rate by 0.93 percentage points and PEP raises the marginal rate by 0.61 percentage points per exemption. OBRA-93 also raises the maximum rate under the alternative minimum tax from 24 percent to 28 percent.

In addition to the increases in marginal income tax rates, OBRA-93 raises the marginal tax rate on wages and self-employment income for some high-income taxpayers by eliminating the ceiling on wages ($141,900 in 1994) subject to the hospital insurance (HI) payroll tax. The HI tax rate is currently 1.45 percent on both employers and employees. Assuming that employees bear the full economic burden of the tax, and taking account of the fact that the employer portion of the tax is deductible, eliminating the HI cap raises marginal tax rates on wages for the highest income taxpayers by about 2.3 percentage points.[2]

OBRA-93 did not change the current maximum marginal tax rate on capital gains of 28 percent. Some taxpayers, however, will face higher marginal tax rates on capital gains because of the extension of the Pease provision and the increase in the AMT. The Pease provision raises the marginal tax rate on capital gains from 28 percent to 28.84 percent for taxpayers with AGI over $111,800 who itemize their deductions. The change in the AMT raises the marginal tax rate on capital gains from 24 percent to 28 percent for some taxpayers who are subject to the AMT.

On average, these provisions in OBRA-93 raise marginal tax rates substantially on wages and other income for taxpayers with AGI over $200,000 (see Table 2). Marginal tax rates on wages increase from 30.9 percent to 42.1 percent, and marginal tax rates on other income (mostly dividends, interest, rent, and business income) increase from 30.5 percent to 38.9 percent. The larger change in the marginal tax rate on wages mostly reflects the effects of eliminating the HI cap.

2. The increase in marginal tax rates is less than the sum of the employer and employee tax rates because the 1.45 percent employer portion is not included in income for income tax or payroll tax purposes.

TABLE 2. SIMULATION OF AVERAGE MARGINAL TAX RATES BEFORE AND AFTER OBRA-93, AT 1994 LEVELS OF INCOME (In percent)

Adjusted Gross Income	Before OBRA-93[a]	After OBRA-93[b]
	Marginal Rate on Wages	
Less Than $10,000	16.7	17.6
$10,000-$20,000	30.1	31.2
$20,000-$30,000	30.2	31.7
$30,000-$40,000	31.9	32.0
$40,000-$50,000	31.3	31.5
$50,000-$75,000	31.9	31.9
$75,000-$100,000	31.0	31.0
$100,000-$200,000	31.6	33.9
$200,000 or More	30.9	42.1
Overall	30.7	32.1
	Marginal Rate on Capital Gains	
Less Than $10,000	2.2	2.3
$10,000-$20,000	12.0	12.5
$20,000-$30,000	17.1	18.5
$30,000-$40,000	21.9	23.8
$40,000-$50,000	20.1	22.9
$50,000-$75,000	25.2	25.9
$75,000-$100,000	27.2	27.3
$100,000-$200,000	27.5	28.5
$200,000 or More	27.4	28.3
Overall	24.9	25.8
	Marginal Rate on Other Income	
Less Than $10,000	6.6	8.5
$10,000-$20,000	16.4	17.5
$20,000-$30,000	17.3	18.8
$30,000-$40,000	19.6	19.9
$40,000-$50,000	18.8	19.4
$50,000-$75,000	24.8	25.0
$75,000-$100,000	27.9	28.0
$100,000-$200,000	29.6	31.5
$200,000 or More	30.5	38.9
Overall	22.9	24.7

SOURCE: Congressional Budget Office.

NOTES: Marginal tax rates are calculated on an individual basis using CBO's tax simulation model and are weighted by wages (first panel), capital gains (second panel), and other adjusted gross income (third panel). Marginal rates on wages reflect the combined effects of Social Security payroll and federal income tax rates. The other marginal rates reflect federal income tax only.

OBRA-93 = Omnibus Budget Reconciliation Act of 1993.

a. Before OBRA-93 law is simulated using the fully phased-in law. The personal exemption and itemized deduction limits are not in effect.

b. After OBRA-93 law is simulated using the 1996 values for the earned income tax credit.

By contrast, the marginal tax rate on capital gains for taxpayers with AGI over $200,000 increases only slightly: from 27.4 percent to 28.3 percent. Thus, OBRA-93 has only a small adverse effect on the incentive to realize capital gains. The differential in rates between capital gains and ordinary income from capital increases substantially, however. Before OBRA-93, the differential was about 3 percentage points. OBRA-93 increases it to 11 percentage points. But it remains far below the 30-percentage-point differential for high-income taxpayers that was in effect before the Tax Reform Act of 1986 (TRA-86). This larger differential increases the incentive for high-income taxpayers (those who currently realize most capital gains) to rearrange their investment portfolios in favor of assets that produce capital gains. It also increases the incentive for corporations to retain profits instead of distributing them.

Marginal Tax Rates on Low-Income Taxpayers

OBRA-93 changes marginal tax rates for low-income taxpayers, mainly by expanding the earned income tax credit. The EITC provides a wage subsidy (a negative marginal tax rate) on earnings up to a maximum eligible earnings limit (the subsidy range). The credit remains fixed for earnings between the maximum eligible earnings limit and the income level at which benefits begin to phase out (the maximum credit range). The EITC increases marginal tax rates in the earnings range at which the benefits phase out.

OBRA-93 expands the EITC by increasing the rates of the basic credit and making childless workers with income of up to $9,000 eligible for a reduced credit. When fully put into effect in 1996, the EITC rate under the new law, compared with pre-OBRA-93 law, increases from zero to 7.65 percent for low-income workers with no children, from 23 percent to 34 percent for workers with one child, and from 25 percent to 40 percent for workers with two or more children (see Table 3). The maximum credit (at 1994 levels of income) increases for all three categories of workers, as does the income level at which the credit begins to phase out. The phaseout rate increases for most workers, but declines slightly for workers with one child. The income at which all benefits phase out (and the EITC ceases to raise the marginal tax rate) increases for all three groups of workers.

TABLE 3. PROJECTION OF TAXPAYER RETURNS RECEIVING THE EITC BEFORE AND AFTER OBRA-93, FISCAL YEAR 1994

	Before OBRA-93[a]		After OBRA-93[b]	
	Marginal Rate from EITC (Percent)	Number of Returns (Millions)	Marginal Rate from EITC (Percent)	Number of Returns (Millions)
Phase-In Range				
No children	n.a.	n.a.	-7.65	1.6
One child	-23.00	2.3	-34.00	1.5
Two or more children	-25.00	1.6	-40.00	1.7
Subtotal	n.a.	3.9	n.a.	4.8
Maximum Credit Range				
No children	n.a.	n.a.	0	0.4
One child	0	1.7	0	1.8
Two or more children	0	1.3	0	0.7
Subtotal	n.a.	3.0	n.a.	2.9
Phaseout Range				
No children	n.a.	n.a.	7.65	2.9
One child	16.43	4.0	15.98	4.7
Two or more children	17.86	3.7	21.06	5.3
Subtotal	n.a.	7.6	n.a.	12.9
All Returns with Credit				
No children	n.a.	n.a.	n.a.	5.0
One child	n.a.	8.0	n.a.	8.0
Two or more children	n.a.	6.5	n.a.	7.7
Total	n.a.	14.5	n.a.	20.6

SOURCE: Congressional Budget Office using its Tax Simulation Model.

NOTE: The number of returns with children is based on tax return data. Childless recipients of the earned income tax credit (EITC) are estimated using data from the Current Population Survey. The estimates for childless returns, however, may not be a reliable indicator of who will file and claim this portion of the credit. OBRA-93 = Omnibus Budget Reconciliation Act of 1993; n.a = not applicable.

a. Does not include the effects of the supplemental health insurance or baby credits.

b. Assumes the fully phased-in (1996) credit parameters.

These changes alter marginal tax rates in complicated ways, depending on a taxpayer's wage level and number of children. In most cases, the changes in the EITC reduce the marginal tax rate (increase the subsidy rate) for taxpayers with earnings in the subsidy range. They have no effect on marginal tax rates of taxpayers who remain in the maximum credit range, and they increase the marginal tax rate on earnings for taxpayers in the phaseout range. In addition, some taxpayers' marginal tax rates will change because the changes in parameters move them from one category to another. The changes in the EITC increase the number of taxpayers in both the subsidy range and the phaseout range; the number of returns in the maximum credit range remains approximately the same.

On average, the changes in the EITC increase the marginal tax rate on wages for taxpayers in the bottom three income groups (see Table 2). In each of these three groups with AGI between zero and $30,000, the marginal tax rate on earnings increases by between 1 and 1.5 percentage points. This increase occurs because the higher marginal rate on taxpayers whose benefits are phasing out affects more wage income than the lower marginal tax rate on taxpayers who are receiving additional credits on their last dollar of earnings.[3]

The Congressional Budget Office (CBO) projects that about 21 million returns would be eligible for the EITC under fully phased-in OBRA-93 law at 1994 levels of income (see Table 3). Of these returns, about 5 million would be in the subsidy range, 3 million in the maximum credit range, and 13 million in the phaseout range. The number of taxpayers in the phaseout range at 1994 levels of income increases from 8 million before OBRA-93 to about 13 million under OBRA-93. The combined result of the increased number of taxpayers in the phaseout range and the higher rate at which benefits phase out is an increase in marginal tax rates on wages for many low-income workers.

Marginal Tax Rates on Other Taxpayers

Other taxpayers experience smaller changes in marginal tax rates (see Table 2). Changes in the formula for taxing Social Security benefits increase marginal tax rates for some Social Security recipients in the middle AGI groups. The rate is higher because the increase in the percentage of benefits subject to tax from 50 percent to 85 percent phases in above a defined threshold for AGI. The maximum increase in the marginal tax rate from this provision is 85

3. For taxpayers with AGI below $10,000, marginal tax rates weighted by wage income increase, but marginal tax rates weighted by the number of returns fall. This occurs because more returns are in the subsidy range than in the phaseout range, but the total wage income of taxpayers in the phaseout range is greater than the wage income of taxpayers in the subsidy range.

percent and affects only taxpayers whose modified AGI (AGI plus tax-exempt interest plus half of Social Security benefits) is greater than $44,000 for joint returns and $34,000 for single returns. (For a taxpayer in the 28 percent bracket, this raises the marginal rate on an additional dollar of income other than Social Security to 51.8 percent.) Once income rises enough to make 85 percent of total benefits subject to tax, the marginal rate reverts back to the statutory marginal income tax rate.

Changes in the alternative minimum tax also raise marginal tax rates for some other taxpayers at moderate levels of AGI. These taxpayers, by definition, have moderate levels of AGI only because of tax preferences, however, and therefore actually have high current incomes.

For taxpayers in middle-income ranges (between $30,000 and $75,000), marginal tax rates increase more on capital gains than on wages and other capital income. There are two reasons: first, the elderly, who are affected by the Social Security changes, also have a large share of realized capital gains. Second, taxpayers who have large capital gains are more likely to pay the AMT than taxpayers who receive most of their income from other sources.

EFFECTS ON PRIVATE SAVING

OBRA-93 will increase national saving by reducing the federal deficit. Part of the increase from higher government saving, however, will be offset by lower private saving. CBO's macroeconomic projections assume that private saving declines by about 30 cents for each dollar of reduction in the federal deficit.

Several factors cause this private saving offset to deficit reduction. First, the private sector must pay for federal deficit reduction through higher taxes, lower transfer payments to individuals, or fewer federal subsidies for public goods and services, such as national defense, scientific research, or highways. Higher taxes and lower transfer payments directly reduce the disposable income of individuals and the after-tax profits of corporations. The decline in income reduces both private consumption and saving. People may also save less because they substitute higher private consumption for lower government services.

Second, less federal borrowing may hold interest rates down, thereby increasing the market value of existing wealth. Greater wealth may cause people to consume a larger fraction of current income.

Third, by lowering the return on private saving and the cost of borrowing, lower interest rates also may lower the proportion of income that people save.

Finally, some economists believe that people will consume more (save less) when the government deficit falls because they understand that less government borrowing today reduces their tax liabilities in the future.[4]

Some methods of reducing the federal deficit reduce private saving more than others. Higher taxes and lower transfer payments reduce disposable income directly and could therefore reduce saving more than cuts in federal programs. Tax increases on higher-income people could reduce saving more than across-the-board tax increases because high-income people save a relatively high proportion of their income. Tax increases on income from capital could reduce saving more than tax increases on consumption or wages if the rate of saving varies positively with the after-tax rate of return on saving.

Effect of OBRA-93 Deficit Reduction

Economists have found that fluctuations in the federal deficit between the late 1940s and the mid-1980s have affected private saving. The typical estimate is that each $1 change in the deficit causes private saving to change in the same direction by 30 cents.[5] All of the factors discussed above--changes in after-tax incomes, in before- and after-tax rates of return, and in current government spending and the outlook for future spending and taxes--change private saving.

But the deficit reduction in OBRA-93 may affect saving differently than deficit reductions in the past because a larger portion of the deficit change in OBRA-93 is caused by higher tax rates on high-income individuals. By raising the marginal tax rate that high-income savers face on some forms of income from capital, such as taxable interest, dividends, rents, and business income, the OBRA-93 provisions also lower the after-tax return to saving.

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4. In the extreme, people may perceive that the federal debt they hold is not wealth because it represents a future claim on taxpayers' resources. If all Americans believed this and acted on their belief, changes in private saving would fully offset any change in the federal deficit, leaving national saving unchanged. See Robert J. Barro, *Macroeconomics* (New York: John Wiley and Sons, 1987); and B. Douglas Bernheim, "Ricardian Equivalence: An Evaluation of Theory and Evidence," in Stanley Fischer, ed., *Macroeconomics Annual, 1987* (Cambridge, Mass.: MIT Press, 1987).

5. For evidence on the estimate, see Lawrence H. Summers, "Issues in Saving Policy," in Gerald F. Adams and Susan M. Wachter, eds., *Saving and Capital Formation* (Lexington, Mass.: Lexington Books, D.C. Heath & Co., 1986), p. 65; and Michael J. Boskin, "Concepts and Measures of Federal Deficits and Debt and Their Impact on Economic Activity," in K.J. Arrow and M.J. Boskin, eds., *Economics of Public Debt* (New York: MacMillian, 1988), p. 77.

Decline in Disposable Income. OBRA-93 will raise taxes by about $221 billion between 1994 and 1998. In the absence of behavioral responses, people's after-tax incomes will decline by the same amount.[6] If recent trends continue, the personal saving rate in the United States should remain at about 4.7 percent of disposable income between 1994 and 1998. If people reduce their saving for each dollar of taxes by the average rate of saving from disposable income, the decline in after-tax income resulting from the $44 billion average annual tax increase in OBRA-93 will reduce personal and total private saving in the 1994-1998 period by about $2.1 billion per year.

The reduction in after-tax income will probably have a greater effect on saving than this calculation indicates. The tax increases in OBRA-93 fall heavily on higher-income families. Before behavioral adjustments, the entire net revenue pickup from OBRA-93 comes from families in the top quintile of the income distribution. Available studies suggest that the personal saving rate of the top 20 percent of the population could be as high as 2.4 times the rate for the entire population.[7] Based on this estimate, the decline in after-tax income caused by the tax increase could by itself reduce private saving by an average of $5 billion per year between 1994 and 1998, or about 11 percent of the increase in tax revenue.

Decline in After-Tax Return on Saving. Several provisions of OBRA-93 reduce the after-tax rate of return on saving by raising the tax rate on income from capital. The most important of these provisions are the higher income tax and AMT rates on individuals. Other provisions that reduce the after-tax return, although by a lesser amount, are the increase in the corporate income tax rate, the lower cap on compensation for pensions, the phase-in of the tax on 85

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6. In analyzing the effect of the tax changes on saving, CBO assumes that individuals bear the burden of all taxes, including higher corporate taxes, in the form of lower real after-tax income. CBO does not distinguish between the effects on saving of lower cash income of individuals and the effects of lower retained earnings of corporations.

   There is evidence that people save a higher proportion of income in the form of profits that corporations retain on their behalf than they do of cash dividends or wages. (See, for example, James Poterba, "Tax Policy and Corporate Saving," *Brookings Papers on Economic Activity*, no. 2, 1987.) This means that the composition of tax increases between corporate income taxes and individual income taxes can affect the amount by which private saving changes. But the tax changes in OBRA-93 will probably have little net effect on retained earnings of corporations. The higher corporate tax rate will reduce retained earnings, but the expanded investment incentives and the increase in the differential between marginal tax rates on dividends and capital gains will increase retained earnings. Because the net effect on retained earnings is minor, analyzing the tax change as if it all appears at the level of the individual taxpayer should have little impact on the estimate of how much saving will fall.

7. See Barry Bosworth, Gary Burtless, and John Sabelhaus, "The Decline in Saving: Evidence from Household Surveys," *Brookings Papers on Economic Activity*, no. 1 (1991); and John Sabelhaus, "What Is the Distributional Burden of Taxing Consumption?" *National Tax Journal*, vol. 46, no. 3 (September 1993), p. 336.

percent of Social Security benefits, and the extension of the top rates under the estate tax.

The increases in income tax rates reduce the after-tax return on saving the most for taxpayers with taxable incomes in excess of $250,000. For these taxpayers, the marginal tax rate increases from 31 percent to 40.79 percent on ordinary capital income (dividends, taxable interest, rents, and unincorporated business income.)[8] This rate increase reduces the after-tax return by 14.2 percent.[9] But the increases in the marginal tax rate affect only a minority of taxpayers in the top quintile. For the top quintile as a whole, the average marginal tax rate on ordinary capital income increases from 28.7 percent to 31.7 percent. This reduces the after-tax return in the top quintile by 4.2 percent. Other provisions also reduce the after-tax return for some taxpayers, but only slightly.

The tax rate increases in OBRA-93 do not apply to untaxed sources of income, such as interest from tax-exempt bonds or the return from household assets (owner-occupied homes and consumer durables). In addition, the tax rate on capital gain income increases only slightly.[10] Income from these tax-exempt assets and capital gains represents between one-half and two-thirds of the capital income of high-income taxpayers.[11] Because the rate increases do not apply to large portions of their income from capital, the average reduction in the after-tax rate of return on all investments for taxpayers in the top quintile is at most 2 percent. The after-tax return declines by much less for other taxpayers.

A lower after-tax return on saving has two offsetting effects on people's rates of saving. On the one hand, the lower return means that less future consumption is gained by giving up a dollar of current consumption. Thus, people substitute current for future consumption by saving less (the substitution effect). On the other hand, the lower return also means that people who are

8. The new top rate is 1.03 times the top statutory rate of 39.6 percent because of the limitation on itemized deductions.

9. The percentage reduction in the after-tax return is 100 times $[(1 - 0.4079)-(1 - 0.31)]/(1 - 0.31) = 14.19$ percent.

10. Returns from tax-preferred assets may decline because the higher marginal tax rates will encourage high-income families to purchase more of them. But these portfolio shifts also raise pretax returns on taxable assets.

11. The capital income shares are estimated from the assets held by families with over $50,000 of income in 1989, and on total flow of funds data from the 1980-1988 period on revaluations of assets. For family assets in 1989 see Arthur Kennickell and Janice Shack-Marquez, "Changes in Family Finances from 1983 to 1989: Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin* (January 1992), pp.1-18.

net savers are less well off during their lifetimes because whatever saving they do earns less. As a result, people tend to cushion the decline in future consumption by saving more now (the wealth effect).

Studies of rates of saving for the entire U.S. population do not establish conclusively the relative size of the substitution and wealth effects. Many studies find that the two effects cancel out each other, implying that the higher tax rates that OBRA-93 imposes on capital income will not change private saving rates. Other studies find that the substitution effect is larger than the wealth effect, which implies that the higher tax rates of OBRA-93 will reduce private saving. For example, one frequently cited study finds that a 1 percent reduction in the after-tax rate of return reduces the private saving rate by 0.4 percent.[12] This means that if the after-tax rate of return falls from 5 percent to 4.5 percent--a 10 percent decline--the rate of saving will fall by 4 percent, from 4.7 percent to about 4.5 percent. Combining this savings response with the estimated 2 percent reduction in the after-tax return for taxpayers in the top quintile, the Congressional Budget Office estimates that OBRA-93 will reduce the rate of saving of the top quintile by at most 0.8 percent.

CBO projects that total personal saving will be about $240 billion a year between 1994 and 1998.[13] Recent research finds that saving of the top quintile is about equal to total saving.[14] Thus, saving of the top quintile will average about $240 billion a year between 1994 and 1998. The estimate of an 0.8 percent decline in the saving rate of the top quintile amounts to an overall decline in personal saving of about $2 billion per year--less than 5 percent of the increase in tax revenues. CBO expects total private saving to decline by a similar amount because, as noted above, retained earnings of corporations are likely to change only slightly.

Overall Effect on Private Saving: Summary

The tax rate increases in OBRA-93 can reduce private saving in two ways: by reducing total after-tax income and by lowering the after-tax rate of return on

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12. Michael J. Boskin, "Taxation, Saving, and the Rate of Interest," *Journal of Political Economy*, vol. 86, no. 3 (1978), pp. S3-S27. This estimate is for the entire population; responses for different groups within the population could differ widely.

13. Congressional Budget Office, *The Economic and Budget Outlook: An Update* (September 1993). The figures in this paper are derived by adjusting calendar year totals for the 1996-1998 period to compute projections of saving by fiscal year.

14. Sabelhaus, "What Is the Distributional Burden of Taxing Consumption?" p. 336. Sabelhaus estimates that total saving in the bottom four quintiles is approximately zero. Positive saving by households in the fourth quintile is about equal to negative saving by households in the bottom three quintiles.

saving. The lower after-tax income could reduce private saving by as much as $5 billion; the lower after-tax return by up to almost $2 billion. Studies by economists, however, do not establish conclusively that the rate of return effect reduces saving at all. Thus, the two effects could reduce private saving by between $5 billion and $7 billion a year--which amounts to between 11 percent and 16 percent of the revenue pickup.

Studies by economists based on historical data predict that people will reduce their saving by about 30 cents for each dollar of deficit reduction. This reduction is about twice as large as the reductions derived from the direct effects of higher tax rates on after-tax incomes and after-tax rates of return. The lower deficits that come from raising taxes can also reduce saving through three other channels. First, the lower federal borrowing can increase the market value of existing wealth by lowering interest rates. As noted above, an increase in wealth may reduce the proportion of income that people save. Second, the lower interest rates also reduce the return to an additional dollar of saving. Third, people may save less if they perceive that the lower federal deficits increase their wealth. This could happen if lower federal deficits today make expected future tax liabilities less than they would otherwise be.

In conclusion, the tax increases in OBRA-93 will reduce private saving, but by much less than the increase in federal revenue. Therefore, if the higher revenues are applied to deficit reduction, national saving will increase.

EFFECTS ON BUSINESS ORGANIZATIONS AND INDUSTRIES

OBRA-93 will influence the economic behavior of businesses in several ways, including effects on the choice of organizational form and on the amount of investment and its allocation among industries.

By increasing the top individual statutory tax rate more than the top corporate rate, OBRA-93 increases the incentive to operate a business in the corporate form. By raising tax rates, extending certain tax preferences, and enacting some new ones, OBRA-93 encourages some investments and discourages others. A number of these provisions are aimed at small businesses. Other provisions of OBRA-93 affect international transactions and limit business deductions.

Top Statutory Tax Rates and the Choice of Business Organization Form

Subchapter C of the Internal Revenue Code imposes a separate tax on corporate profits. Because corporations may not deduct dividends from taxable profits (and individuals may not claim credit for corporate taxes paid on their behalf), shareholders face two levels of income tax on corporate profits--the corporate income tax and the individual income tax on dividend income. By contrast, owners of partnerships pay only the individual income tax. The income of partnerships is allocated directly to them and included in their adjusted gross income.

Corporations that have 35 or fewer shareholders and meet certain other tests may elect to be taxed as Subchapter S corporations. As with partnerships, S corporations do not pay the separate corporate tax; their owners pay individual income tax on their share of the income of the business.

Business behavior after the Tax Reform Act of 1986 indicates that firms are sensitive to statutory tax rates when they choose their business form. TRA-86 reduced the top individual marginal rate below the top corporate rate for the first time (see Table 4). After TRA-86, the share of total corporate profits earned by S corporations increased from 3.1 percent in 1986 to 7.4 percent in 1987, 8.1 percent in 1988, and 8.3 percent in 1989.[15]

OBRA-93 reverses this effect of TRA-86 by raising the top individual tax rate above the top corporate rate. This makes it more advantageous for businesses that retain their earnings to choose the corporate form. Business owners who operate as noncorporate businesses (partnerships and S corporations) now face a maximum statutory tax rate of 39.6 percent, compared with 31 percent in 1991 and 1992. By contrast, OBRA-93 increases the tax rate by 1 percentage point for C corporations. The rate changes reduce the share of pretax profit that owners receive after federal taxes (the after-tax share) from 69 percent to 60.4 percent for owners of partnerships and S corporations and from 66 percent to 65 percent for owners of C corporations that retain their profits. Thus, before OBRA-93 the after-tax share was about 5 percent higher for partnerships and S corporations than for C corporations.

15. For evidence of how TRA-86 affected the growth of S corporations, see Jeffrey Mackie-Mason and Roger Gordon, "Taxes and the Choice of Organizational Form," Working Paper No. 3781 (National Bureau of Economic Research, Cambridge, Mass., 1991); and Susan Nelson, "S Corporations Since the Tax Reform Act of 1986" in National Tax Association, *Proceedings of the Eighty-Fourth Annual Conference on Taxation, 1991* (Columbus, Ohio: National Tax Association--Tax Institute of America, 1992).

TABLE 4. TOP STATUTORY INCOME TAX RATES ON BUSINESS INCOME
(In percent)

	1982-1986	1988-1990	1991-1992	1993 and After
Top Statutory Tax Rate on Owners of:				
Noncorporate Business[a]	50.0	28.0	31.0	39.6
Corporate Business with All Earnings Retained	46.0	34.0	34.0	35.0
Corporate Business with All Earnings Distributed[a]	73.0	52.5	54.5	60.7
After-Tax Income as a Share of Profits in:				
Noncorporate Business[a]	50.0	72.0	69.0	60.4
Corporate Business with All Earnings Retained	54.0	66.0	66.0	65.0
Corporate Business with All Earnings Distributed[a]	27.0	47.5	45.5	39.3

SOURCE: Congressional Budget Office.

a. Assumes top individual income tax rate.

After OBRA-93, the after-tax share is about 8 percent higher for C corporations than for partnerships and S corporations.[16] It is likely, therefore, that OBRA-93 will induce some businesses to switch back to the C corporate form.

16. Owners of closely-held C corporations must pay additional tax in the future to remove retained profits from the corporation: individual income tax if they distribute the profits to themselves and capital gains tax if they sell their share in the business. Because of the benefit of deferral, however, the present value of this additional tax may be small enough to keep the total tax burden on income in C corporations lower than the tax on income in S corporations. By contrast, under pre-OBRA-93 law, the tax burden on C corporations was always higher.

Large businesses generally operate as C corporations and in many cases distribute a significant portion of their annual income as dividends to shareholders. Because shareholders of these corporations pay higher marginal tax rates on their dividend income, OBRA-93 does not substantially improve the relative position of large corporations. At the extreme, the changes in tax rates would make C corporations that distribute all their income slightly worse off compared with S corporations, when the owners of both types of firms are in the top tax bracket (see Table 4). The provisions of OBRA-93 reduce the after-tax share of partnerships and S corporations by 12.5 percent (from 69 percent to 60.4 percent) but reduce the after-tax share of a C corporation that distributes all its income to owners in the top marginal rate bracket by an even larger 13.6 percent (from 45.5 percent to 39.3 percent.)[17]

Therefore, by increasing individual income tax rates, OBRA-93 increases the incentive for C corporations to retain instead of distribute earnings. For corporations with shareholders in the top bracket, the ratio of the after-tax share from retaining profits to the share from distributing them increases from 1.45 (66/45.5) to 1.65 (65/39.3). For corporations that distribute all their profits, OBRA-93 slightly increases the incentive to finance investment with debt instead of equity capital. For corporations that retain all their profits, it reduces the incentive for debt finance.

Investment Incentives

OBRA-93 is likely to affect the pattern of investment more than its overall level. The 1-percentage-point increase in the corporate income tax raises the cost of corporate capital slightly. This discourages investment, but not much. Three provisions encourage selected forms of corporate investment, while one discourages other forms. The incentives differ among types of firms.

The increase in the amount of investment that can be deducted immediately encourages spending on equipment by small firms (see below); extension of the research and experimentation credit through the middle of 1995 temporarily encourages investment by firms that create intangible capital such as patents and copyrights; and changes to the corporate AMT encourage investment in equipment by firms--mostly larger ones--that pay tax under the AMT or expect to pay it in the future. The lengthening of the depreciation lifetime for nonresidential structures from 31.5 years to 39 years discourages firms not paying the AMT from investing in such properties.

17. Between 1989 and 1992, U.S. corporations paid dividends of about two-thirds of their after-tax profits. For a corporation with this typical payout ratio, OBRA-93 reduces the after-tax share by 8.6 percent.

Effects Unique to Small Business

Incentive Effects. OBRA-93 includes provisions that encourage investment and employment in small businesses. The most significant of these provisions increases from $10,000 to $17,500 the amount of investment that taxpayers with annual investments of less than $200,000 can deduct immediately (or "expense"). A related provision increases this amount to $37,500 for small business investing in "empowerment zones" (economically distressed localities). Other provisions that favor small businesses are the rollover of the gain from the sale of publicly traded securities into specialized small business investment companies, the 50 percent exclusion of capital gains income on small business stock held for more than five years, and extension of tax-exempt borrowing in the form of qualified small issue bonds. Finally, OBRA-93 helps some small businesses by extending the health insurance deduction for self-employed persons.

Tax Burden on Small Business Owners. The increases in marginal income tax rates in OBRA-93 and the removal of the Hospital Insurance cap do reduce the after-tax income of small business persons with the highest incomes. But the tax rate increases equally affect other high-income people who work for large corporations and nonprofit organizations, and the income tax rate increases equally affect other high-income people who invest in corporate equity and bonds. Therefore, the tax rate increases will not increase the relative cost of either labor or capital to small business and will not place small businesses at a disadvantage in relation to large corporations.

Although the tax rate increases affect the highest income taxpayers and many high-income people run their own businesses, most small business people do not face higher marginal tax rates under OBRA-93. Most of those who do face higher marginal tax rates under OBRA-93 do not receive the majority of their income from small business.

For the purpose of this analysis, CBO defines a small business person as anyone who files a sole proprietorship, partnership, or Subchapter S corporation tax return. This category includes taxpayers in many different occupations and industries--small retailers, painting contractors, investment bankers, doctors, and lawyers. It also includes employees of large organizations who have financial interests in one or more partnerships.

One measure of the way in which OBRA-93 affects small business people is the percentage who pay higher taxes. Using 1990 Statistics of Income data, CBO estimates 14 million tax returns will report positive business income in 1994. Of those returns, 700,000 will have taxable income above $140,000 for joint returns (or $115,000 for single returns)--the threshold for the 36 percent tax rate. About 40 percent of those 700,000 returns will have income above $250,000--the threshold for the 39.6 percent tax rate. Thus, recent data indicate that about 5 percent of the returns reporting positive business income will face higher statutory marginal tax rates under OBRA-93. Limiting the definition of a small business person to include only those taxpayers who report more business income than wages, CBO estimates that out of about 7 million returns in this group, 350,000 (about 5 percent) would have income subject to the 36 percent tax rate, and 150,000 (about 2 percent) would have income subject to the 39.6 percent tax rate.

Although the tax rate increases affect relatively few small business people by either definition, many of the taxpayers affected by the higher rates report some small business income. CBO estimates (again from the 1990 Statistics of Income data) that slightly more than half of the tax returns that are subject to the higher marginal tax rates will include some positive business income in 1994. For about half of these, however, small business income represents a relatively small fraction of total taxable income. Returns reporting more business income than wages amount to 28 percent of all returns affected by the higher marginal tax rates.

The removal of the HI cap also affects top earners. Before OBRA-93, only earnings below a threshold were subject to HI taxes. OBRA-93 extends the HI tax to earnings over the threshold--estimated to be $141,900 in 1994. Of the 14 million self-employed persons paying HI taxes in 1994, approximately 150,000 will pay higher HI taxes because of OBRA-93.[18]

Other Effects on Business Incentives

International Provisions. Three provisions in OBRA-93 cut back on the preferential treatment of certain types of income from international transactions. First, the oil and gas and shipping industries now must consider their foreign investment income from working capital to be passive income, just like similar income in other industries. Second, controlled foreign corporations no longer receive deferral from current U.S. tax for some forms of income. Third, exports of certain unprocessed softwood timber no longer qualify for

18. Not all small business persons, as defined above, remit HI taxes in the same way. Sole proprietors and partnerships pay HI taxes on their covered earnings through self-employment (SECA) taxes. Owners of S corporations have HI taxes withheld as FICA taxes on the covered portion of wages they receive. Because it is not possible to isolate the wages of S corporation filers from all other wages, the data that CBO reports on higher HI taxes of small business owners omit those who receive wages from S corporations.

preferential tax treatment. These three provisions discourage selected transactions, but will have little effect on most foreign investments of U.S. corporations.

Denial of Deductibility for Certain Business Expenses. OBRA-93 limits or denies deductions for certain business expenses, including business meals and entertainment, club dues, some executive pay, and lobbying. The reduction in the deductible portion of business meals and entertainment from 80 percent to 50 percent raises most of the revenue from this group of provisions.

The rationale for limiting deductions for business meals and entertainment is that a portion of these costs represents noncash consumption to some employees and self-employed people instead of necessary costs of production. If these outlays substitute for higher cash wages, they represent income to employees. In these cases, denying deductions is a simpler way of including this consumption in the tax base than counting the value of meals and entertainment as employee income. By contrast, the rationale on tax neutrality grounds for denying deductions for expenses of lobbying and compensation of highly paid executives is less apparent. For these activities, one can view denial of deductibility as equivalent to an excise tax on activities that the Congress wishes to discourage.

The limitation of deductibility for business meals and entertainment could reduce business spending on these activities, but it is difficult to know how much. Reducing the tax-free share of these expenditures raises their cost to businesses, but the increase in marginal tax rates offsets this in part by increasing the value of all tax-free activities. Taking these offsetting effects into account, a recent Congressional Research Service study suggests that OBRA-93 will not adversely affect the restaurant and entertainment industries.[19]

Tax Increases on Specific Industries and Transactions. Several provisions in OBRA-93 increase taxes either on corporations in specific industries, such as domestic securities dealers or U.S. manufacturing firms that operate in Puerto Rico, or on corporations that undertake specific transactions, such as purchasing insolvent savings and loan institutions or investing in intangible assets. In some cases, new provisions will lead to changes in behavior. For example, the redesigned and scaled-back possessions tax credit gives some high-tech U.S. corporations in Puerto Rico an incentive to substitute labor for capital; other corporations might move their operations elsewhere. By contrast, the provision restricting tax benefits for firms that purchased insolvent

19. Jane G. Gravelle, "Effect of Current Tax Proposals on Employment in the Restaurant and Entertainment Industries" (Congressional Research Service, May 18, 1993).

savings and loan institutions before 1989 will not change the behavior of affected firms because the transactions have already occurred.

The possessions tax credit has allowed U.S. firms to reduce their taxes substantially by investing in U.S. possessions, most notably Puerto Rico. Many U.S. corporations, primarily manufacturing firms, undertake research in the United States that is then applied in production in Puerto Rico. The production is typically very capital-intensive; on average, possessions corporations have received U.S. tax benefits that have exceeded their entire wage bill in Puerto Rico.

OBRA-93 restricts the use of the possessions tax credit by capital-intensive corporations. The provision may reduce investment by U.S. firms in Puerto Rico, but it also may encourage capital-intensive firms that continue to operate there to hire more local employees. The net effect on employment in U.S. possessions is uncertain.

Estimated Payments. OBRA-93 increases estimated payments by requiring corporations to pay 100 percent of their expected annual tax bill as estimated payments through the year. The 100 percent estimated payment requirement is permanent. Under prior law, the required estimated payments were 97 percent of tax liability through 1996 and 91 percent beginning in 1997. The speedup in estimated payments accounts for about one-fifth of the total increase in corporate tax revenue between 1994 and 1998 but has little economic effect. Based on reasonable assumptions about the expected rate of return from deferring the payment of taxes, corporations faced an effective top rate of about 33.9 percent under prior law, which was not much different from the top statutory rate of 34 percent.

CHANGES IN INCENTIVES CLASSIFIED AS TAX EXPENDITURES

"Tax expenditures" are federal revenue losses arising from provisions in the income tax code that give selective relief to particular groups of taxpayers or special incentives for particular types of economic activity. Estimates of tax expenditures reflect the amount of revenue that the federal government forgoes as the result of these preferences, thereby indicating how much the government uses the tax code to further nonrevenue goals. On balance, OBRA-93 increases tax expenditures.

The Normal Tax Structure and Tax Expenditures

The concept of tax expenditures implies that the tax code has both normal and preferential elements. The normal tax structure includes an individual and a corporate income tax. For individuals, the normal structure includes general rate schedules and exemption levels, the standard deduction (or its equivalent), and general rules defining the taxpaying unit and setting forth accounting periods. For corporations, the normal structure includes a basic tax rate and deductions for ordinary and necessary expenses, but does not include graduated rates for corporations. Although graduated rates for individuals reflect society's judgment on how much tax people at different income levels should pay, graduated rates for corporations help some businesses without necessarily reducing rates for lower-income taxpayers.

For individuals, tax expenditures include deductions for mortgage interest, charitable contributions, and state and local income taxes; exemption of interest on state and local bonds; the maximum rate on capital gains; and many others. For corporations, they include rates below the maximum; tax credits for particular types of investment, such as research and experimentation; and accelerated depreciation of machinery and equipment.

Tax legislation can affect tax expenditures directly by changing specific tax preferences or indirectly by changing the normal tax structure--for example, by raising or lowering rates, altering the standard deduction or exemption levels for individuals, or redefining ordinary expenses for corporations. When the normal tax structure changes, some tax expenditures will rise or fall, even if the legislation makes no other changes to the tax code.[20]

The Provisions of OBRA-93

The effects of OBRA-93 on tax expenditures contrast sharply with the provisions of TRA-86. The latter reduced tax expenditures by lowering rates and cutting back or repealing many tax preferences. By comparison, OBRA-93 increases tax expenditures generally by raising the tax rates of higher-income households, and although it scales back some tax preferences, it also enacts some new ones and expands or extends others.

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20. For a more detailed discussion, see Congressional Budget Office, *The Effects of Tax Reform on Tax Expenditures* (March 1988).

The Effects of Increases in Tax Rates

OBRA-93 changes the normal tax structure by increasing individual and corporate tax rates and making the phaseout of the personal exemption permanent. Even if all other provisions of the tax code remain the same, higher tax rates raise the value of tax preferences, thereby encouraging individuals and businesses to undertake more tax-favored activities. OBRA-93 increases individual income tax rates only for very high income individuals and increases the top individual rate much more than the top corporate rate. Consequently, the higher rates significantly increase the value of tax preferences that primarily benefit high-income individuals, but they only slightly increase the value of tax preferences that corporations and a broader group of individual taxpayers claim.

For example, the estimated revenue loss in 1994 from the maximum rate on long-term capital gains increases from $2.4 billion under prior law to $7.6 billion, even though the rate remains at 28 percent. The reason is that most capital gains are realized by high-income taxpayers and the capped rate on gains benefits only taxpayers above the 28 percent bracket. By contrast, the revenue loss for the deduction of mortgage interest increases only slightly in 1994, from $45.5 billion under prior law to $46.4 billion. For the same reason, the estimated revenue loss in 1994 from the deductibility of charitable contributions also increases moderately, from $16.9 billion under prior law to $17.9 billion.[21]

New and Expanded Tax Preferences

OBRA-93 provides new tax preferences and expands existing ones intended to stimulate investment in small businesses and in targeted low-income areas and to assist low-income wage earners (see Table 5).

Small Business Incentives. OBRA-93 increases some existing tax expenditures for small businesses and introduces new ones (see above).

21. The estimates under prior and current law are based on the same economic assumptions, which are from CBO's January 1993 forecast. The estimates compare revenue losses assuming the tax base and rates in prior law with revenue losses assuming the tax base and rates in current law.

TABLE 5. REVENUE EFFECTS OF TAX-PREFERENCE PROVISIONS IN OBRA-93
(By fiscal year, in billions of dollars)

	1994	1995	1996	1997	1998	Five-Year Total
Revenue-Reducing Provisions						
New or Expanded Preferences						
Capital gains incentives for investment in small businesses	a	-0.1	-0.2	-0.2	-0.3	-0.8
Incentives for investment in empowerment zones, enterprise communities, and Indian reservations	-0.3	-0.5	-0.5	-0.6	-0.6	-2.5
Increased expensing under Section 179 to $17,500 for taxable years beginning January 1, 1993	-2.3	-1.0	-0.7	-0.4	-0.2	-4.6
Expansion of earned income credit	a	0.2	-0.4	-0.5	-0.6	-1.7
Extensions of Preferences						
Permanent extensions						
Low-income housing credit	-0.4	-0.6	-0.9	-1.3	-1.7	-4.9
Mortgage bonds and mortgage credit certificates	-0.1	-0.2	-0.2	-0.3	-0.3	-1.0
Small issue bonds	a	a	-0.1	-0.1	-0.1	-0.3
Bonds for high-speed intercity rail facilities	a	a	a	a	-0.1	-0.1
Temporary extensions						
Deduction for health insurance for self-employed individuals through December 31, 1993	-0.6	0	0	0	0	-0.6
Exclusion of employer-provided educational assistance through December 31, 1994	-0.6	-0.3	0	0	0	-0.9
Targeted jobs credit through December 31, 1994	-0.3	-0.2	-0.1	a	a	-0.7
Orphan drug credit through December 31, 1994	a	a	0	0	0	a
Research and experimentation credit through June 30, 1995	-2.2	-1.2	-0.8	-0.4	-0.3	-4.9
Revenue-Raising Provisions						
Repeal or Limitation of Preferences						
Increase in depreciation period for nonresidential real property from 31.5 years to 39 years	0.1	0.3	0.6	1.0	1.4	3.4
Increase in taxable portion of Social Security and Railroad Retirement benefits	1.9	4.6	5.3	6.0	6.7	24.6
Reduction in compensation that can be taken into account for purposes of contributions and benefits under retirement plans	0.2	0.6	0.6	0.6	0.6	2.5
Denial of deduction for club dues	0.1	0.2	0.2	0.2	0.3	1.1

SOURCE: Joint Committee on Taxation.

a. Less than $50 million.

Empowerment Zones and Enterprise Communities. OBRA-93 gives the Secretary of Housing and Urban Development authority to designate six empowerment zones and 65 enterprise communities in urban areas. It also gives the Secretary of Agriculture authority to designate three empowerment zones and 30 enterprise communities in rural areas. The designated areas must satisfy eligibility criteria, including specified poverty rates and limits on population and geographic size. For the most part, the designations will remain in effect for 10 years.

In the nine empowerment zones, the legislation makes available a 20 percent employer wage credit for the first $15,000 of wages paid to a zone resident who works within the zone; expanded tax-exempt financing for certain zone facilities; and up to $37,500 of current deductions, or expensing, for certain zone business property. The 95 enterprise communities are eligible for expanded tax-exempt financing, but not for the other preferences. The empowerment areas and enterprise communities are an outgrowth of earlier enterprise zone proposals, but the range of available incentives is more limited.

The act also provides for the next 10 years two tax incentives for all Indian reservations: enhanced accelerated depreciation for certain property used in a trade or business and certain related infrastructure property; and a 20 percent incremental employer wage credit for wages and health insurance costs, up to $20,000 per employee, paid to tribal members who work on a reservation and earn less than $30,000 a year. The credit is incremental and thus is available only if the sum of wages and health costs for any year exceeds the sum of comparable costs for 1993.

Earned Income Tax Credit. OBRA-93 expands the earned income tax credit by increasing the maximum credit available to taxpayers with one child, increasing over a three-year period the maximum credit available to taxpayers with two or more children, and extending the credit to childless taxpayers.

Bonds for High-Speed Intercity Rail Facilities. OBRA-93 removes all volume limits on the issuance of tax-exempt bonds for high-speed intercity rail facilities that are governmentally owned. Under prior law, 25 percent of each bond issue for high-speed intercity rail facilities, whether privately or publicly owned, had to be counted against the volume limits on a state's issues of bonds for private activities. OBRA-93 removes the requirement for publicly owned facilities, effective for bonds issued after December 31, 1993.

Extensions of Tax Preferences

OBRA-93 extends several tax preferences that had expired or were about to expire under current law (see Table 5). The practice in recent years has been to extend expiring tax preferences for brief periods, generally ranging between six months and a year and a half. Many temporary tax preferences have been extended several times over the last 15 years.

Permanent Extensions. OBRA-93 permanently extends some tax preferences that the Congress had several times renewed for short periods. These preferences include the low-income housing credit and the exemption from taxation of interest on qualified mortgage bonds and small issue bonds.

The low-income housing credit provides an incentive for individuals and corporations to invest in low-income housing. The credit, which is paid annually for 10 years, applies to expenditures for new construction and rehabilitation of low-income housing. Enacted as part of TRA-86 and subsequently modified in 1989, it replaced a variety of other incentives for investment in low-income housing, providing relatively more assistance to lower-income households than the incentives under prior law. OBRA-93 extends the availability of the credit to investments in housing receiving assistance under the HOME program of the National Affordable Housing Act of 1990.

Tax-exempt financing provides a means of borrowing at below-market interest rates. Mortgage bonds and mortgage credit certificates benefit first-time purchasers of single-family homes, provided their income and the purchase price of their homes fall below specified limits. Small issue bonds benefit manufacturers whose capital expenditures are below levels specified in the law and first-time farmers who invest in agricultural land or property.

Like some other tax preferences, the low-income housing credit and the tax-exempt bond provisions are similar in their intent and eligibility criteria to some spending programs. As with many spending programs, they require administrative oversight and incur overhead costs. These tax preferences also incur additional efficiency costs because some of their benefits accrue to investors in low-income housing and purchasers of tax-exempt bonds in the form of higher after-tax returns, instead of flowing entirely to low-income tenants as lower rents, or to homeowners, farmers, or manufacturers in the form of below-market interest rates on mortgages or other loans.[22]

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22. For further analysis of the low-income housing credit, see Congressional Budget Office, "The Cost-Effectiveness of the Low-Income Housing Tax Credit Compared with Housing Vouchers," CBO Staff Memorandum (April 1992).

Temporary Extensions. OBRA-93 also extends several preferences for temporary periods, including the deduction of 25 percent of health insurance expenses for the self-employed, the exemption from income of employer-provided educational assistance, the targeted jobs tax credit, the tax credit for orphan drugs, and the research tax credit. All of these provisions had expired on July 1, 1992. The research tax credit will extend through June 30, 1995; the other preferences expire on December 31, 1994, except for the deduction of health insurance expenses, which expired at the end of 1993. OBRA-93 renews the targeted jobs tax credit for the ninth time since its original enactment in 1978; the exclusion for employer-provided educational assistance for the seventh time since its enactment in 1978; the research and experimentation credit for the sixth time since its enactment in 1981; the deduction for health insurance premiums paid by the self-employed for the fourth time since its enactment in 1986; and the orphan drug credit for the fourth time since its enactment in 1983.

The original purpose of making some tax preferences temporary was to subject subsidies delivered through the tax code to a review process similar to the appropriation and authorization process for spending programs. The extension periods for tax preferences generally ranged between three and five years. Over the years, the Congress has modified several programs, expanding some and imposing limits and tighter eligibility criteria on others. Although this process continues, the extension periods have become much shorter.

Recent short-term extensions reflect the incentives of the pay-as-you-go rules in the Budget Enforcement Act of 1990. Extending revenue-losing provisions for shorter periods allows the Congress to defer some of the offsetting deficit reduction that the rules require. Repeated renewal of a tax preference ultimately increases the deficit as much as long-term or permanent renewal, but estimates of revenue losses from short-term extensions effectively conceal this in the short run. Thus, for example, the estimated revenue losses from 1994 to 1998 from renewing the research and experimentation credit through June 30, 1995, are slightly less than $5 billion. The estimated revenue losses from permanent extension would have been about $10 billion between 1994 and 1998.

Repeal or Limitation of Tax Preferences

OBRA-93 also reduces some tax expenditures. Major items include making the limit on itemized deductions permanent, increasing the depreciation period for nonresidential real property from 31.5 years to 39 years, and increasing the taxable portion of Social Security and Railroad Retirement benefits. OBRA-93 also scales back a number of smaller corporate tax preferences (see the above section on effects on business organizations and industries).

CHAPTER III

EFFECTS ON INCOME DISTRIBUTION

The tax changes in the Omnibus Budget Reconciliation Act of 1993 shift the distribution of the tax burden toward families in the upper-income groups. Effective tax rates increase much more for families in the top quintile (that is, the top 20 percent) than for other families. Within the top quintile, effective tax rates increase the most for families in the top 1 percent of the income distribution. By contrast, tax rates increase only slightly for families in the third and fourth quintiles and decline for families in the bottom two quintiles.

The tax law changes also affect families differently depending on the age of the head of the household and the number of children. Effective tax rates increase more for families headed by people 65 years old or over than for other families and more for families without children than for families with children. The biggest reductions in tax rates are for low-income families with children.

Under current law, the decision to marry can affect the total amount of tax that two people pay. The OBRA-93 tax changes increase the impact of marital status on tax liability for couples with very low income and very high income. For married couples, an increase occurs in both the marriage penalty for two-earner couples with equal (or nearly equal) earnings and the marriage bonus for one-earner couples (and couples in which the lower-earning spouse earns only a small fraction of their total income).

OBRA-93 increases the tax penalty for taxpayers whose incomes are variable. Even under current law, taxpayers whose incomes vary greatly from year to year pay more tax over several years than others who have the same average income but less year-to-year variation. The rate increases in OBRA-93 will increase this penalty for high-income taxpayers.

DISTRIBUTION BY INCOME GROUP

OBRA-93 changes the distribution of the tax burden substantially by increasing income tax rates on upper-income taxpayers and decreasing income taxes for some lower-income taxpayers by expanding the earned income tax credit. The Congressional Budget Office estimates that the OBRA-93 tax provisions (including the refundable portion of the EITC) increase federal taxes for families by about 4 percent and reduce after-tax income by about 1 percent (see Table 6). The effects on families differ dramatically among income

TABLE 6. TAX BURDENS ON FAMILIES BEFORE AND AFTER OBRA-93 USING 1994 INCOME LEVELS, 1998 LAW, AND JANUARY 1993 ECONOMIC ASSUMPTIONS

	All Federal Taxes			Income After Taxes		Effective Tax Rates		Share of Total Change (Percent)
	Average Before OBRA-93 (Dollars)	Change (Dollars)	Change (Percent)	Average Before OBRA-93 (Dollars)	Change (Percent)	Before OBRA-93 (Percent)	After OBRA-93 (Percent)	
Families by Adjusted Family Income								
All Families								
By quintile								
First	589	-166	-28.1	7,878	2.1	7.0	5.0	-8.3
Second	3,119	-35	-1.1	17,623	0.2	15.0	14.9	-1.8
Third	6,498	64	1.0	27,156	-0.2	19.3	19.5	3.2
Fourth	10,800	110	1.0	38,172	-0.3	22.1	22.3	5.7
Fifth	29,203	1,884	6.5	82,111	-2.3	26.2	27.9	100.9
All	10,107	382	3.8	34,129	-1.1	22.8	23.7	100.0
By percentile								
Top 10	41,225	3,473	8.4	111,727	-3.1	27.0	29.2	94.6
Top 5	59,374	6,521	11.0	157,427	-4.1	27.4	30.4	89.4
Top 1	158,719	29,417	18.5	408,157	-7.2	28.0	33.2	76.3
81 to 90	16,757	239	1.4	51,452	-0.5	24.6	24.9	6.3
91 to 95	22,859	388	1.7	65,483	-0.6	25.9	26.3	5.3
96 to 99	36,188	1,177	3.3	98,908	-1.2	26.8	27.7	13.1
Families with Children (Quintiles)								
First	559	-380	-68.0	10,493	3.6	5.1	1.6	-25.8
Second	4,811	-134	-2.8	23,585	0.6	16.9	16.5	-8.8
Third	9,665	73	0.8	35,240	-0.2	21.5	21.7	4.7
Fourth	15,305	144	0.9	49,663	-0.3	23.6	23.8	8.1
Fifth								
81 to 90 percent	22,402	223	1.0	66,243	-0.3	25.3	25.5	5.0
Top 10 percent	54,694	6,450	11.8	147,793	-4.4	27.0	30.2	116.5
All	11,178	336	3.0	37,610	-0.9	22.9	23.6	100.0
Families with Head Age 65 or Older (Quintiles)								
First	200	9	4.6	7,336	-0.1	2.6	2.8	0.5
Second	718	27	3.8	15,412	-0.2	4.4	4.6	1.6
Third	2,169	60	2.8	25,121	-0.2	7.9	8.2	2.9
Fourth	5,037	115	2.3	36,149	-0.3	12.2	12.5	4.5
Fifth								
81 to 90 percent	10,178	651	6.4	50,892	-1.3	16.7	17.7	10.4
Top 10 percent	38,198	3,753	9.8	119,182	-3.1	24.3	26.7	80.0
All	5,615	421	7.5	30,663	-1.4	15.5	16.6	100.0

(Continued)

TABLE 6. CONTINUED

	All Federal Taxes			Income After Taxes		Effective Tax Rates		Share of Total Change (Percent)
	Average Before OBRA-93 (Dollars)	Change (Dollars)	Change (Percent)	Average Before OBRA-93 (Dollars)	Change (Percent)	Before OBRA-93 (Percent)	After OBRA-93 (Percent)	
Other Families (Quintiles)								
First	876	-37	-4.3	5,276	0.7	14.2	13.6	-1.4
Second	3,060	25	0.8	13,066	-0.2	19.0	19.1	1.0
Third	5,842	58	1.0	20,787	-0.3	21.9	22.2	2.5
Fourth	9,843	86	0.9	31,412	-0.3	23.9	24.1	4.7
Fifth								
81 to 90 percent	15,848	153	1.0	45,329	-0.3	25.9	26.2	5.1
Top 10 percent	37,798	2,450	6.5	98,197	-2.5	27.8	29.6	87.7
All	11,308	399	3.5	33,074	-1.2	25.5	26.4	100.0
Families by Dollar Income								
Less than $10,000	455	-68	-14.9	5,577	1.2	7.5	6.4	-2.5
$10,000-$20,000	1,718	-86	-5.0	13,258	0.6	11.5	10.9	-3.9
$20,000-$30,000	4,240	-41	-1.0	20,775	0.2	16.9	16.8	-1.7
$30,000-$40,000	6,891	50	0.7	27,970	-0.2	19.8	19.9	1.6
$40,000-$50,000	9,667	105	1.1	35,062	-0.3	21.6	21.8	2.7
$50,000-$75,000	14,295	192	1.3	46,719	-0.4	23.4	23.7	7.8
$75,000-$100,000	21,604	312	1.4	64,185	-0.5	25.2	25.5	5.6
$100,000-$200,000	33,910	649	1.9	95,854	-0.7	26.1	26.6	8.8
$200,000 or more	135,359	23,521	17.4	350,578	-6.7	27.9	32.7	81.3
All	10,107	382	3.8	34,129	-1.1	22.8	23.7	100.0

SOURCE: Congressional Budget Office.

NOTES: The table shows the effects of tax law changes as applied to families at 1994 levels of income. The table compares provisions effective in 1998 of the new tax law and pre-OBRA-93 law. The representation of the tax law prior to OBRA-93 differs from the actual tax law that would have applied to families in 1994 by treating three temporary provisions--the limitation on itemized deductions, the phase-out of the personal exemption, and the temporary 2.5-cent portion of the federal motor fuels excise tax--as if they had already expired. Thus, the table represents the extension of these three provisions in OBRA-93 as a tax increase, although it has no effect on families in 1994.

It includes the fully phased-in effects of all permanent revenue provisions except the empowerment zone provision, the provisions on estimated tax payments, and miscellaneous compliance measures. The table includes both the outlay and tax portions of the earned income tax credit.

Pretax family income is the sum of wages, salaries, self-employment income, rents, taxable and nontaxable interest, dividends, realized capital gains, pensions, and all cash transfer payments. Income also includes the employer share of Social Security, federal unemployment insurance payroll taxes, and the corporate income tax. For purposes of ranking by adjusted family income, income for each family is divided by the projected 1994 poverty threshold for a family of that size. Quintiles contain equal numbers of people. Families with zero or negative income are excluded from the lowest income category but included in the total.

Changes in individual income taxes are distributed directly to families paying those taxes. Changes in payroll taxes are distributed directly to families paying those taxes, or indirectly through their employers. Changes in federal excise taxes are distributed to families according to their consumption of the taxed good or service. Changes in corporate income taxes are distributed to families according to their income from capital.

OBRA-93 = Omnibus Budget Reconciliation Act of 1993.

quintiles. For example, families in the bottom quintile receive a tax reduction of 28 percent and an average increase in after-tax income of 2 percent. Families in the third and fourth quintiles pay higher taxes, but the bottom four quintiles taken together pay slightly less tax. Consequently, those in the top quintile pay more than 100 percent of the additional taxes. The taxes on these families increase by more than 6 percent, which lowers their after-tax income on average by 2 percent. Compared with families at the top and bottom of the income distribution, families in the three middle quintiles experience relatively small changes in effective tax rates and after-tax incomes.

Families in the top 1 percent of the income distribution pay more than three-fourths of the additional taxes paid by those in the top quintile. For those very high income families, federal taxes rise by more than 18 percent, reducing their after-tax income by 7 percent. These families pay virtually all of the additional taxes from the provisions that impose new marginal tax rate brackets of 36 percent and 39.6 percent on high-income recipients, eliminate the Hospital Insurance cap, make permanent the limit on itemized deductions and the phaseout of personal exemptions, and increase tax rates under the individual alternative minimum tax.

The changes in average effective tax rates for families ranked by income quintile or income level mask shifts in the distribution of tax burdens within income groups. For example, the impact of the increase in motor fuels taxes differs among families depending on the type of cars they drive and how much they drive them. Including more Social Security benefits in income affects mostly older families with relatively high incomes. Expanding the earned income tax credit mainly benefits low-income families with children.

DISTRIBUTION BY AGE AND FAMILY SIZE

The effects of OBRA-93 on tax burdens differ among families depending on whether or not they have children and whether or not the head of the household is elderly. On average, families with children experience a slightly smaller tax increase than nonaged families without children (see Table 6).

This difference occurs because low-income families with children experience a larger tax cut than other low-income families. Even though OBRA-93 expands the EITC to include childless families, the largest increases in the credit are for families with children. Consequently, although OBRA-93 increases after-tax income for families with children in the bottom income quintile by about 4 percent, it increases after-tax income of nonaged families without children by less than 1 percent.

Families headed by people 65 years old or over experience a larger increase in effective tax rates (over 7 percent) than other families (about 3 percent). The relatively larger increase in effective tax rates for these older families occurs for three reasons. First, low-income older families have very little income from employment and in most cases have no children and therefore do not benefit from the expansion of the EITC. Second, older families receive relatively more income from capital than other families at similar income levels. As a result, the increases in corporate income taxes in OBRA-93 affect them relatively more. Most important, for families in the top quintile, OBRA-93 increases taxes more for these older families than for others by increasing the proportion of Social Security benefits included in adjusted gross income. The increased taxation of Social Security benefits affects only couples with incomes above $44,000 and single people with incomes above $34,000.

DISTRIBUTION WITHIN THE BOTTOM QUINTILE

On average, by expanding the EITC, the tax provisions in OBRA-93 increase the after-tax income of families in the bottom quintile of the income distribution by 2 percent. Some low-income families, however, experience a net reduction in income. The expansion of the EITC benefits only those low-income families that are eligible for the credit, while other provisions, including the increases in motor fuels taxes and corporate income taxes, slightly reduce the after-tax income of most low-income families. Among low-income families, the OBRA-93 changes favor families with children and are relatively less favorable for older families (headed by people 65 years old or over).

The OBRA-93 tax provisions reduce average effective tax rates for families with children in the bottom quintile by 68 percent, raising their after-tax income by 4 percent. By contrast, families in the bottom quintile headed by people 65 years old or over experience a small tax rate increase (about 5 percent, or $9 per family on average). Other families in the bottom quintile see their tax rates decline by 4 percent, which raises their after-tax income slightly (see Chapter 2).

HORIZONTAL EQUITY ISSUES

Horizontal equity--when families in the same economic circumstances pay the same amount of tax--is an important criterion of fairness in the tax system. An income tax violates horizontal equity, for example, if tax liability depends on how a taxpayer earns or consumes income. Two other ways in which a progressive income tax can violate horizontal equity is by treating taxpayers differently according to their marital status and the timing of their receipt of income.

OBRA-93 increases the effect of marital status on tax liability by raising marginal tax rates. It increases marriage penalties for some and marriage bonuses for others. The taxpayers it affects are only those with very high and very low incomes. OBRA-93 also increases the tax liability of taxpayers whose incomes fluctuate from year to year, compared with the tax liabilities of taxpayers with the same average incomes whose incomes change little over time.

Marriage Penalties and Bonuses

Under the current income tax, a married couple's tax liability almost always differs from the combined liability that the two people would pay if they earned the same combined income but could file returns as single taxpayers. A married couple will pay more tax in some cases (a "marriage penalty") and less in others (a "marriage bonus"). In general, a couple will pay a marriage penalty if both individuals earn approximately the same income, but will receive a marriage bonus if all or most income is earned by one spouse.

The size of the marriage penalty or bonus depends on the relative magnitudes of the tax law parameters for joint and single returns. The most important of these parameters are the relative width of the tax rate brackets and the relative size of the standard deductions for joint and single filers. Other parameters that affect the marriage penalty include the income amounts at which the EITC reaches its maximum level and begins to phase out, the phaseout ranges for individual retirement account (IRA) deductions, itemized deductions, personal exemptions, and the threshold amounts for including Social Security benefits in income subject to tax.

The principle that two people with the same combined income should pay the same tax regardless of their marital status ("marriage neutrality") is one standard of fairness in taxing families and individuals. An alternative standard of fairness is that all married couples with the same combined income should pay the same tax, regardless of how the income is divided between them. Under a progressive income tax, it is impossible to achieve both standards of equity simultaneously. Requiring all people to file single returns would eliminate marriage penalties and bonuses. However, with graduated tax rates, it would tax couples more when one person earns all the income than when both individuals earn half the combined income. With joint filing, all married couples with the same income pay the same tax, but there will be either marriage penalties or bonuses depending on the relationship between the tax schedules for joint and single returns.

The Economic Recovery Tax Act of 1981 reduced the marriage penalty by allowing an extra deduction for second earners. The deduction was equal to the lesser of 10 percent of the earnings of the lower-earning spouse or $3,000. The Tax Reform Act of 1986 repealed the second-earner deduction, but reduced the marriage penalty by lowering marginal tax rates, reducing the number of tax brackets, and changing standard deductions for joint and single filers.[1]

Provisions in OBRA-93 that affect marriage penalties and bonuses include the expansion of the EITC and the new tax brackets for high-income taxpayers. The changes increase the absolute size of both marriage penalties and marriage bonuses.

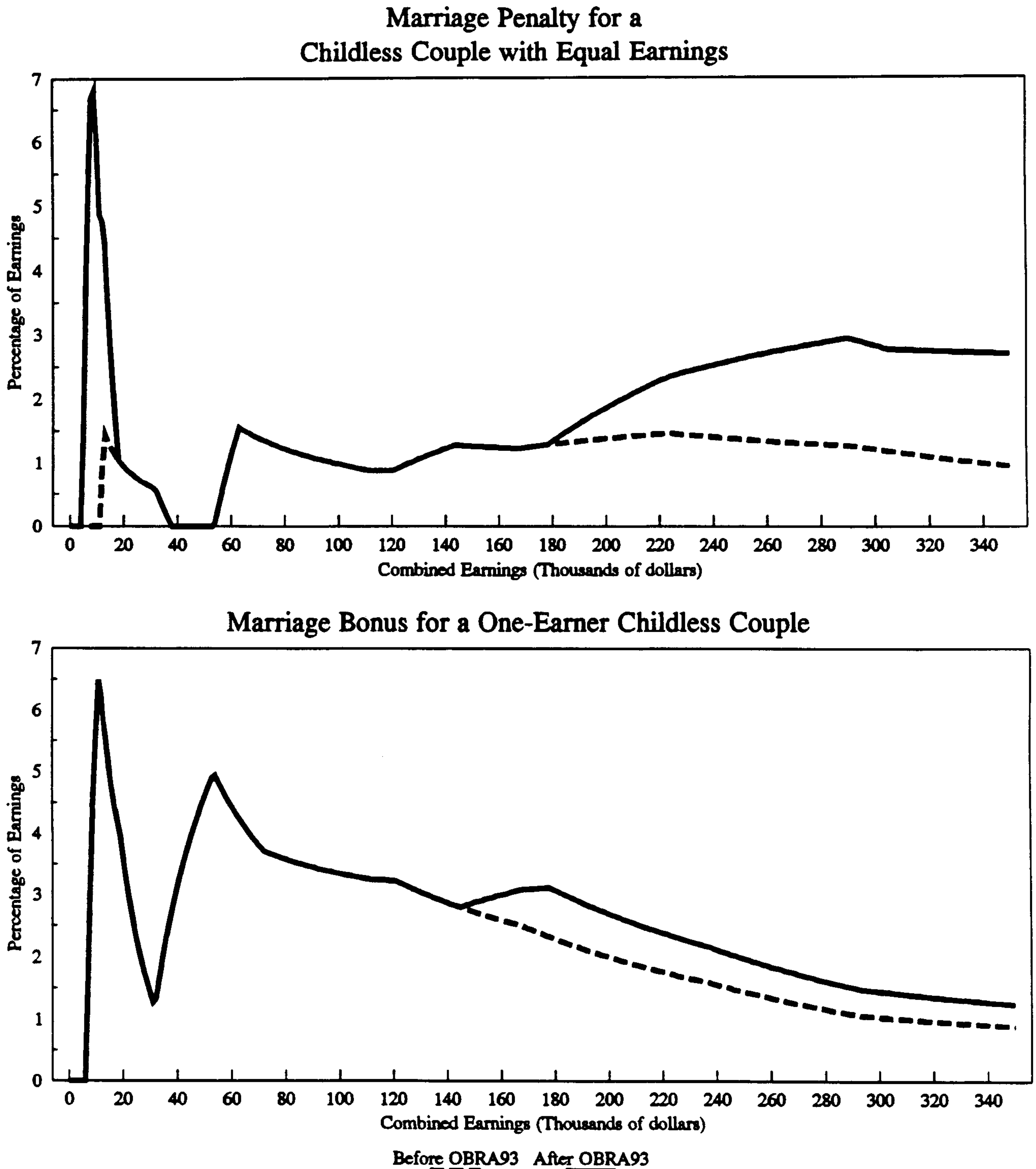
The examples that follow illustrate these effects by showing how OBRA-93 affects the marriage penalty and bonus for two childless couples who receive all their income from earnings--one in which both spouses earn half the total income of the couple and the other in which one spouse earns all the income.[2] OBRA-93 does not affect the marriage penalty or bonus for most couples. It increases the marriage penalty for two-earner couples with very low or very high combined incomes. It increases the marriage bonus for one-earner couples with very high incomes.

The two-earner couple pays a marriage penalty at most income levels (see top panel of Figure 1). But OBRA-93 has no effect on the marriage penalties for couples with combined earnings between $18,000 and $179,000--about 78 percent of couples with earnings.

1. A study using a tax simulation model found that TRA-86 on average reduced the marriage penalty. See Harvey Rosen, "The Marriage Penalty Is Down But Not Out," Working Paper No. 2231 (National Bureau of Economic Research, Cambridge, Mass., 1987).

2. In the examples, the Congressional Budget Office assumes that the taxpayers claim either the standard deduction or itemized deductions equal to 20 percent of earnings, whichever is larger.

Figure 1. Income Tax Marriage Penalty and Bonus Before and After OBRA93



SOURCE: Congressional Budget Office

NOTES: All calculations use 1994 tax parameters.

The estimates assume all income is from earnings and that the taxpayer claims the greater of the standard deduction or 20 percent of earnings.

OBRA-93 = Omnibus Budget Reconciliation Act of 1993.

Expanding the EITC to include families without children increases the marriage penalty for low-income couples. The penalty peaks at almost 7 percent of income for couples with combined incomes of $10,000. Although this penalty is large, it affects very few taxpayers. A combined income of $10,000 would imply that both spouses earn $5,000, an amount one-third less than they would earn if they both worked all year at the minimum wage.

OBRA-93 substantially increases the marriage penalty for two-earner couples with incomes of more than $179,000. This increase results from the new 36 percent bracket, which begins at taxable incomes of $115,000 for single filers and $140,000 for joint filers, and the new 39.6 percent bracket, which begins at a taxable income of $250,000 for both single and joint filers.

For example, under the new law in tax year 1994, a couple with combined earnings of $325,000 pay taxes of $81,797 if they file a joint return. If they each filed a single return with earnings of $162,500, they would pay a combined tax of $72,926. The marriage penalty is $8,871, or 2.7 percent of combined income.

Under pre-OBRA-93 law, the same two people would pay $74,887 if filing a joint return and $71,419 if filing two single returns--a marriage penalty of $3,468, or 1.1 percent of combined income. Overall, OBRA-93 raises the marriage penalty for most couples with combined incomes of more than $179,000 from about 1 percent of combined income under pre-OBRA-93 law to amounts ranging between 1 percent and 3 percent of combined income.

OBRA-93 also increases the marriage bonus for one-earner couples, but only for couples with incomes of more than $140,000 (see bottom panel of Figure 1). The increased marriage bonus occurs because the married earner reaches the 36 percent bracket at a higher taxable income than a single earner.

For example, under the new rates, a married couple with one earner and earnings of $180,000 pays $36,291; if single, the earner would pay $41,815. The marriage bonus for the couple is $5,525, or 3.1 percent of combined earnings. OBRA-93 raises taxes by less than 0.5 percent for the couple, but for a single earner with the same income it raises taxes by 4 percent. Under pre-OBRA law, the marriage bonus was smaller--$4,109, or 2.3 percent of combined earnings. Overall, OBRA-93 raises the marriage bonus for all one-earner couples with earnings of more than $140,000, but the increase in the bonus at all incomes is less than 1 percent of combined income.

The above examples illustrate how OBRA-93 affects the marriage penalty for couples without children. The expansion of the earned income tax credit in OBRA-93 also increases marriage penalties for some couples with children. Suppose, for example, that two people with earnings of $15,000 marry--one with two children and the other with no children. The spouse with children would receive the EITC if single, but receives no EITC when married because the combined income of the couple exceeds the maximum eligible earnings for the EITC. The loss of the EITC imposes a substantial marriage penalty in relation to total income. For this couple, the increase in the EITC in OBRA-93 raises the marriage penalty from $2,019 under pre-OBRA-93 law (6.7 percent of combined income) to $2,985 under current law (9.9 percent of combined income).

These examples illustrate the potential size of marriage penalties at different income levels, but they do not show how many people experienced increases in penalties and bonuses under OBRA-93. The relative numbers of people experiencing marriage penalties and bonuses depend in part on the percentage of married taxpayers with one earner and the division of earnings between spouses in two-earner couples.

Based on projections for shares of earnings from joint returns, CBO estimates that OBRA-93 increased marriage penalties for only a small fraction of couples. The tax rate changes only affected the minority of taxpayers who have very low or very high incomes, and most of those taxpayers whom the changes could potentially affect do not pay a marriage penalty.

Although other factors affect the marriage penalty, joint returns in which the second earner receives less than 20 percent of the couple's earned income probably had either a marriage bonus or a small penalty. These amount to about 57 percent of all joint returns (see Table 7). OBRA-93 increased the marriage penalty only for returns with combined income less than $20,000 and more than $140,000--less than 20 percent of joint returns in 1994. Among those high- and low-income taxpayers, CBO estimates that the second-earning spouse will receive less than 20 percent of combined earnings in more than 70 percent of returns. Consequently, marriage penalties will probably increase in an appreciable way for fewer than 6 percent of returns.

TABLE 7. DISTRIBUTION OF JOINT RETURNS BY COMBINED EARNINGS AND BY SHARE OF LESSER EARNER (In percent)

	One Earner	Fraction of Earnings Held by Lesser Earner: Zero to 10 Percent	10 to 20 Percent	20 to 30 Percent	30 to 40 Percent	40 to 50 Percent	Total	Number of Returns (Millions)
Combined Earnings								
$1-$10,000	74	6	4	4	5	8	100	2.4
$10,000-$20,000	56	7	8	7	10	13	100	3.5
$20,000-$30,000	45	9	10	11	12	13	100	5.6
$30,000-$50,000	37	9	9	12	14	18	100	12.1
$50,000-$75,000	26	10	9	15	19	22	100	9.5
$75,000-$100,000	22	11	9	13	19	26	100	3.4
$100,000-$200,000	32	15	12	13	12	15	100	2.1
$200,000 or More	52	23	10	5	3	6	100	0.5
All Joint Returns	38	10	9	12	14	17	100	39.1

SOURCE: Congressional Budget Office using its Tax Simulation Model and 1994 levels of income.

The Income Averaging Problem

Under a progressive income tax, taxpayers pay more tax over a period of years if their income fluctuates than if their income is the same every year. This situation occurs because, with graduated rates, the additional amount taxpayers pay per dollar of income above their annual average amount exceeds the reduced amount they pay per dollar of income below their annual average.

Before the Tax Reform Act of 1986, the individual income tax contained a special provision for income averaging. This provision enabled taxpayers with taxable income greater than 140 percent of their average taxable income in the previous three years to reduce their tax liability for the current year. The income averaging provisions lowered, but did not eliminate, the extra tax on taxpayers with uneven incomes.

TRA-86 eliminated income averaging, but it reduced the penalty for taxpayers with uneven incomes by flattening the marginal tax rate schedule. OBRA-93 increases marginal income tax rates at the top, but has no provision for income averaging.

The result is that some taxpayers with uneven incomes will pay more tax than those with the same average income but with equal incomes in every year. Take, for example, three joint taxpayers with average incomes of $150,000 per year over five years (see Table 8). Taxpayer 1 has the same income every year; taxpayer 2 has twice as much income in the current year as in each of the previous four years; and taxpayer 3 has three times as much income in the current year as in each of the previous four years.

A comparison of tax liability for these three taxpayers at 1993 tax rates under prior and current law indicates that the additional rate brackets in OBRA-93 increase taxes for all of them. The law imposes a small additional penalty on taxpayer 2 and a much larger additional penalty on taxpayer 3. Under the prior-law rate schedule, all three taxpayers pay the same average annual tax of $38,805. OBRA-93 raises the average annual tax liability to $39,305 for taxpayer 1 (an increase of 1.3 percent), to $39,905 for taxpayer 2 (an increase of 2.8 percent), and to $41,133 for taxpayer 3 (an increase of 6.0 percent.) The penalty for having uneven incomes is $600 per year (over five years) for taxpayer 2 and $1,828 per year for taxpayer 3. These penalties amount to 1.5 percent and 4.4 percent of tax liability for the two taxpayers. As a percentage of taxable income, they amount to 0.4 percent for taxpayer 2 and 1.2 percent for taxpayer 3.

The income averaging formula in effect before TRA-86 would not have reduced the tax liability of taxpayer 2 under either the pre-OBRA-93 or post-OBRA-93 rate schedules. It would have reduced the tax liability of taxpayer 3 by $514 under the post-OBRA-93 rate schedule. This reduction would lower the tax penalty for taxpayer 3 to 3.2 percent of tax liability and 0.9 percent of income.

As the above example illustrates, the penalty for uneven incomes can be substantial for a taxpayer with a taxable income in any year that is both very high and is several multiples of his or her average taxable income. The OBRA-93 rate changes will impose this penalty on very few taxpayers, however, and for most of the taxpayers that it affects the penalty will be small. (The higher marginal tax rates affect less than 1 percent of taxpayers and only a minority of these pay higher taxes because their incomes fluctuate.) The averaging formula in effect before TRA-86, if restored, would reduce the penalty somewhat, but only for taxpayers with extremely uneven incomes.

TABLE 8. EXAMPLES OF PENALTIES FOR JOINT RETURNS WITH UNEVEN INCOMES USING 1994 TAX RATES (In dollars)

	Current Amount	Annual Amount in Four Previous Years	Average Amount
	Taxes with No Income Averaging		
Taxpayer 1			
Taxable income	150,000	150,000	150,000
Tax before OBRA-93	38,805	38,805	38,805
Tax after OBRA-93	39,305	39,305	39,305
Taxpayer 2			
Taxable income	250,000	125,000	150,000
Tax before OBRA-93	69,805	31,055	38,805
Tax after OBRA-93	75,305	31,055	39,905
Taxpayer 3			
Taxable income	321,429	107,143	150,000
Tax before OBRA-93	91,947	25,519	38,805
Tax after OBRA-93	103,590	25,519	41,133
	Taxes with Pre-TRA-86 Income Averaging Formula		
Taxpayer 2			
Before OBRA-93	69,805	31,055	38,805
After OBRA-93	75,305	31,055	39,905
Taxpayer 3			
Before OBRA-93	91,947	25,519	38,805
After OBRA-93	101,019	25,519	40,619

SOURCE: Congressional Budget Office.

NOTE: OBRA-93 = Omnibus Budget Reconciliation Act of 1993; TRA-86 = Tax Reform Act of 1986.

CHAPTER IV

EFFECTS ON EXCISE TAXES AND TRUST FUNDS

The Omnibus Budget Reconciliation Act of 1993, by increasing tax rates on transportation fuels and expanding coverage of the Hospital Insurance payroll tax, affects the balances of trust funds that finance federal transportation programs and Medicare. The increased revenues from excise taxes on transportation fuels go partly to the general fund and partly to the Highway Trust Fund (HTF). The increased revenues from the HI payroll tax go to the HI (Medicare) trust fund. The HI trust fund also receives additional revenues from the OBRA-93 increase in taxation of Social Security benefits.

TAXES ON TRANSPORTATION FUELS

OBRA-93 increases taxes on transportation fuels. It also changes the allocation of revenue from these taxes between trust funds for specific uses and the general fund.

Taxes and Trust Funds Before OBRA-93

Under prior law, most transportation fuels were subject to tax. Most of the revenue from transportation taxes went to trust funds that finance highway spending and other federal transportation programs. Some of the revenues also went to trust funds for other purposes and to the general fund.

The tax rates on transportation fuels in 1993 were as follows: 14.1 cents per gallon on gasoline used as a highway fuel, in small engines (for example, in lawn mowers and snow blowers), in vehicles that use recreational trails, or in recreational motorboats; 20.1 cents per gallon on diesel used as a highway fuel; 15.1 cents per gallon on gasoline and 17.6 cents per gallon on jet fuel used in noncommercial aviation; 17.1 cents per gallon on diesel fuel used in barges traveling on inland or intracoastal waterways;[1] and 0.1 cents per gallon on fuels used in commercial aviation (see Table 9). In addition, there were special tax rates on some alternative highway fuels.

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1. This rate was scheduled to increase to 19.1 cents per gallon for calendar year 1994 and to 20.1 cents per gallon for calendar year 1995 and thereafter.

TABLE 9. FUEL TAX RATES UNDER PRIOR LAW AND UNDER OBRA-93
(In cents per gallon)

Fuel	Tax Rate Under Prior Law: Through Sept. 30, 1995	Tax Rate Under Prior Law: After Sept. 30, 1995[a]	OBRA-93 Tax Rate[a]
Gasoline (Highway use, small engine use, recreational trails use, and noncommercial motorboat use)	14.1	11.6	18.4
Noncommercial Aviation Gasoline	15.1	15.1	19.4
Gasohol	8.7	6.2	13.0
Diesel (Highway use, small engine uses, and recreational trails use)	20.1	17.6	24.4
Noncommercial Motorboat Diesel	0	0	24.4
Commercial Aviation Jet Fuel[b]	0.1	0.1	4.4
Railroad Diesel[c]	2.6	0.1	5.65
Noncommercial Aviation Jet Fuel	17.6	17.6	21.9
Inland Waterway Diesel			
Jan. 1, 1993, through Dec. 31, 1993	17.1	17.1	n.a.
Oct. 1, 1993, through Dec. 31, 1993	n.a.	n.a.	21.4
Jan. 1, 1994, through Dec. 31, 1994	19.1	19.1	23.4
After Dec. 31, 1994	20.1	20.1	24.4
Liquid Petroleum Gas	14.0	11.5	18.3
Compressed Natural Gas	0	0	4.3

SOURCE: Congressional Budget Office.

NOTES: Tax rates include the 0.1 cent per gallon leaking underground storage tank (LUST) tax.
OBRA-93 = Omnibus Budget Reconciliation Act of 1993.

a. These tax rates become effective on October 1, 1993, for all fuels except noncommercial motorboat diesel, which becomes taxable on January 1, 1994. The LUST tax rate and the Airport and Airway Trust Fund financing rates are scheduled to expire after December 31, 1995. The Highway Trust Fund financing rates are scheduled to expire after September 30, 1999. The tax on noncommercial motorboat diesel is scheduled to expire December 31, 1999.

b. Commercial aviation fuel is exempt from the 4.3 cents per gallon excise tax from October 1, 1993, through September 30, 1995.

c. The OBRA-93 tax rate applies beginning October 1, 1995. The applicable tax for October 1, 1993, through September 30, 1995, is 6.9 cents per gallon.

Tax revenue from these sources financed spending from the Highway Trust Fund, the Airport and Airway Trust Fund, the Leaking Underground Storage Tank (LUST) Trust Fund, the Aquatic Resources Trust Fund, the National Recreational Trails Trust Fund, the Inland Waterway Trust Fund, and the Land and Water Conservation Fund (see Figure 2). The Omnibus Budget Reconciliation Act of 1990 allocated 2.5 cents per gallon from the taxes on gasoline (other than aviation gasoline) and diesel fuel to the general fund for the first time. Before OBRA-93, the 2.5-cent portion of the gasoline and diesel fuel tax rates that provided revenues for the general fund was scheduled to expire on September 30, 1995.

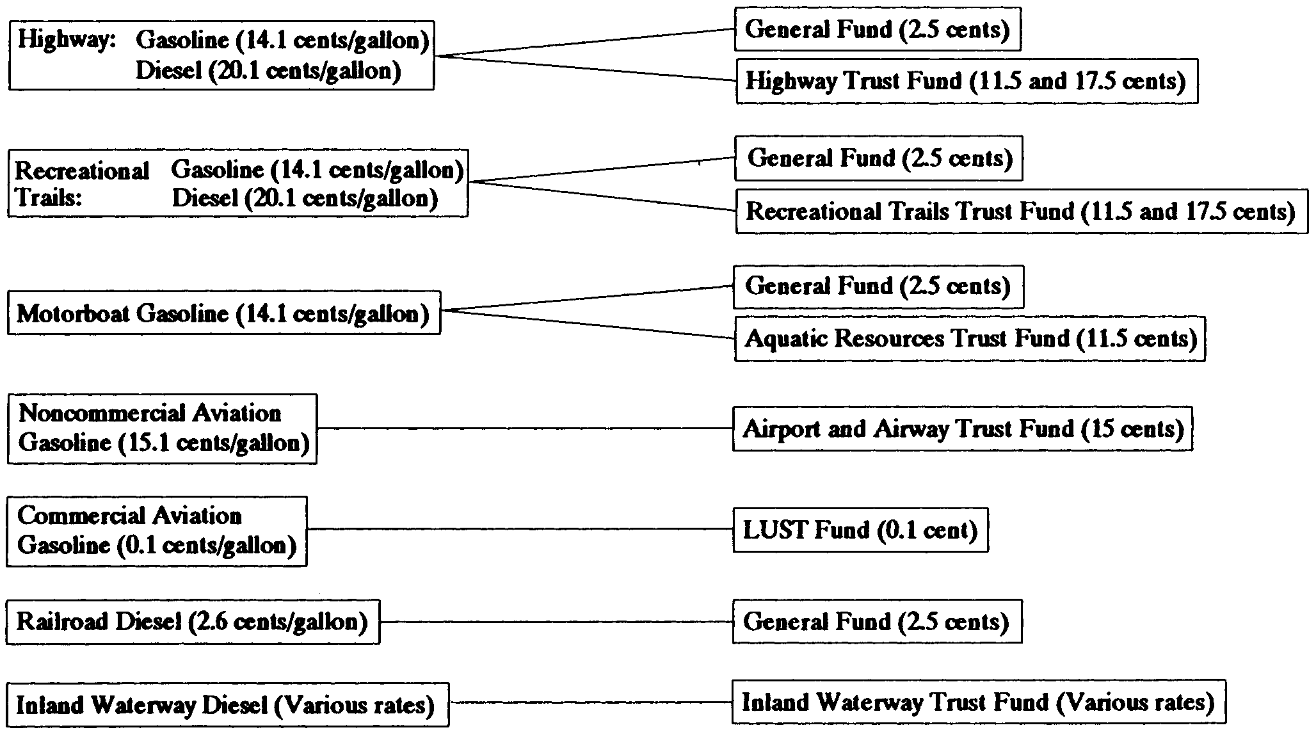
Tax Rate Increases

OBRA-93 increases taxes on transportation fuels, extends the 2.5 cents per gallon portion of the tax on fuels, and taxes noncommercial (recreational) uses of diesel fuel for the first time. It raises the tax rate on most transportation fuels by 4.3 cents per gallon, beginning October 1, 1993 (see Table 9). The 4.3 cents tax rate increase applies to gasoline, diesel, and liquid petroleum gas used as a highway fuel; gasoline and diesel used for off-highway nonbusiness use; gasoline and diesel used in recreational motorboats; fuel used in commercial and noncommercial aviation; diesel used by railroads; and diesel used on inland and intracoastal waterways. The tax rate increases also apply to alternative highway fuels, including gasohol. Fuel used in commercial airline transportation is exempt from the tax until October 1, 1995.

OBRA-93 extends until September 30, 1999, the 2.5-cent portion of the tax on some transportation fuels (primarily highway and recreational motorboat uses of gasoline and highway and railroad uses of diesel fuel). These taxes currently provide revenues for the general fund. The 2.5 cents per gallon tax on railroad diesel becomes 1.25 cents per gallon after September 30, 1995. Before OBRA-93, this portion of the tax on fuels was scheduled to expire on September 30, 1995.

OBRA-93 also imposes a new tax of 24.4 cents per gallon on diesel fuel used in noncommercial motorboats, beginning January 1, 1994. This provision taxes diesel fuel used in noncommercial motorboats for the first time at the same rate as the tax on diesel in other uses. The tax is scheduled to expire after December 31, 1999.

Figure 2.
Flow of Funds from Transportation Fuels Taxes Before OBRA-93



SOURCE: Congressional Budget Office based on the Internal Revenue Code.

NOTES: The allocation of the 0.1 cent per gallon tax to the Leaking Underground Storage Tank (LUST) Trust Fund is not depicted above, except in the case of commercial aviation gasoline.

OBRA-93 = Omnibus Budget Reconciliation Act of 1993.

Allocation to Trust Funds

OBRA-93 allocates the additional revenue from the 4.3 cents per gallon tax increase on transportation fuels to the general fund (see Figures 2 and 3). Revenue from the new tax on diesel fuel in noncommercial motorboats will also be retained in the general fund.

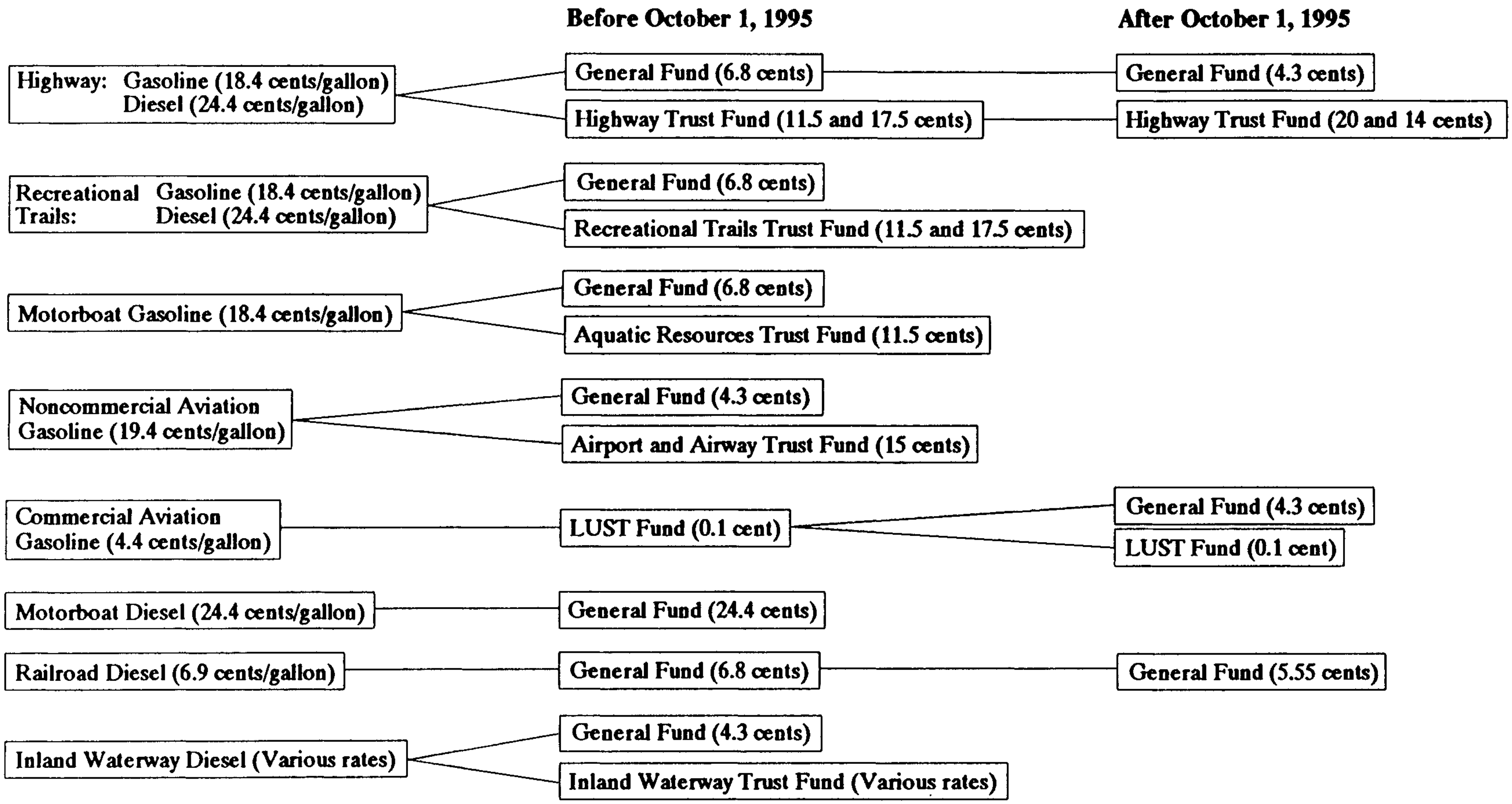
Although OBRA-93 allocates new tax revenues to the general fund, it also increases funding for the Highway Trust Fund. It does this by allocating to the HTF most of the revenue from extending the 2.5 cents per gallon portion of the tax beyond September 30, 1995. Under prior law, the revenues from this tax went to the general fund. After September 30, 1995, the only revenue from this tax that will remain in the general fund will be the amount attributable to noncommercial motorboats, small engines, recreational trails, and railroad fuel uses. The remainder of revenues (about 97 percent) will go to the HTF.

The transfer of revenues to the HTF from extending the 2.5 cents portion of the transportation fuels taxes will provide sufficient funds to finance the spending that the Congress authorized in the Intermodal Surface Transportation Efficiency Act of 1991 (ISTEA). Since enacting ISTEA, the Congress has limited obligations below authorized levels. If the Congress sets obligation limitations that are consistent with the spending levels that ISTEA authorized, highway spending will increase. But highway spending is discretionary, and total discretionary spending is subject to the annual caps imposed under the Budget Enforcement Act of 1990. Consequently, the additional highway spending will require offsetting cuts in other discretionary spending.

Changes in Tax Administration

To improve compliance, OBRA-93 places the tax collection point for diesel fuel at the distributor, the same collection point as the gasoline tax, beginning January 1, 1994. Under prior law, the Internal Revenue Service (IRS) collected the diesel fuel tax at the final-distributor level because diesel fuel for transportation is physically indistinguishable from exempt home heating oil.

Figure 3.
Flow of Funds from Transportation Fuels Taxes After OBRA-93



SOURCE: Congressional Budget Office based on the Internal Revenue Code as amended by OBRA-93.

NOTES: The allocation of the 0.1 cent per gallon tax to the Leaking Underground Storage Tank (LUST) Trust Fund is not depicted above, except in the case of commercial aviation gasoline. The LUST tax rate expires December 31, 1995.

OBRA-93 = Omnibus Budget Reconciliation Act of 1993.

Instead, OBRA-93 requires taxpayers to dye untaxed diesel fuel before it leaves the terminal.[2] Vendors or purchasers who are exempt users or who use undyed (taxed) fuel for an exempt purpose may apply for a refund of the tax from the IRS.

Effects on Consumers

Under prior law, CBO projected the gasoline price to be $1.24 per gallon in 1994. The 4.3 cents per gallon increase in the tax rate will raise the 1994 gasoline price by about 3 percent. CBO estimates that the tax increase will reduce the consumption of motor gasoline by less than 1 percent.

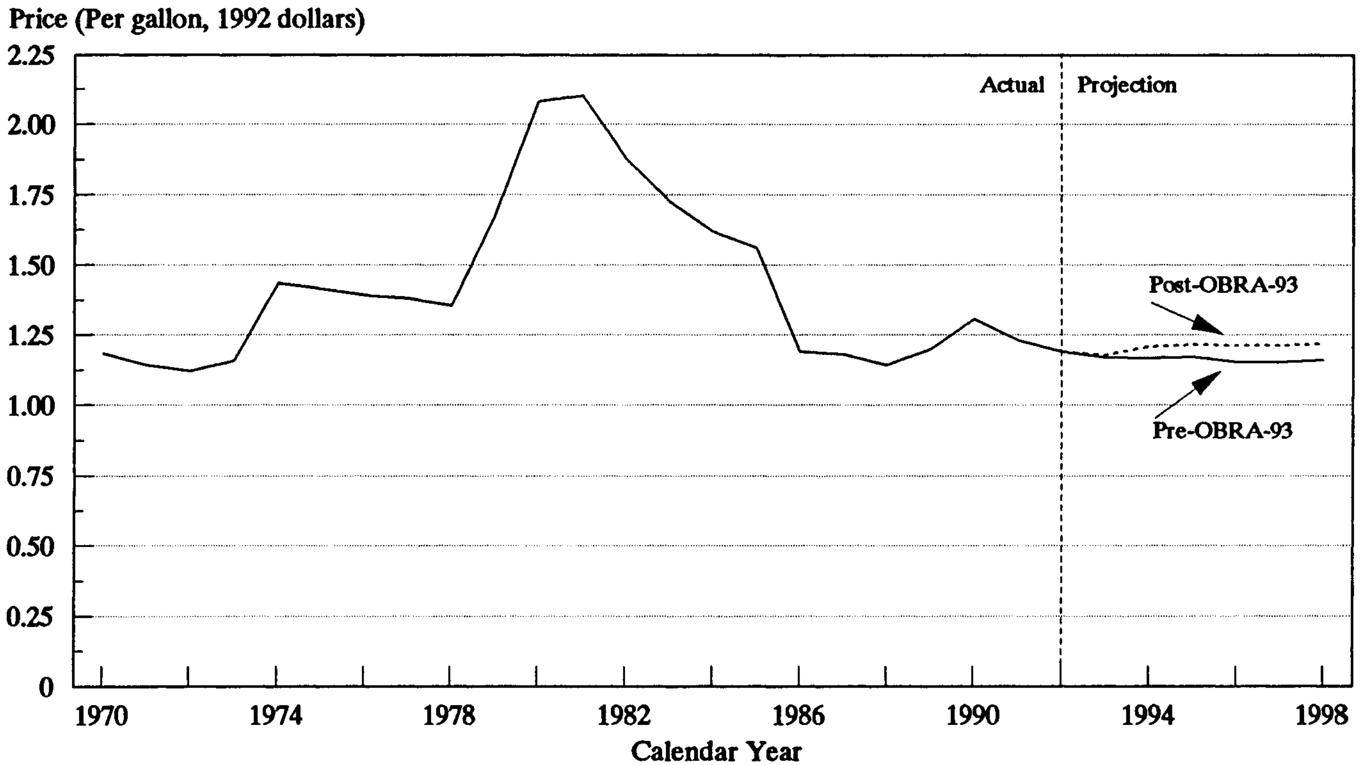
The tax increase will leave the price of gasoline in constant dollars about equal to its level before the 1973 oil embargo and significantly below levels reached in the late 1970s and early 1980s (see Figure 4). It will also leave average U.S. tax rates for gasoline and diesel fuel significantly below tax rates in other countries of the Organization for Economic Cooperation and Development (see Table 10).

CBO estimates that the 4.3 cents per gallon increase in the tax on transportation fuels will raise an average urban household's annual cost of purchasing motor fuels by about $45. This figure includes both the increased cost of direct household motor fuel purchases and the increased cost of other goods resulting from higher transportation costs in the business sector. It includes an offset for the effect of higher consumer prices on indexed transfer programs and on individual income tax exemptions, deductions, and brackets.

The impact of the tax increase will vary among households depending on how many miles they drive, the road congestion conditions that they face, and the fuel efficiency of their vehicles. Because these factors, especially driving distances, vary among regions, the impact of the tax will differ in different parts of the country. But differences among urban regions will not be large. The average urban household in the Northeast and Midwest spends slightly less than the national average on motor fuels; the average urban household in the South and West spends virtually the same as the national average. (Urban households account for about 85 percent of the U.S.

2 This provision is designed to work in conjunction with the requirement in the Clean Air Act Amendments of 1990 specifying that, beginning October 1, 1993, off-highway diesel fuel with a sulphur content in excess of 0.05 percent by weight be dyed.

Figure 4.
Real Average Retail Prices of Gasoline Before and After Incorporating the Effects of OBRA-93



SOURCE: Congressional Budget Office.

NOTES: Retail prices include state and federal taxes.
OBRA-93 = Omnibus Budget Reconciliation Act of 1993.

TABLE 10. MOTOR FUEL TAX RATES FOR SELECTED COUNTRIES AS OF AUGUST 1, 1993 (In U.S. dollars per gallon)

Country	Gasoline	Diesel
Belgium	2.12	1.40
Canada[a]	0.78	0.63
France	2.21	1.22
Germany	2.14	1.31
Italy	2.36	1.65
Japan	2.04	0.98
Netherlands	2.40	1.10
United Kingdom	1.71	1.45
United States[b]	0.33	0.39

SOURCE: Congressional Budget Office based on Department of Transportation, Federal Highway Administration, "Monthly Motor Fuel Reported by States" (April 1993); Organization for Economic Cooperation and Development, "Energy Prices and Taxes" (First Quarter 1993).

NOTE: Rates were converted to U.S. currency using current exchange rates. The source for foreign tax rates was data collected by the U.S. Department of Energy.

a. Canadian tax rates are for the first quarter of 1993.

b. Includes the weighted average of state tax rates and federal tax rates.

population.) Differences between rural and urban households are larger, however. The average rural household spends about 20 percent more than the national average on highway motor fuels.[3]

PAYROLL TAXES AND THE HOSPITAL INSURANCE TRUST FUND

Before the enactment of OBRA-93, CBO estimated that the Hospital Insurance Medicare trust fund would be depleted by 1999. OBRA-93 increases revenues for the HI trust fund and enacts outlay savings in the Medicare program. These tax and spending changes delay the projected depletion of the trust fund until 2003. Higher revenues account for two-thirds of the improvement in the trust fund's balance between 1994 and 1998. The vast majority of the new revenues for the HI trust fund derive from two provisions:

3. For a fuller discussion of the regional impacts of alternative energy taxes, see statement of Robert D. Reischauer, Director, Congressional Budget Office, before the Senate Committee on Energy and Natural Resources, February 24, 1993.

eliminating the HI taxable earnings cap and increasing the taxation of Social Security benefits.

OBRA-93 eliminates the maximum taxable earnings cap for HI Medicare taxes beginning January 1, 1994. (The cap on the amount of wages subject to the tax was $135,000 in 1993 and was indexed to the growth rate of the Social Security wage base.) This provision increases HI taxes for fewer than 3 million workers, or about 2 percent of the work force.

Before OBRA-93, the cap made the HI tax regressive at the top of the income distribution because workers earning more than the maximum level of taxable earnings paid a smaller share of their income in payroll taxes than other workers. Eliminating the cap removes this regressive feature of the tax and makes it strictly proportional to wages. One can argue, however, that the tax should not rise much with income because it finances Medicare benefits that do not rise either with income or with taxes paid. Eliminating the maximum taxable earnings cap raises the subsidy that high-wage workers pay to other workers to finance their future Medicare benefits.

OBRA-93 increased the amount of Social Security and Railroad Retirement (Tier I) benefits subject to income taxes. Before OBRA-93, adjusted gross income included the lesser of one-half of Social Security and Tier I benefits or one-half of the excess of the taxpayer's combined income (AGI plus nontaxable interest income plus one-half of Social Security and Tier I benefits) over a threshold amount. The threshold amount was $25,000 for single returns and $32,000 for joint returns.

OBRA-93 establishes an additional threshold amount at which the lesser of 85 percent of Social Security and Tier I benefits or 85 percent of the excess of the taxpayer's combined income is included in AGI. The new threshold amount is $34,000 for single returns and $44,000 for joint returns. Including 85 percent of benefits in AGI makes the tax treatment of Social Security for workers with high earnings roughly comparable to that of contributory retirement plans in the private sector. The tax treatment of Social Security benefits remains more generous than contributory plans for those with relatively low earnings.

OBRA-93 allocates the revenue from taxing Social Security benefits to two different trust funds. Revenues from the pre-OBRA-93 taxes continue to be allocated to the Social Security (OASDI) trust fund. But revenues from the additional taxes imposed by OBRA-93 will be transferred to the HI trust fund.

The reduction in HI Medicare spending comes mainly from reduced payments to hospitals, physicians, and other health care providers. The largest provision reduces the annual indexing factor used to calculate the reimbursements to hospitals under the prospective payment system.

CHAPTER V

CONCLUSIONS

The Omnibus Budget Reconciliation Act of 1993 reduces the federal deficit by $433 billion between 1994 and 1998 compared with the Congressional Budget Office baseline. The revenue provisions of the act account for more than half of the reduction in the deficit.

The tax provisions in OBRA-93 increase the tax burden on the highest income taxpayers, while reducing taxes on average for low-income families. The increase in marginal tax rates on the highest income taxpayers reduces their incentives to work and save and increases their incentive to participate in tax-favored activities. OBRA-93 expands and extends some existing tax preferences, introduces some new ones, and reduces or eliminates others. The changes in tax rates and in more narrow provisions affect the allocation of investment among industries and locations, the choice of business organizational form and firm size, and some employment and consumption choices.

OBRA-93 increases taxes on high-income taxpayers by adding two new marginal tax rate brackets, increasing the rate of the individual alternative minimum tax, extending the provisions of current law that limit itemized deductions and phase out personal exemptions for high-income taxpayers, and removing the cap on wages subject to the Hospital Insurance payroll tax. At the same time, OBRA-93 reduces taxes on low-income families by expanding the earned income tax credit. Taxes on middle-income families increase, but only slightly.

OBRA-93 also redistributes the tax burden among types of families. On average, taxes on families with children increase slightly less than those on other families, largely because of the expansion of the EITC. Taxes increase slightly more on families with an elderly head than on other families, largely because of the provision that increases the taxation of Social Security benefits.

The higher marginal tax rates and the changes in the EITC also affect how the tax law treats families with similar incomes but different circumstances. The expansion of the EITC increases marriage penalties for some low-income families with children. The higher marginal tax rates increase both marriage penalties and marriage bonuses for high-income people, with the effect depending on their total income and the share of earned income received by each spouse. The higher marginal tax rates also increase the tax penalty that graduated rates impose on people whose incomes vary from year to year.

The higher marginal tax rates on high-income taxpayers in OBRA-93 reduce incentives to work and save and increase incentives to take compensation in the form of tax-free fringe benefits, spend money on tax-deductible goods and services, and shift saving to tax-exempt and tax-preferred assets. OBRA-93 also changes marginal rates for low-income taxpayers by increasing the subsidy rate of the EITC and raising both the rate and the income level at which the subsidy phases out. Marginal tax rates increase for some low-income workers and decrease for others; on average, marginal rates on earned income in the bottom quintile increase slightly. Middle-income taxpayers experience much smaller changes in marginal tax rates than either high- or low-income taxpayers.

The higher tax rates will reduce private saving, offsetting some of the increase in national saving from the lower federal deficit. The tax increases can affect private saving both by reducing the total after-tax income of high-income families and by reducing the after-tax rate of return they receive from new saving. Economists do not agree, however, on whether the lower after-tax returns will reduce saving and, if so, by how much. CBO estimates that the two effects combined will lower private saving by between $5 billion and $7 billion per year.

OBRA-93 influences many business decisions. Provisions in the law encourage Subchapter S corporations to switch back to the C corporate form, encourage investment and employment in small businesses, discourage some international transactions, and discourage investment in U.S. possessions by capital-intensive corporations, although without necessarily reducing employment in possessions. Other provisions have little behavioral effect. These include provisions that affect past transactions, such as the restriction on tax benefits for firms that purchased insolvent savings and loans, and provisions that alter effective tax rates only slightly, such as the speedup in corporate estimated tax payments.

The higher marginal tax rates in OBRA-93 do not place small businesses at a disadvantage compared with large corporations. Although some investors in, and employees of, small businesses will face higher marginal tax rates, they would pay the same rates if they received an equal income from other assets or employers. Moreover, most small business people do not face higher marginal tax rates under OBRA-93, and most taxpayers whose marginal tax rates increase do not receive the majority of their income from small business activities.

Tax expenditures are the revenue losses from provisions of the tax law that provide selective relief for groups of taxpayers or special incentives for particular economic activities. OBRA-93 extends some tax expenditure provisions, introduces some new tax expenditures, and limits others. On balance, however, OBRA-93 increases tax expenditures because the higher marginal rates it imposes raise the value of provisions that convey selective tax relief. The higher rates significantly increase the value of tax preferences that primarily benefit high-income individuals, but only slightly increase the value of preferences that corporations and a broader group of individuals claim.

OBRA-93 increases tax rates on gasoline and other transportation fuels. It increases the tax rates on most consumption of these fuels by 4.3 cents per gallon and also extends through September 30, 1999, the 2.5-cent portion of the tax that was scheduled to expire on September 30, 1995. CBO estimates that the 4.3 cents per gallon tax increase will raise the average household's annual cost of purchasing motor fuels by only $45 and reduce consumption by less than 1 percent. Even with this increase, the price of gasoline in constant dollars will remain about the same as before the 1973 oil embargo and will continue to be much lower than the price in other countries belonging to the Organization for Economic Cooperation and Development.

OBRA-93 also reallocates revenues among the general fund and special trust funds. The 4.3-cent tax increase will go to the general fund, in contrast to the historical practice until 1990 of allocating all gasoline tax revenues to the Highway Trust Fund. The 2.5-cent portion of the tax that now goes to the general fund, however, will be reallocated to the HTF after October 1, 1995. OBRA-93 also significantly increases funding for the Medicare's Hospital Insurance Trust Fund. It does that by increasing revenues from the HI payroll tax, allocating revenues from the increased taxation of Social Security benefits to the fund, and reducing HI (Medicare) spending.