NLWJC - Kagan

DPC - Box 004 - Folder 013

Budget Materials - Corporate Welfare/Tax Expenditures

Budget materials – corporate welfare/
tax expenditures

Largest Tax Expenditures for FY2001\1.

Provisions with greatest impact on businesses		Revenue Loss ($ billions)
1.	Accelerated depreciation of machinery and equipment	32.2
2.	Exclusion of interest for private purpose bonds	6.8
3.	Graduated corporation income tax rate	6.1
4.	Credits for corporations receiving income from business in US possessions	3.6
5.	Credit for low-income housing investments	3.4
6.	Deferral of income from controlled foreign corporations	2.9
7.	Accelerated depreciation on rental housing	2.5
8.	Expensing of R & E expenditures	2.3
9.	Exclusion of income of foreign sales corporations	2.0
10.	Inventory property sales source rules exception	1.9
11.	Percentage depletion	1.6
12.	Accelerated depreciation of buildings other than rental housing	1.6
13.	Exclusion of interest on owner-occupied mortgage subsidy bonds	1.5
14.	Exemption of credit union income	1.0
15.	Alternative fuel production credit	0.8

Source: Budget of the US Government, Fiscal Year 1997, Table 5-2, pp.65-67.

Note: Tax expenditures estimates do not reflect taxpayer behavior or interaction effects, and may significantly differ from revenue estimates.

\1. Latest date available.

ADMINISTRATION REVENUE-RAISING PROPOSALS NOT INCLUDED IN TRA97

	$millions	
Financial Products	5 Yr	10 Yr
• Defer interest deduction on certain convertible debt***	160	519
• Reduce dividends-received deduction to 50%*	1750	3918
• Deny DRD for certain preferred stock***	184	724
• Disallowance of interest on debt allocable to tax-exempt obligations**	213	636
• Average cost basis for securities**	3011[a]	6142[a]
Corporate		
• Repeal percentage depletion for nonfuel minerals on certain Federal lands***	476	991
• Sunset extension of section 29 credit for nonconventional fuels*	476	1018
• Conversion of large corporations into S corporations*	119	514
Foreign		
• Captive insurance companies***	68	67
• Modify foreign tax credit carryover rules***	1221	1946
• Foreign oil and gas income**	371	991
• Sales source rule**	4518	11483
Accounting		
• Repeal lower-of-cost-or-market inventory method***	1513	1767
• Repeal components-of-cost inventory method***	934	2110
Administrative		
• Increased information reporting penalties***	90	223
• Substantial understatement penalty for corporations***	169	248
• Withholding on certain gambling winnings***	25	30
• Deposit requirement for FUTA taxes***	1320	1481
Excise Taxes		
• Reinstate Oil Spill Liability Trust Fund taxes***	1161	1408
• Reinstate Superfund taxes***	7720[b]	9869[b]
Other		
• Section 1031 like-kind exchange modifications**	1801[a]	3953[a]
	27300	50038

***/ Politically viable.

**/ Politically viable with modifications.

*/ Not politically viable.

[a]/ Estimates were made prior to enactment of TRA 97. The provisions identified would have large interaction effects with the provisions of TRA 97 and, therefore, the estimates are no longer reliable.

[b]/ Extension of these taxes was already included in the Administration's FY 1998 Mid-Session Review.

TABLE 5–3. MAJOR TAX EXPENDITURES IN THE INCOME TAX, RANKED BY TOTAL 1998 REVENUE LOSS

(In millions of dollars)

Provision	1998	1998–2002
Exclusion of employer contributions for medical insurance premiums and medical care	75,750	435,745
Net exclusion of employer pension-plan contributions and earnings	56,245	285,445
Deductibility of mortgage interest on owner-occupied homes	52,115	284,790
Step-up basis of capital gains at death	31,945	173,040
Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	30,995	169,370
Accelerated depreciation of machinery and equipment (normal tax method)	29,285	175,965
Deductibility of charitable contributions	22,340	123,365
Exclusion of OASI benefits for retired workers	18,495	100,345
Deductibility of State and local property tax on owner-occupied homes	17,435	95,285
Exclusion of interest on public purpose State and local debt	15,735	77,245
Deferral of capital gains on home sales	15,290	81,165
Deferral on income on life insurance and annuity contracts	11,940	67,975
Exclusion of interest on State and local debt for various non-public purposes	8,925	42,450
Net exclusion of Individual Retirement Account contributions and earnings	8,600	45,465
Capital gains (other than agriculture, timber, iron ore, and coal) (normal tax method)	8,480	45,010
Earned income credit [1]	5,814	31,725
Exclusion of workmen's compensation benefits	5,305	29,590
Exclusion of capital gains on home sales for persons age 55 and over	5,095	27,210
Graduated corporation income tax rate (normal tax method)	4,940	27,165
Accelerated depreciation of buildings other than rental housing (normal tax method)	4,660	13,190
Deductibility of medical expenses	4,535	26,470
Exclusion of Social Security benefits for dependents and survivors	4,175	22,665
Exception from passive loss rules for $25,000 of rental loss	3,470	15,395
Net exclusion of Keogh plan contributions and earnings	3,325	18,460
Credit for low-income housing investments	3,270	17,135
Exclusion of veterans disability compensation	2,930	16,455
Credit for child and dependent care expenses	2,840	15,700
Tax credit for corporations receiving income from doing business in U.S. possessions	2,770	14,485
Exclusion of employer-provided premiums on group term life insurance	2,745	15,140
Exclusion of Social Security disability insurance benefits	2,615	15,315
Deferral of income from controlled foreign corporations (normal tax method)	2,400	14,000
Exclusion of benefits and allowances to armed forces personnel	2,095	10,695
Exclusion of interest on State and local debt for private nonprofit health facilities	2,005	9,325
Exclusion of income earned abroad by United States citizens	1,865	11,590
Exclusion of income of foreign sales corporations	1,700	9,500
Inventory property sales source rules exception	1,600	9,000
Accelerated depreciation on rental housing (normal tax method)	1,555	10,395
Additional deduction for the elderly	1,495	7,535
Exclusion of reimbursed employee parking expenses	1,315	6,945
Deferral of interest on savings bonds	1,285	6,095
Excess of percentage over cost depletion (fuels)	1,170	6,045
Credit for increasing research activities	1,045	1,445
Deferral of income from post 1987 installment sales	995	5,175
Expensing of certain small investments (normal tax method)	900	3,900
Exclusion of employer provided child care	890	5,150
Parental personal exemption for students age 19 or over	885	4,935
Exclusion of scholarship and fellowship income (normal tax method)	850	4,340
Exemption of credit union income	745	4,195
Special ESOP rules	720	3,830
Empowerment zones	640	3,240
Exclusion of employee meals and lodging (other than military)	630	3,505
Exclusion of public assistance benefits (normal tax method)	550	3,005
Deductibility of casualty losses	510	2,815
Alternative fuel production credit	485	2,575
Exclusion of railroad retirement system benefits	450	2,275
Expensing of multiperiod timber growing costs	440	2,415
Expensing of research and experimentation expenditures (normal tax method)	430	3,200
Exclusion of parsonage allowances	335	1,920
Excess of percentage over cost depletion, nonfuel minerals	300	1,565
Exclusion of interest on small issue IDBs	260	1,255
Tax exemption of certain insurance companies	255	1,400
Amortization of start-up costs (normal tax method)	205	1,075
Adoption assistance	200	1,610
Capital gains treatment of certain income	175	925
Exclusion of employer-provided premiums on accident and disability insurance	175	975
Carryover basis of capital gains on gifts	160	900
Permanent exceptions from imputed interest rules	155	800
Work opportunity tax credit	150	275
Exclusion of military disability pensions	130	650

From Don Lubick

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TP

RIGOROUS REVIEW OF BUSINESS TAX EXPENDITURES

INFORMATION

What is the issue?

Many business tax preferences have been enacted over the years to stimulate business investment or to promote other worthwhile objectives. However, in view of the budget deficit, it will be necessary to reduce direct government spending, and to subject business tax preferences to careful scrutiny. Many business tax preferences are not cost effective (the revenue cost of these incentives frequently exceeds the value of the induced activity). Even cost effective preferences may be inefficient because they encourage unproductive investments.

The issue has taken increased prominence in recent weeks as a group of nine senators, including McCain and Kennedy, introduced legislation on January 28 to establish a commission to attack corporate subsidies. John Kasich is leading the "Stop Corporate Welfare" coalition which has targeted 12 *expenditure* programs for elimination. Kasich's group has purposefully avoided targeting any corporate tax subsidies. Given the interest in the broad topic of trimming corporate subsidies, the following discussion lays out the pros and cons of different approaches to this issue.

What are the options?

There are at least four broad approaches to this issue: creating a high-level commission to assess and then make recommendations on the efficacy of various business tax subsidies; cutting or reforming on a case-by-case basis each provision; reducing a broad class of specified preferences by an across-the-board cut; or eliminating preferences by sunsetting, possibly in exchange for restoring a smaller number of preferences. Presumably, each of these approaches would focus primarily on identified tax preferences and possibly "loophole closing," leaving compliance measures to be addressed in the ordinary fashion.

a. Establish a "Corporate Base Broadening Commission"

This option would create a commission, modeled after the base-closing commission, that would review corporate tax preferences item-by-item. After studying the economic rationale for each provision, it would recommend reduction or elimination of these preferences as a package to be voted up or down by Congress.

Pros and cons:

The commission idea is politically popular and may provide political cover for the inevitable screams of those whose tax preference may be lost. Subjecting a package of tax expenditure cuts for an up or down vote may also minimize log-rolling where votes in support of one preference item are traded for votes in support of another.

Treasury and the tax-writing committees of Congress would give up some of their power and responsibility to a base broadening commission. Taking this step is extreme -- it is a tacit statement that the system is broken, so well-intentioned piecemeal reform of the corporate tax base is impossible. The FY 1998 budget proposes a number of provisions that would broaden the base, so Treasury clearly feels the system is not irreparably broken. However, the development of this package confirmed the difficulty in addressing business tax expenditures on a large scale. A different concern arises about the possible makeup of a base broadening commission. If appointments are shared jointly by Congress and the Administration, situations could arise where the actions of the committee are contrary to the Administration's interests and sound policy.

b. Eliminate specific tax preferences.

This proposal does the hard work of scouring, provision by provision, the tax code to root out the most objectionable preferences. Tax preferences to be eliminated may be narrow subsidies that benefit particular industries, such as exporters, credit unions, and energy producers, or broad provisions that benefit businesses in general, such as accelerated depreciation. Tax preferences for particular industries are often the most difficult to justify, and eliminating them would limit opposition to specific interest groups. Curtailing broad provisions would generate opposition from all capital intensive industries, including manufacturing, transportation, and utilities.

Pros and cons

This is the way that base broadening should proceed. Each provision of the code should periodically be subject to a rigorous cost-benefit test. Those that fail the test should be eliminated. This is, in fact, the path the Administration has taken in the last several budgets. This year we have proposed to curtail approximately $25 billion through FY 2002 in unwarranted corporate tax preferences. We presumably will not be successful in eliminating these subsidies and others may be reform targets in the future. Hence, we have not reached the limits of this approach.

The problem with this approach is that special interests mobilize vigorously to defend "their" provision. An (almost) inevitable problem in representative democracies is that a small but actively mobilized minority can often thwart changes that would bring small benefits to the larger public, despite the fact that the aggregate benefit of reform outweighs the costs imposed on the special interests. While this problem arises frequently, it does not paralyze the system. In the specific case of loophole closers, we are likely to be successful with some of our initiatives. We should build on these successes.

c. Reduce tax expenditures across-the-board, for example, by 10 or 20 percent.

This option would provide an across-the-board reduction in the value of a broad range of business tax preferences, in some cases by restoring a percentage of the excess deductions or excluded receipts to taxable income, and in other cases by permitting taxpayers to use only a percentage of the credits that would otherwise be available. A 10 percent reduction applied to a comprehensive list of business tax expenditures would raise approximately $4 billion per year, but would add significant complexity to the tax code.

Pros and cons

The primary advantage to this approach is that it appears to be fair. It would be advanced with the rhetoric of shared sacrifice where all interests are asked to make due with smaller subsidies.

The apparent advantage of "shared sacrifice" would surely be ephemeral. Approximately 80 percent of the revenue gain from this option comes from scaling back accelerated depreciation. The other provisions, which save less than $1 billion, will generate large political costs. Additionally, the reliance upon cutting back accelerated depreciation as the overriding constituent of the cutback endangers the image of the proposal as a broad-based attack on preferences. Moreover, the premise that the expenditures included in the "haircut" are all equally inappropriate would not withstand scrutiny. Rather, this approach can only be advocated on the basis of rough justice, together with the admission that the system generally is incapable of dealing with these issues in any substantive or policy-specific basis.

d. Sunset all business tax expenditures.

Sunsetting all or virtually all business tax expenditures could be made effective at the beginning of 2001 or contingent on the failure to attain a specified budget target in the previous fiscal year. A trigger is contingent and less threatening than a hard sunset, but an enacted sunset indicates seriousness of motive and firm belief in the soundness of the policy to sacrifice all or some of the specified items. At the same time, the proposal would establish fast track procedures for, and would envision restoring, all but some amount (say $5 billion in FY 2002) of the sunsetted tax expenditures.

Pros and cons

This is a potentially elegant solution to reducing corporate tax expenditures if Congress agreed to the rules of the game. All (or most) corporate subsidies would be slated for termination, with the promise that some (fairly high) percentage would be renewed following the sunset. The burden would then be placed on Congress to determine which subsidies merited renewal and which would be allowed to lapse. Sunsetting tax expenditures on a specific date--the present treatment of certain tax expenditures, such as the research tax credit-- makes these incentives subject to periodic review. If applied across-the-board, the sunset approach would not narrowly target specific sectors. The pain would be spread unless Congress directs otherwise under the fast track procedures.

While decision-making responsibility may be deflected under this option, it is not clear why Congress would agree to this plan. It gives decision-making authority and responsibility to someone else, which in this case would not be welcome, particularly given the alternative of doing nothing. Moreover, this approach could create significant uncertainty and potentially encourage taxpayers to accelerate investment into the tax-favored activities to beat the sunset date. It may also be difficult for the Administration to sunset tax preferences that it has proposed or endorsed, such as the low-income housing tax credit, expensing for small businesses, and empowerment zones. But if these expenditures were left off the specified list consistent with the Administration's priorities, surely Congressional leaders would demand the exclusion up front of other business tax expenditures that are consistent with their priorities.

Office of Tax Policy
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Options for Increasing Standard Deduction Amounts

Option 1: Loses $10 billion in 2007

Increase standard deduction amounts by 10 percent:

	Single	Joint	Head-of-Household
Current Law	$5,400	$9,050	$7,950
Proposed Law	$5,940	$9,955	$8,745

- The number of returns with itemized deductions would be reduced by 4.2 million returns, from 44.5 million returns to 40.3 million returns.
- The number of returns with positive tax liability would be reduced by 1.3 million returns, from 100.3 million returns to 99.0 million returns.

Option 2: Loses $50 billion in 2007

Increase standard deductions by 68 percent:

	Single	Joint	Head-of-Household
Current Law	$5,400	$9,050	$7,950
Proposed Law	$9,072	$15,204	$13,356

- The number of returns with itemized deductions would be reduced by 15.9 million returns, from 44.5 million returns to 28.6 million returns.
- The number of returns with positive tax liability would be reduced by 8.6 million returns, from 100.3 million returns to 91.7 million returns.

Options for Reducing Tax Rates 1/

(2007 law and levels)

Revenue effect of reducing:	$ billions
15% Rate to 14% for:	
All taxpayers	-25.4
Only current 15% bracket taxpayers	-12.7
28% Rate to 27%	-9.3
31% Rate to 30%	-1.7
36% Rate to 35%	-1.8
39.6% Rate to 38.6%	-3.2

Department of the Treasury 11/12/97

Office of Tax Analysis

1/ Estimates assume no taxpayer behavior and are therefore static.