Options for Reducing the Deficit: 2014 to 2023

NOVEMBER 2013
In fiscal year 2013, the federal government collected $2.8 trillion in revenues. Individual income taxes were the largest source of revenues, accounting for more than 47 percent of the total. Social insurance taxes (primarily payroll taxes collected to support Social Security and Medicare) accounted for 34 percent, about 10 percent came from corporate income taxes, and other receipts—from excise taxes, estate and gift taxes, earnings of the Federal Reserve System, customs duties, and miscellaneous fees and fines—made up the remaining 9 percent.

Relative to the size of the economy, federal revenues increased robustly between 2012 and 2013. In 2013, revenues equaled 16.7 percent of gross domestic product (GDP), which is 1.5 percentage points above their share of GDP in 2012. That strong growth is attributable partly to the January 2013 expiration of a 2 percentage-point reduction in the payroll tax, but receipts of individual income taxes also rose because of three other factors:

- Beginning in January, tax rates on personal income above certain thresholds went up;
- In anticipation of changes in tax law, some high-income taxpayers realized more income late in calendar year 2012 and therefore paid taxes on that income in fiscal year 2013; and
- Personal income rose for reasons that are unrelated to changes in tax provisions.

The Congressional Budget Office (CBO) also attributes some of the growth in revenues this year to increases in the average tax rate on domestic economic profits, which boosted receipts from corporate income taxes.\(^1\)

Revenues would be greater if not for the more than 200 tax expenditures in the individual and corporate income tax system, which will total more than $1 trillion in 2013, CBO estimates.\(^2\) Those tax expenditures—so called because they resemble federal spending to the extent that they provide financial assistance for specific activities, entities, or groups of people—are exclusions, deductions, exemptions, and credits in the individual and corporate income tax systems that cause revenues to be lower than they would be otherwise for any given schedule of tax rates (see Box 4-1).

**Trends in Revenues**

Over the past 40 years, total federal revenues have averaged 17.4 percent of GDP—ranging from a high of 19.9 percent of GDP in 2000 to a low of 14.6 percent in 2009 and 2010 (see Figure 4-1 on page 102). The variation over time in total revenues as a percentage of GDP is primarily the result of fluctuations in receipts of individual income tax payments and, to a lesser extent, of fluctuations in collections of corporate income taxes. Revenues from individual income taxes have ranged from slightly more than 6 percent of GDP (in 2010) to slightly less than 10 percent of GDP (in 2000). Since the 1970s, corporate income taxes have ranged from about 1 percent to about 3 percent of GDP.

The variation in revenues generated by individual and corporate income taxes has stemmed in part from changes in economic conditions and from the way those changes interact with the tax code. For example, in the absence of legislated tax reductions, receipts from individual income taxes tend to grow relative to GDP.

---

1. The average tax rate is the ratio of corporate income taxes to domestic economic profits. An increase in that measure typically occurs because taxable corporate profits increase faster than domestic economic profits. Domestic economic profits do not account for certain factors that affect corporate income taxes, such as deductions for bad debts, income from capital gains realizations, and deductions for accelerated depreciation.
2. The estimates of tax expenditures account for effects both from income taxes and from payroll taxes. Because they are based on people's behavior with the tax expenditures in place, the estimates do not represent the revenues the government would collect if those provisions of the tax code were eliminated and taxpayers adjusted their activities in response.
because of a phenomenon known as real bracket creep—rising real (inflation-adjusted) income tends to push more and more income into higher tax brackets. In addition, because some parameters of the tax system are not indexed for inflation, rising prices also push a greater share of income into higher tax brackets. During economic downturns, corporate profits generally fall as a share of GDP, causing corporate tax revenues to shrink, and losses in households’ income tend to push a greater share of total income into lower tax brackets, resulting in lower revenues from individual income taxes. Thus, total tax revenues automatically rise relative to GDP when the economy is strong and decline relative to GDP when the economy is weak.

3. That effect was more pronounced before 1984, when the parameters of the individual income tax began to be indexed for inflation.
Social insurance taxes, by contrast, have been a stable source of federal revenues. Receipts from those taxes increased as a percentage of GDP during the 1970s and 1980s because of rising tax rates, increases in the number of people paying those taxes, and growth in the share of wages subject to the taxes. For most of the past two decades, legislation has not had a substantial effect on social insurance taxes, and the primary base for those taxes—wages and salaries—has varied less as a share of GDP than have other sources of income. In 2011 and 2012, however, the temporary reduction in the Social Security tax rate caused receipts from social insurance taxes to drop; with the expiration of that provision at the end of 2012, social insurance receipts as a share of GDP are expected to approach their historical level—close to 6 percent of GDP.
Revenues from other taxes and fees declined relative to the size of the economy over the period from 1971 to 2013 mainly because receipts from excise taxes—which are levied on such goods and services as gasoline, alcohol, tobacco, and air travel—have steadily dwindled as a share of GDP over time. That decline is chiefly because those taxes are usually levied on the quantity of goods sold rather than on their cost, and the rates have generally not kept up with inflation.

Under current law, revenues are projected to increase further, to 17.7 percent of GDP in 2014 and 18.6 percent in 2015, and then to remain above 18 percent of GDP from 2016 through 2023. About half of the expected increase in the next two years would stem from changes in tax rules, such as the scheduled expiration at the end of December 2013 of enhanced depreciation deductions allowed for certain business investments. Accounting for the other half are factors related mainly to the strengthening economy, including increases relative to GDP in some components of taxable income (such as wages and salaries, capital gains realizations, proprietors’ income, and domestic economic profits) and the continued rise to more normal levels in the average tax rate on domestic economic profits. CBO projects that revenues will grow at close to the same rate as GDP over the 2015–2023 period. Individual income tax receipts are projected to rise relative to GDP as increases in taxpayers’ real income push more income into higher tax brackets; in contrast, corporate income tax receipts and remittances to the U.S. Treasury from the Federal Reserve are projected to fall relative to GDP.

Trends in Tax Expenditures
Unlike discretionary spending programs (and some mandatory programs), most tax expenditures are not subject to periodic reauthorization or annual appropriations. And, as is the case for entitlement programs, any person or entity that meets program requirements can receive benefits. Because of the way tax expenditures are treated in the budget, however, they are much less transparent than is spending on entitlement programs.

Ten of the largest tax expenditures will account for approximately two-thirds of the total budgetary effect of all tax expenditures in 2013, CBO estimates. They fall in four major categories, as follows:

- **Exclusions** from taxable income of employment-based health insurance, net pension contributions and earnings, capital gains on assets transferred at death, and a portion of Social Security and Railroad Retirement benefits;
CHAPTER FOUR: REVENUE OPTIONS

OPTIONS FOR REDUCING THE DEFICIT: 2014 TO 2023

Figure 4-2.

Budgetary Effects of Selected Major Tax Expenditures, Fiscal Years 2014 to 2023

(Percentage of gross domestic product)

Source: Congressional Budget Office.

Notes: Because estimates of tax expenditures are based on people's behavior with the tax expenditures in place, the estimates do not reflect the amount of revenues that would be raised if those provisions of the tax code were eliminated and taxpayers adjusted their activities in response to those changes.

The exclusion from taxable income of employment-based health insurance includes employers' contributions for health care, health insurance premiums, and long-term-care insurance premiums.

a. Includes effect on payroll taxes.
b. Includes effect on outlays.

- Itemized deductions for certain taxes paid to state and local governments, mortgage interest payments, and charitable contributions;
- Preferential tax rates applied to capital gains and dividends; and
- Tax credits, specifically the earned income tax credit and the child tax credit.

CBO estimates that in 2013, those 10 tax expenditures will total more than $900 billion in income and payroll taxes, or 5.6 percent of GDP, and they are projected to amount to nearly $12 trillion, or 5.3 percent of GDP, between 2014 and 2023 (see Figure 4-2). In 2013, the combined costs of the 10 tax expenditures will equal

about one-third of federal revenues, CBO estimates, and they will exceed spending on Social Security, defense, or Medicare.\(^5\)

Beginning in 2014, the tax credits that some people will receive to help pay health insurance premiums under the Affordable Care Act will represent a new tax expenditure. CBO and the staff of the Joint Committee on Taxation (JCT) estimate that those tax credits will equal 0.2 percent of GDP in 2015 and 0.5 percent of GDP by 2023.

Corporate tax expenditures reduce revenues by much less than individual tax expenditures do. The largest corporate tax expenditure—estimated by JCT to total about $42 billion in fiscal year 2013 and $266 billion from 2013 through 2017—is for the deferral of taxes on the income of controlled foreign corporations (that is, income earned by foreign subsidiaries of U.S. multinational corporations) from their business activities abroad.\(^6\) Although the federal government taxes the worldwide income of U.S. businesses, the income that foreign subsidiaries of U.S. multinational corporations earn is not subject to U.S. taxation until it is paid to a U.S. parent company—that is, the tax is deferred until the income is repatriated.

The second-largest corporate tax expenditure is the deduction for domestic production activities: U.S. businesses engaged in manufacturing and certain other types of domestic production may deduct from their taxable income a percentage of what they earn from those activities. That expenditure will total $14 billion in fiscal year 2013 and $78 billion from 2013 through 2017, JCT estimates.\(^7\)

**Methodology Underlying the Revenue Estimates**

Nearly all of the revenue estimates in this chapter were prepared by JCT. The budgetary savings were estimated relative to CBO’s baseline projections for receipts, under the general assumption that current laws remain in effect and specifically that scheduled changes in provisions of the tax code take effect and no additional changes are enacted to those provisions.\(^8\) If combined, the options might interact with one another in ways that could alter their revenue effects and their impact on households and the economy.

CBO’s and JCT’s budget estimates generally reflect changes in the behavior of people and firms, except for those that would affect total output in the economy—such as any changes in labor supply or private investment resulting from changes in fiscal policy. The convention of not incorporating macroeconomic effects in cost estimates has been followed in the Congressional budget process since it was established in 1974. CBO and JCT separately produce estimates of the effects of some major proposals on overall output and, in turn, the effects of those changes in output on the federal budget.

However, cost estimates incorporate other changes in people’s behavior that would have budgetary effects. An impending increase in the tax rate applicable to capital gains, for example, would spur some investors to sell assets before the rate increase took effect. Or, when faced with paying higher Social Security taxes for their employees, employers would pay less in salaries and benefits to offset the higher payroll taxes. Revenue estimates for those options would incorporate such behavioral responses: The acceleration of capital gains realizations in the first example would cause a temporary hike in taxable realizations in the year before implementation of the

---

5. For calendar year 2013, more than half of the combined benefits of those expenditures will accrue to households in the nation’s top quintile (or one-fifth) by income, and 17 percent will go to households in the top 1 percent, CBO estimates. In contrast, 13 percent will accrue to households in the middle quintile, and just 8 percent will accrue to those in the lowest quintile. Measured relative to after-tax income, the benefits are greatest for the lowest and highest income quintiles. In calendar year 2013, CBO estimates, the combined benefits will equal nearly 12 percent of after-tax income for households in the lowest quintile, more than 9 percent for households in the highest quintile, and less than 8 percent for households in the middle three quintiles. See Congressional Budget Office, *The Distribution of Major Tax Expenditures in the Individual Income Tax System* (May 2013), www.cbo.gov/publication/43768.


7. The estimates for the deduction include revenues from both the corporate income tax and the individual income tax (attributable to activities of noncorporate businesses).

8. As specified in the Balanced Budget and Emergency Deficit Control Act of 1985, CBO’s baseline reflects the assumption that expiring excise taxes dedicated to trust funds will be extended (unlike other expiring tax provisions, which are assumed to follow the schedules set forth in current law).
increase, and the change in compensation in the second example would cause individual income tax receipts to fall at the same time that payroll tax revenues rise.

Some revenue options would affect outlays as well as receipts. For example, options that would change eligibility for, or the amount of, refundable tax credits would generally cause a change in outlays because the amount of such credits that exceeds someone’s income tax liability (before the tax credit) is usually paid to the person and is recorded in the budget as an outlay. In addition, changes in other tax provisions could affect the allocation of refundable credits between outlays and receipts. For instance, when tax rates are increased (with no changes in the amounts of refundable tax credits or eligibility for them), the portion of the refundable credits that offsets tax liabilities increases (because the tax liabilities that can be offset are greater) and the outlay portion of the credits falls correspondingly; the total cost of the credit remains the same. For simplicity in presentation, the revenue estimates for options that affect refundable tax credits represent the net effects on revenues and outlays combined.

Options that would expand the base for Social Security taxes would affect outlays as well. When options would require some or all workers to contribute more to the Social Security system, those workers would receive larger benefits when they retired or became disabled. For nearly all such options in this report, CBO anticipates that a change in Social Security benefit payments would be small over the period from 2014 through 2023, and thus the estimates for those options do not include those outlay effects. One exception, however, is Option 18, which would increase the amount of earnings subject to Social Security tax. In that case, the effects on Social Security outlays over the 10-year projection period would be more sizable; they are shown separately in the table for that option.

**Options in This Chapter**

This chapter presents 36 options grouped into several categories according to the part of the tax system they would target: individual income tax rates, the individual income tax base, individual income tax credits, payroll taxes, taxation of income from businesses and other entities, taxation of income from worldwide business activity, excise taxes, and other taxes and fees.

Several comprehensive approaches to changing tax policy—each with the potential to increase revenues substantially—that have received much attention lately are not included in this report. One would eliminate or reduce the value of all or most tax expenditures. Another would fundamentally change the tax treatment of multinational corporations. Yet another would impose a tax on most goods and activities, possibly through a value-added tax.

Each would have significant consequences for the economy and for the federal budget:

- Limiting or eliminating a broad array of tax expenditures would influence many taxpayers’ decisions to engage in certain activities or to purchase favored goods.

- Changing the tax treatment of multinationals would, to some extent, affect businesses’ choices about how and where to invest. Those changes also would affect incentives for engaging in various strategies that allow a business to avoid paying U.S. taxes on some income.

- Creating a value-added tax would favor saving more than consumption because it would tax businesses’ receipts from the sales of their goods and services instead of taxing people’s income.

Although this chapter includes options that contain elements of those approaches, none of the options is as comprehensive as those approaches. One reason that the report does not contain options that entail comprehensive changes to the tax code is that such proposals often are combined with those that would reduce individual and corporate income tax rates or—in the case of a value-added tax—replace an existing tax, and therefore their effects may be best assessed in the context of such broader packages. Moreover, the estimates would vary greatly depending on the particular proposals’ specifications. Hence, the amount—and even the direction—of the budgetary impact of broad approaches to changing tax policy is uncertain.
Revenues—Option 1

Increase Individual Income Tax Rates

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Revenues</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Raise all tax rates on ordinary income by 1 percentage point</td>
<td>37</td>
<td>56</td>
<td>60</td>
<td>65</td>
<td>69</td>
<td>73</td>
<td>77</td>
<td>81</td>
<td>86</td>
<td>90</td>
<td>287</td>
<td>694</td>
</tr>
<tr>
<td>Raise ordinary income tax rates in the following brackets by 1 percentage point: 28 percent and over</td>
<td>7</td>
<td>11</td>
<td>12</td>
<td>14</td>
<td>15</td>
<td>16</td>
<td>17</td>
<td>19</td>
<td>20</td>
<td>21</td>
<td>59</td>
<td>152</td>
</tr>
<tr>
<td>Raise ordinary income tax rates in the following brackets by 1 percentage point: 35 percent and over</td>
<td>5</td>
<td>7</td>
<td>8</td>
<td>9</td>
<td>10</td>
<td>10</td>
<td>11</td>
<td>12</td>
<td>13</td>
<td>13</td>
<td>38</td>
<td>98</td>
</tr>
</tbody>
</table>

Source: Staff of the Joint Committee on Taxation.

Note: This option would take effect in January 2014. The estimates include the effects on outlays resulting from changes in refundable tax credits.

Under current law, ordinary income earned by most individuals is taxed at the following seven statutory rates: 10 percent, 15 percent, 25 percent, 28 percent, 33 percent, 35 percent, and 39.6 percent. (Ordinary income is all income subject to the income tax except long-term capital gains and dividends.)

As specified by the tax code, different statutory tax rates apply to different portions of people’s taxable ordinary income. (Taxable income generally equals gross income minus allowable adjustments, exemptions, and deductions.) Tax brackets—the income ranges to which the different rates apply—vary depending on taxpayers’ filing status (see the table on the next page). In 2013, for example, a person filing singly with taxable income of $40,000 would pay a tax rate of 10 percent on the first $8,925 of taxable income, 15 percent on the next $27,325, and 25 percent on the remaining $3,750 of taxable income. The starting points for those income ranges are adjusted, or indexed, to increase with inflation each year.

Income in the form of long-term capital gains and dividends is taxed under a separate rate schedule, with a maximum statutory rate of 20 percent. Income from both short-term and long-term capital gains and dividends, along with other investment income received by higher-income taxpayers, is also subject to an additional tax of 3.8 percent as a result of the Affordable Care Act.

Taxpayers who are subject to the alternative minimum tax (AMT) face statutory rates of 26 percent and 28 percent. (The AMT is a parallel income tax system with fewer exemptions, deductions, credits, and rates than the regular income tax. Households must calculate the amount they owe under both the AMT and the regular income tax and pay the larger of the two amounts.) However, the AMT does not affect most of the highest-income taxpayers because the highest statutory rate under the AMT is only 28 percent, and many deductions allowed under the regular income tax are still allowed under the AMT.
This option includes three alternative approaches for increasing statutory rates under the individual income tax. Those approaches are as follows:

- Raise all tax rates on ordinary income (income subject to the regular rate schedule) by 1 percentage point.
- Raise all tax rates on ordinary income in the top four brackets—28 percent and over—by 1 percentage point.
- Raise all tax rates on ordinary income in the top two brackets—35 percent and over—by 1 percentage point.

_Raising all statutory tax rates on ordinary income by 1 percentage point_ would increase revenues by a total of $694 billion from 2014 through 2023, according to estimates by the staff of the Joint Committee on Taxation (JCT). If this alternative was implemented, for example, the top rate of 39.6 percent would increase to 40.6 percent. Because the AMT would remain the same as under current law, some taxpayers would not face higher taxes under the option.

Alternatively, lawmakers could target specific individual income tax rates. For example, _boosting rates only on ordinary income in the top four brackets—28 percent and over—by 1 percentage point_ would raise revenues by $152 billion over the 10-year period, according to JCT. By targeting a smaller group of taxpayers than the first approach, this alternative would raise significantly less revenue. As another example, _boosting rates only on ordinary income in the top two brackets—35 percent and over—by 1 percentage point_ would raise revenues by $98 billion over the 10-year period, according to JCT. Because most people who are subject to the top rate in the regular income tax are not subject to the alternative minimum tax, the AMT would not significantly limit the effect of that increase in regular tax rates. By targeting a smaller group of taxpayers than the first or second alternative, this alternative would raise even less revenue.

As a way to boost revenues, an increase in tax rates would offer some administrative advantages over other types of tax increases because it would require only minor changes to the current tax system. Rate hikes also would have drawbacks, however. Higher tax rates would reduce people’s incentive to work and save. In addition, they would encourage taxpayers to shift income from taxable to nontaxable forms (for example, by substituting tax-exempt bonds for other investments or opting for more tax-exempt fringe benefits instead of cash compensation) and to increase spending on tax-deductible items relative to other items (for example, by paying more in home mortgage interest and less for other things). In those ways, higher tax rates would cause economic resources to be allocated less efficiently than they would be under current law.

<table>
<thead>
<tr>
<th>Starting Points for Tax Brackets (2013 dollars)</th>
<th>Statutory Tax Rate on Ordinary Taxable Income (Percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single Filers</td>
<td>Joint Filers</td>
</tr>
<tr>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>8,925</td>
<td>17,850</td>
</tr>
<tr>
<td>36,250</td>
<td>72,500</td>
</tr>
<tr>
<td>87,850</td>
<td>146,400</td>
</tr>
<tr>
<td>183,250</td>
<td>223,050</td>
</tr>
<tr>
<td>398,350</td>
<td>398,850</td>
</tr>
<tr>
<td>400,000</td>
<td>450,000</td>
</tr>
</tbody>
</table>
The estimates shown here incorporate the effect of taxpayers shifting income from taxable forms to nontaxable or tax-deferred forms. However, the estimates do not incorporate changes in how much people would work or save in response to higher tax rates. Such changes would depend in part on whether the federal government used the added tax revenues to reduce deficits or to finance increases in spending or cuts in other taxes.

RELATED OPTIONS: Revenues, Options 2 and 3

Revenues—Option 2

Implement a New Minimum Tax on Adjusted Gross Income

Under current law, individual taxpayers are subject to statutory tax rates on ordinary income (income other than capital gains and dividends) that rise from 0 percent to 39.6 percent. The Affordable Care Act imposed an additional tax of 3.8 percent on investment earnings realized by high-income taxpayers. However, people in the highest tax brackets generally may pay a smaller share of their income in income taxes than those brackets might suggest, for at least two reasons. First, income realized from capital gains and dividends—which represents a substantial share of income for many people in the highest brackets—is generally subject to income tax rates of 20 percent or less (before the application of the 3.8 percent additional tax). Second, taxpayers can claim exemptions and deductions (both subject to limits) to reduce their taxable income, and they can further lower their tax liability using credits.

Taxpayers may also be liable for an alternative minimum tax (AMT), which was intended to impose taxes on high-income individuals who use tax preferences to greatly reduce or even eliminate their liability under the regular income tax. The AMT allows fewer exemptions, deductions, and tax credits than are allowed under the regular income tax, and taxpayers are required to pay the higher of their regular tax liability or their AMT liability. However, the AMT does not affect most of the highest-income taxpayers because the highest statutory rate under the AMT is only 28 percent, and many deductions allowed under the regular income tax are still allowed under the AMT.

In addition to the individual income tax, taxpayers are subject to payroll tax rates of up to 7.65 percent on their earnings: 6.2 percent for Social Security (Old-Age and Survivors Insurance and Disability Insurance) and 1.45 percent for Medicare Part A (Hospital Insurance). Employers also pay 7.65 percent of their employees’ earnings to help finance those benefits. Beginning in 2013, the Affordable Care Act imposed an additional tax of 0.9 percent on all earnings above $200,000 for single taxpayers and $250,000 for joint filers. However, the majority of those payroll taxes—specifically, those that fund Social Security benefits—are levied only on the first $113,700 of earned income. Therefore, as a share of income, payroll taxes have a smaller effect on higher-income taxpayers than on many lower-income taxpayers.

This option would impose a new minimum tax equal to 30 percent of adjusted gross income, or AGI (AGI includes income from all sources not specifically excluded by the tax code, minus certain deductions.) To reduce the liability associated with the new minimum tax, taxpayers could use just one credit equal to 28 percent of their charitable contributions. Taxpayers would pay whichever was higher: the new minimum tax or the sum of individual income taxes owed by the taxpayer and the portion of payroll taxes he or she paid as an employee. (When calculating individual income taxes, the taxpayer would include the 3.8 percent surtax on investment income and any liability under the current AMT.) The new minimum tax would be phased in for taxpayers with AGI between $1 million and $2 million beginning in 2014; those thresholds would be adjusted, or indexed, for inflation thereafter. The option would raise $76 billion from 2014 through 2023, according to estimates by the staff of the Joint Committee on Taxation.

One argument in favor of this option is that it would enhance the progressivity of the tax system. The various exclusions, deductions, credits, and preferential tax rates on certain investment income under the individual income tax—combined with the cap on earnings that are taxable for Social Security—allow some higher-income taxpayers, especially those whose income is primarily in the form of capital gains and dividends, to pay a smaller share of their income in taxes than many lower-income taxpayers, especially those whose income is primarily in
the form of wages or salaries. By creating a new minimum tax with no deductions and just one tax credit, the option would increase the share of income paid in taxes by some higher-income taxpayers.

One argument against this option is that, by effectively imposing a second AMT, it would increase the complexity of the tax code—reducing the transparency of the tax system and making tax planning more difficult. Raising taxes on higher-income people through the existing tax system—for example, by increasing the top statutory rates or eliminating or limiting certain tax deductions or exclusions—would be simpler to implement.

Further, by eliminating or limiting tax preferences, the option would alter the affected taxpayers’ incentives to undertake certain activities. Under current law, for example, the tax subsidy rate for charitable contributions can be as high as 39.6 percent. For taxpayers subject to the minimum tax, this option would cap the subsidy rate at 28 percent of contributions. That reduction in the tax subsidy for charitable contributions would reduce donations to charities.

The option would also raise marginal tax rates faced by some taxpayers. (The marginal tax rate is the percentage of an additional dollar of income from labor or capital that is paid in taxes.) For example, the option would impose a minimum tax rate of 30 percent on most capital gains and dividends received by affected taxpayers. In contrast, the highest tax rate on most capital gains and dividends is 23.8 percent under current law. Raising the marginal tax rate on capital gains and dividends would reduce taxpayers’ incentives to save. In addition, the higher marginal tax rates on earnings faced by some higher-income taxpayers would lessen their incentive to work.

RELATED OPTIONS: Revenues, Options 1 and 3

RELATED CBO PUBLICATION: The Individual Alternative Minimum Tax (January 2010), www.cbo.gov/publication/41810
CHAPTER FOUR: REVENUE OPTIONS

OPTIONS FOR REDUCING THE DEFICIT: 2014 TO 2023

Revenues—Option 3

Raise the Tax Rates on Long-Term Capital Gains and Dividends by 2 Percentage Points

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Revenues</td>
<td>1.2</td>
<td>4.6</td>
<td>5.0</td>
<td>5.3</td>
<td>5.6</td>
<td>5.9</td>
<td>6.1</td>
<td>6.4</td>
<td>6.6</td>
<td>6.8</td>
<td>21.7</td>
<td>53.4</td>
</tr>
</tbody>
</table>

Source: Staff of the Joint Committee on Taxation.

Note: This option would take effect in January 2014.

When individuals sell an asset for more than the price at which they obtained it, they generally realize a capital gain that is subject to taxation. Most taxable capital gains are realized from the sale of corporate stocks, other financial assets, real estate, and unincorporated businesses. Since the adoption of the individual income tax in 1913, long-term gains (those realized on assets held for more than a year) have usually been taxed at lower rates than other sources of income, such as wages, interest, and dividends. However, starting in 2003, the tax rates on qualified dividends were lowered to match those of long-term capital gains. Qualified dividends are generally paid by domestic corporations or certain foreign corporations (including, for example, corporations whose stock is traded in one of the major securities markets in the United States).

The current tax rates on long-term capital gains and qualified dividends depend on several features of the tax code:

- The basic tax rates on those forms of income depend on the statutory tax rates that would be applicable to taxpayers’ ordinary income—that is, income from sources other than long-term capital gains and qualified dividends. A taxpayer in the 10 percent or 15 percent tax bracket for ordinary income does not pay any taxes on long-term capital gains and qualified dividends. A taxpayer in the brackets for ordinary income that range from 25 percent through 35 percent faces a basic tax rate on long-term capital gains and dividends of 15 percent. For a taxpayer in the top bracket for ordinary income—39.6 percent—that rate increases to 20 percent.

- Beginning in 2013, certain income from long-term capital gains and dividends, along with certain other types of investment income, is also subject to an additional tax of 3.8 percent under provisions of the Affordable Care Act. Married taxpayers who file joint returns are subject to that additional tax if their modified adjusted gross income is greater than $250,000; that threshold drops to $200,000 for taxpayers who are not married. (Adjusted gross income, or AGI, includes income from all sources not specifically excluded by the tax code, minus certain deductions. Modified AGI includes foreign income that is normally excluded from AGI.) The additional tax is applied to the smaller of two amounts: net investment income or the amount by which modified AGI exceeds the thresholds.

- Other provisions of the tax code—including those that limit or phase out other tax preferences—effectively increase taxes on long-term capital gains and dividends. For example, the total value of certain itemized deductions is reduced if a taxpayer’s AGI is above a specified threshold. As a result, most taxpayers in the 39.6 percent tax bracket for ordinary income lose 3 cents of itemized deductions for each dollar of additional long-term gains, causing their tax rate to increase by more than a percentage point.

Taking all of those provisions together, the tax rate on long-term capital gains and dividends is nearly 25 percent for most people in the top income tax bracket. Although that bracket applies to less than 1 percent of all taxpayers, the income of those taxpayers accounts for roughly two-thirds of income from dividends and realized long-term capital gains.

1. Under the American Taxpayer Relief Act of 2012, those thresholds were set, beginning in 2013, at $250,000 for taxpayers filing as single, $275,000 for taxpayers filing as a head of household, $300,000 for married taxpayers filing jointly, and $150,000 for married taxpayers filing separately. The thresholds are adjusted, or indexed, for inflation. A similar provision, with lower thresholds, was in effect before 2010.
This option would raise the basic tax rates on long-term capital gains and dividends by 2 percentage points. Those basic rates would then be 2 percent for taxpayers in the 10 percent and 15 percent brackets for ordinary income, 17 percent for taxpayers in the brackets ranging from 25 percent through 35 percent, and 22 percent for taxpayers in the top bracket. The option would not change the other provisions of the tax code that also affect taxes on capital gains and dividends. The staff of the Joint Committee on Taxation estimates that this option would raise federal revenues by $53 billion over the 2014–2023 period.

One advantage of raising tax rates on long-term capital gains and dividends, rather than raising tax rates on ordinary income, is that it would reduce the incentive for taxpayers to try to mischaracterize labor compensation and profits as capital gains. Such strategizing occurs under current law even though the tax code and regulations governing taxes contain numerous provisions that attempt to limit it. Reducing the incentive to mischaracterize compensation and profits as capital gains would reduce the resources devoted to circumventing the rules.

Another rationale for raising revenue through this option is that it would be progressive with respect to people’s wealth and income. Most taxable dividends and capital gains are received by people with significant wealth and income, although some are received by retirees who have greater wealth but less income than some younger people who are still in the labor force. Therefore, raising tax rates on long-term capital gains and dividends would impose, on average, a larger burden on people with significant financial resources than on people with fewer resources.

A disadvantage of the option is that raising tax rates on long-term capital gains and dividends would influence investment decisions by increasing the tax burden on investment income. By lowering the after-tax return on investments, the increased tax rates would reduce the incentive to invest in businesses. Another disadvantage is that the proposal would exacerbate an existing bias that favors debt-financed investment by businesses over equity-financed investment. That bias is greatest for investors in firms that pay the corporate income tax because corporate profits are taxed once under the corporate income tax and a second time when those profits are paid out as dividends or reinvested and taxed later as capital gains on the sale of corporate stock. In contrast, profits of unincorporated businesses, rents, and interest are taxed only once. That difference distorts investment decisions by discouraging investment funded through new issues of corporate stock and encouraging, instead, either borrowing to fund corporate investments or the formation and expansion of noncorporate businesses. The bias against equity funding of corporate investments would not expand if the option exempted dividends and capital gains on corporate stock—limiting the tax increase to capital gains on those assets that are not taxed under both the corporate and the individual income taxes. That modification, however, would also reduce the revenue gains from the option.

Another argument against implementing the option is that, by taxing long-term capital gains and dividends at higher rates, certain undertakings—such as starting a new business or investing in a new technology—might be less profitable, and investors might therefore undervalue their benefits to the economy. The option could also encourage people to hold on to investments longer than they would prefer so as to postpone the capital gains tax, although taxpayer responses would vary over time and depend on the type of investment. If assets are held until death, the tax is avoided entirely. Postponing the sale of assets, however, means that people could not modify their holdings to suit their current needs.

RELATED OPTIONS: Revenues, Options 1, 2, 11, and 34

Revenues—Option 4

Use an Alternative Measure of Inflation to Index Some Parameters of the Tax Code

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Revenues</td>
<td>1</td>
<td>3</td>
<td>6</td>
<td>9</td>
<td>11</td>
<td>15</td>
<td>18</td>
<td>22</td>
<td>25</td>
<td>29</td>
<td>30</td>
<td>140</td>
</tr>
</tbody>
</table>

Source: Staff of the Joint Committee on Taxation.

Note: This option would take effect in January 2014. The estimates include the effects on outlays resulting from changes in refundable tax credits.

Some parameters of the tax code are adjusted each year on the basis of changes in the prices of goods and services, as measured by the consumer price index for all urban consumers (CPI-U). Adjusting those tax parameters every year by the percentage change in the CPI-U is intended to keep their values relatively stable in real (inflation-adjusted) terms. Among the tax parameters that are adjusted, or indexed, for inflation are the amounts of the personal and dependent exemptions; the size of the standard deductions; the income thresholds that divide the rate brackets for the individual income tax; the amount of annual gifts exempt from the gift tax; and the income thresholds and phaseout boundaries for the earned income tax credit and several other credits. In addition, starting in 2013, the exemption amounts for the individual alternative minimum tax (AMT), the income thresholds at which those exemptions phase out, and the income threshold at which the second AMT rate bracket begins are all indexed for inflation.

Indexing is accomplished by adjusting a parameter’s value in a base year by the percentage change in the CPI-U between that base year and the most recent year for which the CPI-U is available. The annual period used for the calculation is not a calendar year but the 12 months that elapse from September to August. The value of the CPI-U in August becomes available in September, which allows enough time to index the tax parameters and prepare the necessary forms for the coming tax year. Adjustments in parameters of the tax code are calculated as follows: In the base year of 1987, for example, the standard deduction for a single tax filer was $3,000. Between 1987 and 2011, the CPI-U increased by 98.6 percent; correspondingly, the standard deduction (rounded to the lowest $50 increment) increased to $5,950 for 2012.

The standard CPI-U, however, overstates changes in the cost of living by not fully taking into account the extent to which households substitute one product for another when the relative prices of products change. To address that “substitution bias,” the Bureau of Labor Statistics (BLS) created the chained CPI-U. Whereas the standard CPI-U uses a basket of products reflecting consumption patterns that are as much as two years old, the chained CPI-U incorporates adjustments that people make in the types of products they buy from one month to the next. Although the chained CPI-U corrects for the substitution bias in the standard CPI-U, neither the chained nor the standard CPI-U perfectly captures changes in the cost of living because neither fully accounts for increases in the quality of existing products or the value of new products. The CPI-U also overstates increases in the cost of living because of a statistical bias related to the limited amount of price data that BLS can collect. The chained CPI-U does not have the same statistical bias.

Under this option, the chained CPI-U would be used instead of the standard CPI-U to adjust various parameters of the tax code. The Congressional Budget Office estimates that the chained CPI-U is likely to grow at an average annual rate that is 0.25 percentage points less than the standard CPI-U over the next decade. Therefore, using the chained CPI-U to index tax parameters would increase the amount of income subject to taxation and result in higher tax revenues. Furthermore, the effects of instituting such a policy would grow over time. The net revenue increase would be about $1 billion in 2014 but would reach $29 billion in 2023, the staff of the Joint Committee on Taxation estimates. Net additional revenues would total about $140 billion from 2014 through 2023.

An argument in favor of using the chained CPI-U to adjust tax parameters is that this approach would more accurately reflect changes in the cost of living and modify each taxpayer’s liability accordingly. The chained CPI-U...
provides a better measure of changes in the cost of living in two ways: by more quickly capturing the extent to which households adjust their consumption in response to changes in relative prices and by using a formula that essentially eliminates the statistical bias that can occur when estimates of aggregate price changes are calculated on the basis of relatively small samples of prices.

An argument against implementing this option is that only an initial estimate of the chained CPI-U is available on a monthly basis; a final and more accurate estimate is delayed because it is more complicated and time-consuming to compute than the standard CPI-U. (Details of that approach are available in a web-only technical appendix that CBO released with its February 2010 issue brief Using a Different Measure of Inflation for Indexing Federal Programs and the Tax Code.) At the start of every year, all of the initial estimates for the prior year are revised, and one year later those interim estimates are further revised and made final. Because of those delays, the initial and interim estimates of the chained CPI-U, which typically contain errors, would need to be used to index the parameters in the tax code. Since the chained CPI-U was first published in 2002, however, the changes between the initial and final values have been relatively small. If the adjustment for each year was based on the index value from an earlier base year, those small errors would not accumulate beyond the current year. Furthermore, because the initial and interim estimates of the chained CPI-U have been closer to the final version of the chained CPI-U than the standard CPI-U has been, those estimates still reflect the basic improvement attributable to the chained CPI-U.

RELATED OPTION: Mandatory Spending, Option 23

Revenues—Option 5
Convert the Mortgage Interest Deduction to a 15 Percent Tax Credit

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Revenues</td>
<td>0.2</td>
<td>0.9</td>
<td>1.4</td>
<td>2.2</td>
<td>3.4</td>
<td>5.5</td>
<td>8.4</td>
<td>9.1</td>
<td>9.9</td>
<td>10.8</td>
<td>8.1</td>
<td>51.7</td>
</tr>
</tbody>
</table>

Source: Staff of the Joint Committee on Taxation.

Note: This option would take effect in January 2014. The estimates include the effects on outlays resulting from changes in refundable tax credits.

The tax code treats investments in owner-occupied housing more favorably than it does other types of investments. For example, landlords can deduct certain expenses—such as mortgage interest, property taxes, depreciation, and maintenance—from their income, but they have to pay taxes on rental income, net of those expenses, and on any capital gain realized when their property is sold. In contrast, homeowners can deduct mortgage interest and property taxes if they itemize deductions, even though they do not pay tax on the net rental value of their home. (Other housing-related expenses, however, cannot be deducted from homeowners’ income.) In addition, in most circumstances, homeowners can exclude from taxation capital gains of up to $250,000 ($500,000 for married couples filing joint tax returns) when they sell their primary residence.

Under current law, the deduction for mortgage interest is restricted in two ways. First, the tax code limits the amount of mortgage debt that can be included in calculating the interest deduction to $1.1 million: $1 million for debt that a homeowner incurs to buy, build, or improve a first or second home; and $100,000 for other debt (such as a home-equity loan) for which the owner uses the personal residence as security, regardless of the purpose of that loan. Second, beginning in 2013, the total value of certain itemized deductions—including the deduction for mortgage interest—is reduced if the taxpayer’s adjusted gross income is above a specified threshold.1 (Adjusted gross income includes income from all sources not specifically excluded by the tax code, minus certain deductions.)

This option would gradually convert the tax deduction for mortgage interest to a 15 percent nonrefundable tax credit. The option would be phased in over six years, beginning in 2014. From 2014 through 2018, the deduction would still be available, but the maximum amount of the mortgage deduction would be reduced by $100,000 each year—to $1 million in 2014, $900,000 in 2015, and so on, until it reached $600,000 in 2018. In 2019 and later years, the deduction would be replaced by a 15 percent credit, the maximum amount of mortgage debt that could be included in the credit calculation would be $500,000, and the credit could be applied only to interest on debt incurred to buy, build, or improve a first home. (Other types of loans, such as those incurred to buy second homes and those using homes as security, would be excluded.) Because the credit would be nonrefundable, people with no income tax liability before the credit was taken into account would not receive any credit, and people whose precredit income tax liability was less than the full amount of the credit would receive only the portion of the credit that offset the amount of taxes they otherwise would owe. The option would raise $52 billion from 2014 through 2023, according to estimates by the staff of the Joint Committee on Taxation.

Relative to other taxpayers, lower-income people receive the least benefit from the current itemized deduction, for three reasons. First, lower-income people are less likely than higher-income people to have sufficient deductions to make itemizing worthwhile; for taxpayers with only small amounts of deductions that can be itemized, the standard deduction—which is a flat dollar amount—provides a larger tax benefit. Second, the value of itemized deductions is greater for people in higher income tax brackets. And third, the value of the mortgage interest

---

1. Under the American Taxpayer Relief Act of 2012, thresholds for reducing the value of certain itemized deductions were set, beginning in 2013, at $250,000 for taxpayers filing as single, $275,000 for taxpayers filing as head of household, $300,000 for married taxpayers filing jointly, and $450,000 for married taxpayers filing separately. The thresholds are adjusted, or indexed, for inflation. A similar provision, with lower thresholds, was in effect before 2010.
deduction is greater for people who have larger mortgages.

Unlike the current mortgage interest deduction, a credit would be available to taxpayers who do not itemize and would provide the same subsidy rate to all recipients, regardless of income; however, taxpayers with larger mortgages—up to the $500,000 limit specified in this option—would still receive a greater benefit from the credit than would households with smaller mortgages. Altogether, many higher-income people would receive a smaller tax benefit for housing than under current law, and many lower- and middle-income people would receive a larger tax benefit. (The credit could be made available to more households by making it refundable, although doing so would significantly reduce the revenue gain.)

One argument, then, in favor of the option is that it would distribute the mortgage interest tax subsidy more evenly across households with different amounts of income. Another argument in favor of the option is that it would increase the tax incentive for homeownership for lower- and middle-income taxpayers who might otherwise rent. Research indicates that when people own their homes rather than rent, they maintain their properties better and participate more in civic affairs. However, because individuals are unlikely to consider those benefits to the community when deciding whether to buy or rent a personal residence, a subsidy that encourages homeownership can help align individuals’ choices with the community’s interest.

Another argument for such a change is that it probably would improve the overall allocation of resources in the economy. With its higher subsidy rates for taxpayers in higher tax brackets and its high $1.1 million limit on loans, the current mortgage interest deduction encourages people who would buy houses anyway to purchase more expensive dwellings than they otherwise might. That reduces the savings available for productive investment in businesses. Reducing the tax subsidy for owner-occupied housing would moderate that effect. And because investment in owner-occupied housing is boosted by the tax subsidy, and investment in many businesses is held down by taxes on their profits, the before-tax return on the additional business investment that would occur under this option would generally be higher than the forgone return from housing.

One disadvantage of the option is that, by providing a larger tax benefit to lower- and middle-income people than they receive under current law and thereby encouraging more of them to buy houses and to buy more expensive houses than they otherwise would, the option would increase the risk that some people take on. Principal residences tend to be the largest asset that people own and the source of their largest debt. When home prices rise, homeowners’ wealth can rise significantly. However, when prices drop, people can lose their homes and much of their wealth, especially if their incomes fall at the same time and they cannot keep up with their mortgage payments. The experience of the past half-dozen years demonstrates that risk vividly.

Another disadvantage of the option is that it would adversely affect the housing industry and people who currently own their own homes—especially in the short term. Many homeowners have taken out long-term mortgages under the presumption that they would be able to deduct the interest on their loans. Many financial institutions have been willing to lend homebuyers higher amounts than they otherwise might have under the presumption that the mortgage interest deduction would help those buyers repay their loans. Reducing the tax subsidy for housing would make it more difficult for some homeowners to meet their mortgage obligations. Such a change would also reduce the amount new homebuyers would be willing to pay, which would lower the prices of homes, on average. Lower housing prices would create further stress on the finances of existing owners and lead to reduced housing construction. Over time, as the supply of housing declined, housing prices would rise again, but probably not to the levels they would reach.
under current law. Most of those hardships could be eased by phasing in restrictions on the mortgage interest deduction. Because of the lengthy terms of mortgages, however, and the slowness with which the stock of housing changes, substantial adjustment costs would still occur even with a six-year phase-in period.

RELATED OPTIONS: Revenues, Options 6 and 8; and Mandatory Spending, Option 5

Eliminate the Deduction for State and Local Taxes

In determining their taxable income, taxpayers may choose the standard deduction when they file their tax returns, or they may itemize and deduct certain expenses (including state and local taxes on income, real estate, and personal property) from their adjusted gross income, or AGI. (AGI includes income from all sources not specifically excluded by the tax code, minus certain deductions.) Under the American Jobs Creation Act of 2004, taxpayers who itemized could opt to deduct state and local sales taxes, which previously had not been deductible, instead of state and local income taxes. The American Taxpayer Relief Act of 2012 extended that provision but only through 2013. Beginning in 2013, the total value of certain itemized deductions—including the deduction for state and local taxes—is reduced if the taxpayer’s AGI is above a specified threshold.1

This option would eliminate the deductibility of state and local tax payments, a change that would increase federal revenues by $954 billion from 2014 through 2023, the staff of the Joint Committee on Taxation estimates.

The deduction for state and local taxes is effectively a federal subsidy to state and local governments; that means the federal government essentially pays a share of people’s state and local taxes. Therefore, the deduction indirectly finances spending by those governments at the expense of other uses of federal revenues. This option would take away the incentive that the current subsidy provides for state and local government spending, although some research indicates that total state and local spending is not sensitive to that incentive.

An argument in favor of removing the deduction is that the federal government should not subsidize state and local governments through the tax deduction because state and local taxes are largely paid in return for services provided to the public. If that is the case, such taxes are analogous to spending on other types of consumption, which are nondeductible. Another argument is that the deduction largely benefits wealthier localities, where many taxpayers itemize, are in the upper income tax brackets, and enjoy more abundant state and local government services. Because the value of an additional dollar of itemized deductions increases with the marginal tax rate (the percentage of an additional dollar of income from labor or capital that is paid in federal taxes), the deductions are worth more to taxpayers in higher income tax brackets than they are to those in lower income brackets. Additionally, the deductibility of taxes could deter states and localities from financing services with non-deductible fees, which could be more efficient.

An argument against eliminating the current deduction involves the equity of the tax system as a whole. A person who must pay relatively high state and local taxes has less money with which to pay federal taxes than does someone with the same total income and smaller state and local tax bills. The validity of that argument, however, depends at least in part on whether people who pay higher state and local taxes also benefit more from goods and services provided by states and localities.

1. Under the American Taxpayer Relief Act of 2012, those thresholds were set at $250,000 for taxpayers filing as single, $275,000 for taxpayers filing as a head of household, $500,000 for married taxpayers filing jointly, and $150,000 for married taxpayers filing separately. The thresholds are adjusted, or indexed, for inflation. A similar provision, with lower thresholds, was in effect before 2010.

RELATED OPTIONS: Revenues, Options 5 and 8

Revenues—Option 7

Curtail the Deduction for Charitable Giving

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Revenues</td>
<td>4</td>
<td>18</td>
<td>19</td>
<td>21</td>
<td>22</td>
<td>23</td>
<td>25</td>
<td>26</td>
<td>27</td>
<td>28</td>
<td>84</td>
<td>212</td>
</tr>
</tbody>
</table>

Source: Staff of the Joint Committee on Taxation.

Note: This option would take effect in January 2014.

Current law allows taxpayers who itemize to deduct the value of their contributions to qualifying charitable organizations. By lowering the after-tax cost of donating to charities, the deduction provides an added incentive to donate. In calendar year 2011 (the most recent year for which data are available), taxpayers claimed $174 billion in charitable contributions on 38 million tax returns.

The deduction is restricted in two ways. First, charitable contributions may not exceed 50 percent of a taxpayer’s adjusted gross income (AGI) in any one year. (AGI includes income from all sources not specifically excluded by the tax code, minus certain deductions.) Second, beginning in 2013, the total value of certain itemized deductions—including the deduction for charitable donations—is reduced if the taxpayer’s AGI is above a specified threshold.1

This option would further curtail the deduction for charitable donations while preserving a tax incentive for donating. Only contributions in excess of 2 percent of AGI would be deductible for a taxpayer who itemizes. That amount would still be subject to the additional reduction described above for higher-income taxpayers in 2013 and thereafter. Limiting the deduction to contributions in excess of 2 percent of AGI would match the treatment that now applies to unreimbursed employee expenses, such as job-related travel costs and union dues. Such a policy change would increase revenues by $212 billion from 2014 through 2023, the staff of the Joint Committee on Taxation estimates.

An argument in favor of this option is that, even without a deduction, a significant share of charitable donations would probably still be made. Therefore, allowing taxpayers to deduct contributions is economically inefficient because it results in a large loss of federal revenue for a very small increase in charitable giving. For taxpayers who contribute more than 2 percent of their AGI to charity, this option would maintain the current incentive to donate but at much less cost to the federal government. People who make large donations often are more responsive to that tax incentive than people who make small contributions. Moreover, deductions of smaller contributions are more likely to be fraudulent because donations that are less than $250 do not require the same degree of documentation as those that are larger.

A potential disadvantage of this option is that total charitable giving would decline, albeit by only a small amount, the Congressional Budget Office estimates. People who contribute less than 2 percent of their AGI would no longer have a tax incentive to donate, and many of them could reduce their contributions. Although larger donors would still have an incentive to give, they would have slightly lower after-tax income because of the smaller deduction and thus might reduce their contributions as well (although by a lesser percentage than smaller donors). Another effect of creating the 2 percent floor is that it would encourage taxpayers who had planned to

1. Under the American Taxpayer Relief Act of 2012, those thresholds were set at $250,000 for taxpayers filing as single, $275,000 for taxpayers filing as a head of household, $300,000 for married taxpayers filing jointly, and $150,000 for married taxpayers filing separately. The thresholds are adjusted, or indexed, for inflation. A similar provision, with lower thresholds, was in effect before 2010.
make gifts over several years to combine donations into a single tax year to qualify for the deduction. As a result, some taxpayers would devote more resources to tax planning than they otherwise would have in an effort to best time their contributions and thereby minimize the amount of taxes they owe over a multiyear period.

RELATED OPTION: Revenues, Option 8

Revenues—Option 8

Limit the Value of Itemized Deductions

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Revenues</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Limit the tax benefits of itemized deductions to 28 percent of their total value</td>
<td>6</td>
<td>12</td>
<td>13</td>
<td>13</td>
<td>14</td>
<td>14</td>
<td>15</td>
<td>15</td>
<td>16</td>
<td>17</td>
<td>58</td>
<td>135</td>
<td></td>
</tr>
<tr>
<td>Limit the tax value of itemized deductions to 6 percent of AGI</td>
<td>6</td>
<td>11</td>
<td>9</td>
<td>8</td>
<td>7</td>
<td>7</td>
<td>6</td>
<td>6</td>
<td>6</td>
<td>6</td>
<td>40</td>
<td>71</td>
<td></td>
</tr>
<tr>
<td>Limit itemized deductions to $500,000 for joint filers ($$250,000 for all others)</td>
<td>9</td>
<td>17</td>
<td>16</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>72</td>
<td>146</td>
<td></td>
</tr>
</tbody>
</table>

Source: Staff of the Joint Committee on Taxation.

Notes: This option would take effect in January 2014.

AGI = adjusted gross income.

When preparing their income tax returns, taxpayers may either choose the standard deduction—which is a flat dollar amount—or choose to itemize and deduct certain expenses, such as state and local taxes, mortgage interest, charitable contributions, and some medical expenses. Taxpayers benefit from itemizing when the value of their deductions exceeds the amount of the standard deduction. The fact that those expenses are deductible reduces the cost of incurring them; so, in effect, the itemized deductions serve as subsidies for undertaking deductible activities. The tax savings from itemized deductions, and thus the amount of the subsidies, generally depend on a taxpayer's marginal tax rate (the percentage of an additional dollar of income from labor or capital that is paid in taxes). For instance, $10,000 in deductions reduces tax liability by $1,500 for someone in the 15 percent tax bracket and by $2,800 for someone in the 28 percent tax bracket. Those tax savings constitute a “tax expenditure” by the federal government. (Tax expenditures resemble federal spending by providing financial assistance for specific activities, entities, or groups of people.)

The tax code imposes some limits on the amount of itemized deductions that taxpayers can claim. For some types of expenses (such as medical expenses), only the amount that exceeds a certain percentage of the taxpayer's adjusted gross income (AGI) can be deducted. (AGI includes income from all sources not specifically excluded by the tax code, minus certain deductions.) Moreover, taxpayers cannot deduct home mortgage interest on loans above $1.1 million. In addition, the total value of certain itemized deductions is reduced by 3 percent of the amount by which a taxpayer's AGI exceeds a specified threshold. The maximum limit is equal to 80 percent of itemized deductions (that is, taxpayers retain no less than 20 percent of their deductions). That limit, originally proposed by Congressman Donald Pease, is often called the Pease limitation.

This option considers three alternative approaches that would replace the Pease limitation with broader restrictions on the total amount of itemized deductions that taxpayers are allowed to take:

- The first alternative would limit the tax benefits of itemized deductions to 28 percent of the deductions’ total value. As a result, taxpayers in tax brackets with statutory rates above 28 percent would receive less benefit from itemized deductions than under current law, whereas taxpayers in tax brackets with statutory rates that are equal to or lower than 28 percent would be unaffected by the change. The staff of the Joint Committee on Taxation (JCT) estimates that this approach
would increase revenues by $135 billion from 2014 through 2023.

* The second alternative would limit the tax benefits of itemized deductions to 6 percent of a taxpayer’s AGI. As a result, taxpayers whose savings from itemized deductions exceeded 6 percent of their AGI would receive less benefit from itemized deductions than under current law, whereas taxpayers whose savings from itemized deductions was 6 percent or less of their AGI would be unaffected by the change. This approach would raise revenues by $71 billion from 2014 through 2023, according to JCT’s estimates.

* The third alternative would limit itemized deductions to $500,000 for married taxpayers who file joint returns and $250,000 for other taxpayers, with those thresholds adjusted, or indexed, for inflation. As a result, taxpayers whose itemized deductions exceeded $500,000 or $250,000, depending on their filing status, would receive less benefit from itemized deductions than under current law, whereas taxpayers whose itemized deductions were equal to or less than those thresholds would be unaffected by the change. JCT estimates that this approach would raise revenues by $146 billion from 2014 through 2023.

The primary argument for the option is that the availability of itemized deductions encourages taxpayers to spend more on deductible activities in order to receive the tax benefits those activities provide, and that tendency can lead to an inefficient allocation of economic resources. For example, the mortgage interest deduction prompts people to take out larger mortgages and buy more expensive houses, and therefore to invest less in other assets, than they would if all investments were treated equally. Reducing the tax benefits of itemized deductions would reduce taxpayers’ incentive to spend more on goods or activities than they ordinarily would just because those activities receive favored treatment in the tax code. Doing less of certain activities for which expenses can be deducted under current law—in particular, activities that primarily benefit the taxpayers undertaking the activities—would improve the allocation of resources. However, doing less of other activities for which expenses can be deducted—in particular, those activities that offer widespread benefits—could worsen the allocation of resources. An oft-cited example in the latter category is the work of charitable organizations.

If policymakers wanted to maintain the current tax subsidy for certain activities while reducing the tax subsidy for others, they could adopt one of the approaches described in this option but exempt certain deductions entirely from the restrictions or limit certain deductions in a less constraining way. For example, policymakers could limit most itemized deductions in one of the ways offered above but allow taxpayers to fully deduct at their marginal tax rates any charitable contributions that are greater than some specified percentage of AGI (see Option 7). Imposing a floor on the amount of charitable contributions that could be deducted would reduce the tax expenditure for such contributions while continuing to encourage additional contributions by taxpayers who would give charities the threshold amount anyway.

Each of the three alternatives in this option would reduce the incentives for taxpayers to spend more on goods or activities that can be deducted, but in different ways and to different degrees. Limiting the tax benefit of deductions to 28 percent of their total value would reduce the incentives created by the existing system only for taxpayers in rate brackets above 28 percent, who would see their subsidy rate fall to 28 percent from as high as 39.6 percent. Those taxpayers would continue to receive a tax benefit for each additional dollar they spent on tax-preferred items, but the amount of that benefit would be less than under current law. Other taxpayers would not experience any change in their incentives to spend money on tax-preferred items. In contrast, limiting the tax value of itemized deductions to 6 percent of AGI or capping deductions at fixed-dollar amounts would eliminate the tax incentives for some taxpayers to spend more on tax-preferred items because taxpayers would not receive any tax benefit for each additional dollar spent above those thresholds. Among all itemizers, limiting the tax subsidy to 28 percent would have the smallest effect on incentives to spend on tax-preferred items, the Congressional Budget Office estimates. Limiting the tax benefits of itemized deductions to 6 percent of a taxpayer’s AGI would have the largest effect on incentives.

Each variant would increase the tax burden more for higher-income taxpayers than for those with lower incomes because people with higher incomes typically have more deductions and because the per-dollar tax

1. Those estimates take into account the number of people who would be affected as well as the amount of deductions that they currently claim.
benefit of those deductions rises with income. Under current law, the tax benefit of the three largest itemized deductions—for state and local taxes, mortgage interest, and charitable contributions—equals 0.1 percent of after-tax income for households in the lowest income quintile, 0.4 percent for the middle quintile, 2.5 percent for the highest quintile, and 3.9 percent for the top percentile. Capping the tax value of deductions at 28 percent would increase taxes primarily on taxpayers in the top 10 percent of the pretax household income distribution. Limiting the amount of deductions to a fixed dollar amount would chiefly increase taxes on taxpayers in top percentile of the income distribution because only the highest-income taxpayers tend to have deductions over $250,000 (or $125,000 for taxpayers who do not file jointly). In contrast, limiting the tax value of deductions to 6 percent of AGI would, to some extent, increase taxes on taxpayers throughout the top half of the income distribution because even some taxpayers in the middle quintile have deductions that are a large share of their income.

An argument against any of the alternatives described in this option is that some deductions are intended to yield a measure of taxable income that more accurately reflects a person’s ability to pay taxes. For example, the deductions for payments of investment interest and unreimbursed employee business expenses allow people to subtract the costs of earning the income that is being taxed. And taxpayers with high medical expenses or casualty and theft losses have fewer resources than taxpayers with the same amount of income and smaller expenses or losses (all else being equal). Under this option, taxpayers subject to the limitations on deductions would not be able to fully subtract those expenses from their taxable income.

Another argument for not adopting any of the three alternatives is that they would increase the complexity of the tax code to some extent. Of the three approaches, the simplest would be to cap total itemized deductions at a flat dollar amount. In contrast, capping the tax benefit of itemized deductions—either at 28 percent of itemized deductions or at 6 percent of AGI—would require taxpayers to do more complicated calculations to determine their tax liability: They would have to compute their taxes using two different methods and then pay the higher of the two amounts.

Each of these approaches could be expanded by subjecting more tax provisions to the limits or by tightening the limits on itemized deductions described above. For example, the President’s budget for 2014 proposed that a 28 percent limit be applied not only to itemized deductions but also to a broader set of tax provisions, including the exclusion for interest earned on tax-exempt state and local bonds, employment-based health insurance paid for by employers or with before-tax employee dollars, and employee contributions to defined contribution retirement plans and individual retirement plans. Applying a 28 percent limit to all of the provisions specified in the President’s budget would increase revenues by more than $400 billion over the 2014–2023 period. Alternatively, adopting the third approach above but reducing the income thresholds to $100,000 for joint filers and $50,000 for other taxpayers would also raise more than $400 billion over that period.
Revenues—Option 9

Include Employer-Paid Premiums for Income Replacement Insurance in Employees’ Taxable Income

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Revenues</td>
<td>18</td>
<td>33</td>
<td>33</td>
<td>34</td>
<td>33</td>
<td>34</td>
<td>35</td>
<td>35</td>
<td>36</td>
<td>37</td>
<td>150</td>
<td>326</td>
</tr>
</tbody>
</table>

Source: Staff of the Joint Committee on Taxation.

Note: This option would take effect in January 2014. To the extent that the option would affect Social Security payroll taxes, a portion of the revenues would be off-budget. In addition, the option would increase outlays for Social Security by a small amount. The estimates do not include those effects on outlays.

Benefits that replace income for the unemployed, injured, or disabled are currently subject to different tax treatments. Whereas unemployment benefits are fully taxable, benefits paid under workers’ compensation programs (for work-related injuries or illnesses) are tax-exempt. Disability benefits (for non-work-related injuries) may be taxable, depending on who paid the premiums for the disability insurance. If the employer paid the premiums, the benefits are taxable (although the recipient’s tax liability can be offset partly by special income tax credits for the elderly or disabled). If the employee paid the premiums out of after-tax income, the benefits are not taxed.

This option would gradually eliminate any tax on income replacement benefits over a five-year period but would immediately include in employees’ taxable income the value of several taxes, insurance premiums, and other contributions paid by employers. Specifically, all of the following would be subject to the individual income tax and the payroll taxes for Social Security and Medicare: the taxes that employers pay under the Federal Unemployment Tax Act and to various state unemployment programs; 50 percent of the premiums that employers pay for workers’ compensation (that is, excluding the portion covering medical expenses); and the portion of insurance premiums or contributions to pension plans that employers pay to fund disability benefits. Together, those changes would increase revenues by $326 billion over the 2014–2023 period, the staff of the Joint Committee on Taxation estimates. Over the long term, the gain in revenues would result almost entirely from adding workers’ compensation premiums to taxable income. Including those various items in employees’ taxable earnings, and thus in the wage base from which Social Security benefits are calculated, also would increase federal spending for Social Security. Between 2014 and 2023, the option would increase federal spending very slightly, but the effect on spending would continue to increase after 2023 as more people whose premiums were taxed retired and began collecting Social Security benefits. The estimates shown above do not include any such effects on outlays.

An advantage of this option is that it would treat different kinds of income replacement insurance similarly and thereby eliminate many of the somewhat arbitrary disparities that currently exist. For example, people who are unable to work because of an injury would not be taxed differently on the basis of whether their injury was related to a previous job. Another advantage of the option is that it would spread the tax burden among all workers covered by such insurance rather than placing the burden solely on beneficiaries, as is presently the case with unemployment insurance and employer-paid disability insurance. The effect on covered workers would be relatively small: Their after-tax earnings would fall, on average, by less than one-half of one percent. However, the effect would be greatest among low-wage workers, some of whom would be less likely to seek work as a result.

A disadvantage of the option is that it would discourage unemployed individuals from accepting available work because, with unemployment benefits no longer taxable, their disposable income would be higher while they were unemployed than is the case under current law. Research shows that higher after-tax unemployment benefits tend to lengthen periods of unemployment, particularly among those who have no savings and cannot obtain loans after they lose their job. (However, in a tight labor market, the increase in disposable income would also allow unemployed people more time to find a job that best matches their skill set.)
Another argument against the option is that it would not eliminate all disparities in the way income replacement benefits are treated. For example, the income replacement portion of adjudicated awards and out-of-court settlements for injuries not related to work and not covered by insurance would remain entirely exempt from taxation.

Likewise, extended unemployment benefits that the federal government sometimes provides during economic downturns would never be taxed because no amount corresponding to an employer’s contribution would ever have been included in the recipients’ taxable income.

RELATED OPTION: Revenues, Option 22

RELATED CBO PUBLICATION: Unemployment Insurance in the Wake of the Recent Recession (November 2012), www.cbo.gov/publication/43734
Revenues—Option 10

Include Investment Income From Life Insurance and Annuities in Taxable Income

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Revenues</td>
<td>13</td>
<td>24</td>
<td>21</td>
<td>20</td>
<td>21</td>
<td>21</td>
<td>22</td>
<td>22</td>
<td>23</td>
<td>23</td>
<td>99</td>
<td>210</td>
</tr>
</tbody>
</table>

Source: Staff of the Joint Committee on Taxation.

Note: This option would take effect in January 2014.

Certain types of life insurance policies and annuities combine features of insurance and tax-favored savings accounts. (An annuity is a contract with an insurance company under which, in exchange for premiums, the company agrees to make fixed or variable payments to a person at a future time, usually during retirement.) Portions of the premiums paid for certain types of insurance policies, such as whole-life polices, and for annuities are invested and earn interest, dividends, and other types of investment income. (A whole-life policy is a contract with an insurance company that provides life insurance coverage throughout the policyholder’s lifetime—not just for a specified period, as is the case with term life insurance.) That investment income, sometimes called inside buildup, is generally not included in taxable income until it is paid out to the policyholder as a return of cash value or as a recurring payment. If the inside buildup is used to reduce premiums in later years (as occurs with whole-life policies) or is paid out because of the death of the insured, it can escape taxation under the income tax.

Under this option, life insurance companies would inform policyholders annually of the investment income their accounts have realized, just as mutual funds do now, and policyholders would include those amounts in their taxable income for that year. In turn, the cash value from life insurance policies and recurring payments from annuities would be taxable only to the extent that accrued capital gains had not already been taxed. This approach would make the tax treatment of investment income from life insurance and annuities match the treatment of income from bank accounts, taxable bonds, or mutual funds. (Taxes on investment income from annuities purchased as part of a qualified pension plan or qualified individual retirement account would still be deferred until benefits were paid.) Such changes in tax treatment would increase revenues by $210 billion from 2014 through 2023, the staff of the Joint Committee on Taxation estimates. Those revenue gains would diminish over time, however, relative to the size of the economy, because taxes paid on the inside buildup would lower taxes paid on future payouts.

An advantage of the option is that people would be less likely to base decisions about the purchase of whole life insurance and annuities on tax considerations. Investment income from whole life insurance and annuities would be taxed as it was realized, just as income from bank accounts, mutual funds, and many other types of financial instruments is taxed. The option would tax whole life insurance and term life insurance in the same way. Because term insurance provides coverage for a specified period and pays benefits only if the policyholder dies during the term, it generates no inside buildup and, hence, does not offer the tax advantage that whole-life insurance does under current law. By eliminating the tax advantages associated with whole life insurance and annuities, when compared with those provided by other forms of investment, the option would encourage people to focus on how much life insurance and annuity income they need—rather than on the expected tax savings—when purchasing those products.

As a result, the change would reduce people’s incentive to purchase life insurance and annuities. Without that incentive, however, people might buy too little insurance if they underestimate the financial hardship that their death would impose on their families. They might also underestimate their retirement spending or life span and, thus, buy too little annuity insurance to protect against outliving their assets. However, little evidence exists about how successful the current tax treatment is in encouraging people to obtain adequate amounts of insurance.
If providing an incentive to purchase life insurance is, indeed, considered a useful part of the tax system, an alternative approach would be to encourage such purchases directly by giving people a tax credit for their life insurance premiums or by allowing them to deduct part of those premiums from their taxable income. Either approach would encourage people to purchase term insurance as well as whole-life policies.

Another disadvantage of taxing inside buildup is that the people who would be affected by the change would not have access to the buildup to pay the tax. People who had accumulated considerable savings from contributions to whole-life policies or annuities could owe substantial amounts of taxes relative to the cash income from which they would have to pay the taxes.

RELATED OPTIONS: Revenues, Options 13 and 14
Revenues—Option 11

Tax Carried Interest as Ordinary Income

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Revenues</td>
<td>1.2</td>
<td>1.5</td>
<td>1.8</td>
<td>2.2</td>
<td>2.2</td>
<td>2.0</td>
<td>1.8</td>
<td>1.7</td>
<td>1.5</td>
<td>1.4</td>
<td>8.9</td>
<td>17.4</td>
</tr>
</tbody>
</table>

Source: Staff of the Joint Committee on Taxation.

Note: This option would take effect in January 2014. To the extent that the option would affect Social Security payroll taxes, a portion of the revenues would be off-budget. In addition, the option would increase outlays for Social Security by a small amount. The estimates do not include those effects on outlays.

Investment funds—such as private equity, real estate, and hedge funds—are typically organized as partnerships with one or more general partners managing the fund. The general partners determine investment strategy; solicit capital contributions; acquire, manage, and sell assets; arrange loans; and provide administrative support for all of those activities. Such partnerships also typically include limited partners, who contribute capital to the partnership but do not participate in the fund’s management. General partners can invest their own financial capital in the partnership, but such investments usually represent a small share of the total funds invested.

General partners typically receive two types of compensation for managing a fund: a fee tied to some percentage of the fund’s assets under management; and a profit share, or “carried interest,” tied to some percentage of the profits generated by the fund. A common compensation agreement gives general partners a 2 percent fee and 20 percent in carried interest. The fee, less the fund’s expenses, is subject to ordinary income tax rates and the self-employment tax. In contrast, the carried interest that general partners receive is taxed in the same way as the investment income passed through to the limited partners. For example, if that investment income consists solely of capital gains, the carried interest is taxed only when those gains are realized and at the lower capital gains rate. The general partners’ share of dividends is also taxed at the lower rate.

This option would treat the carried interest that partners receive for performing investment management services as labor income, taxable at ordinary income tax rates and subject to the self-employment tax. Income those partners received as a return on their own capital contribution would not be affected. If implemented, the change would produce an estimated $17 billion in revenues from 2014 through 2023. Almost all of the additional labor income would be above the maximum amount subject to the Social Security portion of the self-employment tax; however, the small amount of such income below the cap would affect the wage base from which Social Security benefits are calculated and thus increase federal spending in future years. The estimates shown here do not include any effects on such outlays.

Arguments in favor of this option reflect the view that carried interest should be considered performance-based compensation for management services rather than a return on the financial capital invested by the general partner. In accordance with that viewpoint, the option would eliminate two notable differences in the way carried interest and comparable forms of income are currently taxed. First, taxing carried interest as ordinary income would make its treatment consistent with that applied to many other forms of performance-based compensation, such as bonuses and most stock options. Second, the option would equalize the tax treatment of income that partners receive for performing investment management services and the treatment of income earned by corporate executives who do similar work. (The managers of publicly traded mutual funds, for example, also invest in a variety of assets. And the executives of many corporations direct investment, arrange financing, purchase other companies, or spin off components of their enterprises.)

Arguments against the option reflect the view that general partners’ investment decisions are more analogous to those of an entrepreneur than those of a corporate executive. From that perspective, this option would treat the income of partners who manage investment funds differently from that earned by entrepreneurs when they sell their businesses. Profits from such sales generally are taxed as capital gains, even though some of those profits represent a direct return on specific labor services.
provided by the entrepreneur. Another argument against such a policy change is that to the extent that carried interest is a reward for taking successful risks, the policy change would reduce the incentive for general partners to undertake such risks. That reduced incentive, in turn, would probably deter innovation, new products, and more efficient markets and businesses. It is not clear, however, to what extent a lower rate on capital gains contributes to such outcomes, or even whether promoting risky investment offers more economic advantages than disadvantages.

Some firms would probably respond to such a change by restructuring their compensation arrangements so that as much compensation as possible could continue to be treated as capital gains. (The revenue estimates shown above reflect the likelihood of such restructuring.) That could be accomplished if the limited partners made an interest-free nonrecourse loan to the general partner, who would then invest the proceeds of that loan in the fund. (A borrower is not personally liable for a nonrecourse loan beyond the pledged collateral, which in this case would be the general partner’s claim on future profits.) At the time the partnership sold its assets, any difference between the proceeds allocated to the general partner and the loan principal, plus the implicit interest costs attributable to that loan, would be treated as a capital gain or loss. An alternative (but complex) policy approach would be to treat all carried interest as if a nonrecourse loan had actually been made. Under that approach, the general partner would typically pay more in taxes than under current law but less than if all carried interest was treated as ordinary income.

RELATED OPTION: Revenues, Option 3

RELATED CBO PUBLICATION: Testimony of Peter R. Orszag, Director, before the House Committee on Ways and Means, The Taxation of Carried Interest (September 6, 2007), www.cbo.gov/publication/19113
Revenues—Option 12

Include All Income That U.S. Citizens Earn Abroad in Taxable Income

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Revenues</td>
<td>2.8</td>
<td>6.2</td>
<td>7.2</td>
<td>8.2</td>
<td>8.9</td>
<td>9.5</td>
<td>10.3</td>
<td>11.0</td>
<td>11.7</td>
<td>12.7</td>
<td>33.3</td>
<td>88.5</td>
</tr>
</tbody>
</table>

Source: Staff of the Joint Committee on Taxation.

Note: This option would take effect in January 2014. The estimates include the effects on outlays resulting from changes in refundable tax credits.

U.S. citizens who live in other countries must file an individual U.S. tax return each year, but several provisions of the tax code reduce their U.S. tax liability. First, those citizens may exclude from taxation some of the income they earn abroad: up to $97,600 for single filers and up to $195,200 for joint filers in calendar year 2013. (Those amounts are adjusted, or indexed, for inflation.) Second, under certain circumstances, U.S. citizens living abroad can also claim an exclusion or deduction for any allowance their employers provide for housing in a foreign country. Those two tax provisions—combined with the personal exemptions and deductions available to taxpayers living in either the United States or other countries—mean that U.S. citizens who reside abroad and earn over $100,000 (or, in the case of married U.S. citizens living abroad, over $200,000) may not incur any U.S. income tax liability, even if they pay no taxes to the country in which they live. Third, if those citizens pay taxes to the country in which they live, they can receive a credit on their U.S. taxes for foreign taxes paid on any income above the U.S. exclusion amount. As a result, most U.S. tax filers who live abroad do not have any U.S. tax liability.

This option would retain the credit for taxes paid to foreign governments but would require U.S. citizens living overseas to include all of the income they earned abroad, including housing allowances, in their adjusted gross income. (Adjusted gross income includes income from all sources not specifically excluded by the tax code, minus certain deductions.) As a result, U.S. citizens living in countries with lower tax rates than those in the United States would tend to owe more—and, in some cases, potentially much more—in U.S. taxes than under current law, while U.S. citizens residing in countries with higher tax rates would generally continue not to owe U.S. taxes on their earned income. The staff of the Joint Committee on Taxation estimates that implementing such a change would increase revenues by $89 billion over the 2014–2023 period.

One rationale for eliminating the partial exclusion for foreign earnings is related to a certain concept of equity—that U.S. citizens with comparable income should incur similar tax liabilities, regardless of where they live. Under the option, people could not move to low-tax foreign countries to escape U.S. tax liability while retaining the benefits of U.S. citizenship. (To discourage U.S. citizens from moving abroad to avoid taxes, the Heroes Earnings Assistance and Relief Tax Act of 2008 instituted a significant “expatriation tax” on the net worth of wealthy taxpayers who renounce their U.S. citizenship for any reason.)

However, the United States is the only member of the Organisation for Economic Co-operation and Development that taxes the income of its citizens on a worldwide basis; therefore, eliminating the exemption for income earned abroad would move the United States further out of alignment with the rest of the world in terms of the tax treatment of foreign-earned income. Another argument for not making this change is that U.S. citizens who live in other countries do not receive all of the same services from the U.S. government that are available domestically, and they may receive fewer services from the low-tax countries in which they reside.


RELATED OPTION: Revenues, Option 30
Revenues—Option 13

Tax Social Security and Railroad Retirement Benefits in the Same Way That Distributions From Defined Benefit Pensions Are Taxed

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Revenues</td>
<td>17</td>
<td>35</td>
<td>37</td>
<td>38</td>
<td>40</td>
<td>41</td>
<td>43</td>
<td>44</td>
<td>46</td>
<td>48</td>
<td>166</td>
<td>388</td>
</tr>
</tbody>
</table>

Source: Staff of the Joint Committee on Taxation.

Note: This option would take effect in January 2014.

Under current law, less than 30 percent of the benefits paid by the Social Security and Railroad Retirement programs are subject to the federal income tax. Recipients with income below a specified threshold pay no taxes on those benefits. Most recipients fall into that category, which constitutes the first tier of a three-tiered tax structure. If the sum of their adjusted gross income, their non-taxable interest income, and one-half of their Social Security and Tier I Railroad Retirement benefits exceeds $25,000 (for single taxpayers) or $32,000 (for couples filing jointly), up to 50 percent of the benefits are taxed. Above a higher threshold—$34,000 for single filers and $44,000 for joint filers—as much as 85 percent of the benefits are taxed.

By contrast, distributions from defined benefit plans are taxable except for the portion that represents the recovery of an employee’s “basis”—that is, his or her after-tax contributions to the plan. In the year that distributions begin, the recipient determines the percentage of each year’s payment that is considered to be the nontaxable recovery of previous after-tax contributions, based on the cumulative amount of those contributions and projections of his or her life expectancy. Once the recipient has recovered his or her entire basis tax-free, all subsequent pension distributions are fully taxed. (Distributions from traditional defined contribution plans and from individual retirement accounts, to the extent that they are funded by after-tax contributions, are also taxed on amounts exceeding the basis.)

This option would treat the Social Security and Railroad Retirement programs in the same way that defined benefit pensions are treated—by defining a basis and taxing only those benefits that exceed that amount. For employed individuals, the basis would be the payroll taxes they paid out of after-tax income to support those programs (but not the equal amount that employers paid on their workers’ behalf). For self-employed people, the basis would be the portion (50 percent) of their self-employment taxes that is not deductible from their taxable income. Revenues would increase by $388 billion from 2014 through 2023, the staff of the Joint Committee on Taxation estimates.

An argument in favor of this option concerns equity. Taxing benefits from the Social Security and Railroad Retirement programs in the same way as those from defined benefit pensions would make the tax system more equitable in at least two ways. First, it would eliminate the preferential treatment given to Social Security benefits but not to pension benefits—a preference that is minimal for higher-income taxpayers but much larger for low- and middle-income taxpayers. Second, it would treat elderly and nonelderly taxpayers with comparable income the same way. For people who pay taxes on Social Security benefits under current law, the option could also simplify the preparation of tax returns. Instead of taxpayers calculating the taxable portion themselves, the Social Security Administration—which would have information on their lifetime contributions and life expectancy—could compute the taxable amount of benefits and provide that information to beneficiaries each year.

This option also has drawbacks. It would have the greatest impact on people with the lowest income: People with income below $44,000, including some who depend solely on Social Security or Railroad Retirement for their support, would see their taxes increase by the greatest

1. Distributions from Roth plans, which allow after-tax contributions only, are entirely tax-exempt—a more favorable treatment than the tax-free recovery of basis only. If Social Security benefits were treated like distributions from Roth plans, half the benefits would be exempt from taxation, reflecting the share financed by employees’ contributions, which are after-tax (or, in the case of the self-employed, the share of their contributions that is not deducted from their taxable income).
percentage. In addition, raising taxes on Social Security and Railroad Retirement benefits would be equivalent to reducing those benefits and could be construed as violating the implicit promises of those programs, especially because the option would provide little or no opportunity for current retirees and people nearing retirement to adjust their saving or retirement strategies to mitigate the impact. Finally, more elderly people would have to file tax returns than do so now, and calculating the percentage of each recipient’s benefits that would be excluded from taxation would impose an additional burden on the Social Security Administration.

RELATED OPTIONS: Revenues, Options 10 and 14

RELATED CBO PUBLICATION: Social Security Policy Options (July 2010), www.cbo.gov/publication/21547
Revenues—Option 14

Further Limit Annual Contributions to Retirement Plans

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Revenues</td>
<td>4.5</td>
<td>6.7</td>
<td>7.3</td>
<td>8.1</td>
<td>8.7</td>
<td>9.4</td>
<td>10.0</td>
<td>10.8</td>
<td>11.3</td>
<td>12.0</td>
<td>35.3</td>
<td>88.7</td>
</tr>
</tbody>
</table>

Source: Staff of the Joint Committee on Taxation.

Note: This option would take effect in January 2014. To the extent that the option would affect Social Security payroll taxes, a portion of the revenues would be off-budget. In addition, the option would increase outlays for Social Security by a small amount. The estimates do not include those effects on outlays.

Current law allows taxpayers to make contributions to certain types of tax-preferred retirement plans up to a maximum annual amount that varies depending on the type of plan and the age of the taxpayer. The most common such vehicles are defined contribution plans (any plan that does not guarantee a particular benefit amount upon retirement) and individual retirement accounts (IRAs). Defined contribution plans are sponsored by employers. Some—most commonly, 401(k) plans—accept contributions by employees; others are funded entirely by the employer. IRAs are maintained by the participants themselves.

Most of the tax savings associated with retirement plans arise because the investment income that accrues in the account is either explicitly or effectively exempt from taxation. That is clearest in the case of Roth retirement plans—both IRAs and 401(k)s—which do not allow contributions to be excluded from taxable income. Instead, the taxpayer benefits by not paying tax on the investment income, either as it accrues or when it is withdrawn. More traditional types of tax-preferred retirement plans allow taxpayers to exclude contributions from their taxable income and defer the payment of taxes until they withdraw funds. If the taxpayer is subject to the same tax rate that applied when the contribution was made, the value of the deduction is offset by the tax on withdrawals. The actual tax benefit is equivalent to that provided by Roth plans—effectively exempting investment income from taxation. (In the traditional structure, however, the tax benefits can be higher or lower than under a Roth plan depending on the tax bracket participants are in when they retire.)

The value of the tax exemption for investment earnings increases with the participant’s income tax rate. Thus, a worker in the 15 percent tax bracket saves 15 cents on each dollar of investment income accrued in his or her retirement plan; however, an employee in the 35 percent tax bracket avoids taxes equal to 35 cents per dollar of investment income. (If the investment income is in the form of capital gains, lower tax rates apply, but they are still graduated by income.)

Individuals under the age of 50 may contribute up to $17,500 to 401(k) and similar employment-based plans in 2013; participants ages 50 and above are also allowed to make “catch-up” contributions of up to $5,500, enabling them to make as much as $23,000 in total contributions in 2013. In general, the limits on an individual’s contributions apply to all defined contribution plans combined. However, contributions to 457(b) plans, available primarily to employees of state and local governments, are subject to a separate limit. As a result, employees who are enrolled in both 401(k) and 457(b) plans can contribute the maximum amount to both plans, thereby allowing some people to make tax-preferred contributions of as much as $46,000 in a single year. Employers may also contribute to their workers’ defined contribution plans, up to a maximum of $51,000 per person in 2013, less any contributions made by the employee.

In 2013, contributions to IRAs are limited to $5,500 for taxpayers under the age of 50 and $6,500 for those ages 50 and above. The amount of such contributions that is tax deductible is phased out above certain income thresholds if either the taxpayer or the taxpayer’s spouse is covered by an employment-based plan. Annual contribution limits for all types of plans are adjusted, or indexed, for inflation but increase only in $500 increments.

Under this option, individuals’ maximum allowable contributions would be reduced to $15,500 per year for 401(k)—type plans and $5,000 per year for IRAs, regardless of a taxpayer’s age. The option would also require that all contributions to employment-based plans—
including 457(b) plans—be subject to a single combined limit. Total allowable employer and employee contributions to a defined contribution plan would be reduced from $51,000 per year to $46,000. If implemented, the option would increase revenues by $89 billion from 2014 through 2023, the staff of the Joint Committee on Taxation estimates. The option would also affect federal outlays, but by much smaller sums. Reducing the amount that employers are allowed to contribute would increase taxable wages, the base from which Social Security benefits are calculated, and thus would increase federal spending for Social Security by a small amount. Contributions by employees are already included in the wage base for Social Security. (The estimates shown here do not include any effects on such outlays.)

One argument in favor of this option centers on fairness. The option would reduce the disparity in tax benefits that exists between higher- and lower-income taxpayers in two ways. First, those directly affected by the option would make fewer contributions and accrue less tax-preferred investment income, so the greater benefit of the exemption to those in higher tax brackets would be reduced. Second, the option would affect more higher-income taxpayers than lower-income taxpayers. The limits on 401(k) contributions affect few taxpayers—only 5 percent of participants in calendar year 2006 (the most recent year for which such data are available)—but of those affected, 69 percent had income in excess of $160,000 that year. The option also would level the playing field between those who currently benefit from higher contribution limits (people ages 50 and over and employees of state and local governments) and those subject to lower limits.

In addition to enhancing fairness, the option would improve economic efficiency. A goal of tax-preferred retirement plans is to increase private saving (although at the cost of some public saving). However, the higher-income individuals who are constrained by the current limits on contributions are most likely to be those who can fund the tax-preferred accounts using money they have already saved or would save anyway; in that case, the tax preference provides benefits to the individuals involved without boosting aggregate saving. Thus, the option would increase public saving—by reducing the deficit—at the cost of very little private saving.

The main argument against this option is that it would reduce the retirement saving of some people, particularly those who find it difficult to save because of income constraints or family responsibilities. Although only 5 percent of workers with income under $80,000 contributed to IRAs in 2006, more than one-third contributed the maximum amount permitted. Those workers generally have relatively little in accumulated savings and are more likely to respond to the incentive to save than are people in higher-income groups. Eliminating the extra allowance for catch-up contributions would adversely affect those ages 50 and over who might have failed to save enough for a comfortable retirement while raising their families. The amount that they could contribute to tax-preferred retirement accounts would be cut at precisely the time when reduced family obligations and impending retirement make them more likely to respond to tax incentives to save more.

Finally, further limiting total contributions to a defined contribution plan would create an incentive for some small businesses to terminate their plans if the tax benefits of the plan to the owners were outweighed by the cost of administering it. To the extent that plans were terminated, employees would then have to rely on IRAs, which would lead some to save less because of the lower contribution limits.

RELATED OPTIONS: Revenues, Options 10 and 13

Revenues—Option 15

Eliminate the Tax Exemption for New Qualified Private Activity Bonds

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Revenues</td>
<td>0.1</td>
<td>0.5</td>
<td>1.0</td>
<td>1.7</td>
<td>2.4</td>
<td>3.2</td>
<td>4.1</td>
<td>5.0</td>
<td>5.9</td>
<td>6.6</td>
<td>5.7</td>
<td>30.5</td>
</tr>
</tbody>
</table>

Source: Staff of the Joint Committee on Taxation.
Note: This option would take effect in January 2014.

The U.S. tax code permits state and local governments to finance certain projects by issuing bonds whose interest payments are exempt from federal income taxes. As a result, those bonds pay lower rates of interest than they would if the interest payments were taxable. For the most part, proceeds from tax-exempt bonds finance public projects, such as the construction of schools and highways. In some cases, however, state and local governments issue tax-exempt bonds to finance private-sector projects. The issuance of such bonds—which are known as qualified private activity bonds—is authorized by the tax code to fund private projects that provide at least some public benefits. Eligible projects include the construction or repair of infrastructure and certain activities, such as building schools and hospitals, undertaken by nonprofit organizations. (Those organizations are sometimes called 501(c)(3)s after the section of the tax code that authorizes them.)

This option would eliminate the tax exemption for new qualified private activity bonds beginning in 2014. The option would increase revenues by $31 billion through 2023, according to estimates by the staff of the Joint Committee on Taxation.

One rationale for this option is that eliminating the tax exemption for new qualified private activity bonds would improve economic efficiency in some cases. For example, the owners of some of the infrastructure facilities that benefit from the tax exemption can capture—through fees and other charges—much of the value of the services they provide. Therefore, such investments probably would take place without a subsidy. In those instances, providing a tax exemption for such investments would be inefficient because the tax exemption would shift resources from taxpayers to private investors without generating any additional public benefits. As another example, in cases in which the public benefit from a private-sector facility would be small relative to the existing tax exemption, the subsidy sometimes would lead to investment in projects whose total value (counting private as well as public benefits) was less than their costs.

Another argument in favor of this option is that it would encourage nonprofit organizations to be more selective when choosing projects and, in general, to operate more efficiently. Nonprofit organizations do not pay federal income tax on their investment income. Many nonprofit universities, hospitals, and other institutions use tax-exempt debt to finance projects that they could fund by selling their own assets. By holding onto those assets, they can earn an untaxed return that is higher than the interest they pay on their tax-exempt debt. Eliminating the tax exemption for the debt-financed projects of nonprofit organizations would put those projects on an even footing with the projects financed by selling assets. Further, the tightening of nonprofit organizations’ financial constraints that would result from eliminating the tax exemption would encourage those organizations to operate more cost-effectively, although some nonprofits with small asset bases, or endowments, could be forced to cut back or even cease operations.

A disadvantage of this option is that some projects that would not be undertaken without a tax exemption would provide sufficient public benefits to warrant a subsidy. For example, some roads can have broad social benefits (because they are part of a larger transportation network) and, at the same time, be appealing to private owners (because those owners and operators could collect tolls from users). State and local governments are increasingly looking to the private sector to undertake projects of that sort, and supporters of qualified private activity bonds argue that eliminating the tax exemption would remove an important source of funding for them. (This concern may be especially acute now because the finances of state and local governments have been weakened by the economic downturn and slow recovery; if that were the
principal concern about this option, however, then its implementation could be delayed a few years until the economy is expanding more strongly.)

If lawmakers wished to continue to support infrastructure investment and other projects undertaken by the private sector, they could do so more efficiently by subsidizing them directly rather than by subsidizing them through the tax system. Tax-exempt financing is inefficient for two reasons: First, the reduction in borrowing costs for issuers of those bonds is less than the federal revenues foregone through the tax exemption. (The interest rate on tax-exempt debt is determined by the market-clearing tax-exempt bond buyer, who will typically be in a lower marginal income tax bracket—and hence be willing to accept a lower tax-free rate of return—than the average tax-exempt bond buyer, who determines the amount of federal revenue foregone as a result of the tax exemption.) Second, the amount of subsidy delivered is determined by the tax code and so does not vary across projects according to federal priorities. Lawmakers could, instead, provide a direct subsidy for certain projects by guaranteeing loans or making loans available to the private sector at below-market rates of interest. By offering a direct subsidy, the federal government would be better able than it is through the tax system both to select the types of projects receiving support and to determine the amount of the subsidy.

RELATED OPTION: Revenues, Option 6

Federal support for higher education takes many forms, including grants, subsidized loans, and tax preferences. Those tax preferences include several types of tax-advantaged accounts that allow families to save for their child's postsecondary education as well as education-related credits and deductions. The major credits and deductions in effect in 2013 or scheduled to be reinstated under current law are the following:

- The American Opportunity Tax Credit (AOTC) replaced and expanded the Hope tax credit starting in 2009. Although it was scheduled to expire at the end of 2012, the AOTC was extended through 2017 by the American Taxpayer Relief Act of 2012. Unlike the Hope tax credit, which was nonrefundable, the AOTC is partially refundable—that is, families whose income tax liability (before the credit is applied) is less than the total amount of the credit may receive all or a portion of the credit as a payment. The AOTC is available to cover qualifying educational expenses for up to four years of postsecondary education. In 2013, the AOTC can total as much as $2,500 (100 percent of the first $2,000 in qualifying expenses and then 25 percent of the next $2,000). Up to 40 percent of the credit (or $1,000) is refundable. The amount of the AOTC gradually declines (is “phased out”) for higher-income tax filers. In 2013, the AOTC is reduced for married couples who file jointly and have modified adjusted gross income (MAGI) between $160,000 and $180,000 and for single filers with MAGI between $80,000 and $90,000.1 Neither the credit amount nor the income thresholds are adjusted, or indexed, for inflation over the 2009–2017 period in which the AOTC is in effect.

- The nonrefundable Lifetime Learning tax credit provides up to $2,000 for qualifying tuition and fees. (The credit equals 20 percent of each dollar of qualifying expenses up to a maximum of $10,000.) Only one Lifetime Learning credit may be claimed per tax return per year, but the expenses of more than one family member (a taxpayer, spouse, or dependent) may be included in the calculation. The Lifetime Learning credit can be used after the first two years of postsecondary education and by students who attend school less than half-time. Taxpayers may not claim the Lifetime Learning credit and the AOTC for the same student in the same year. In 2013, the Lifetime Learning tax credit is gradually reduced for joint filers whose MAGI is between $107,000 and $127,000 and for single filers whose MAGI is between $53,000 and $63,000. Those income thresholds are adjusted for inflation over time.

- Tax filers may deduct from their taxable income up to $2,500 per year for interest payments on student loans. This deduction is available regardless of whether a tax filer itemizes deductions. In 2013, the interest deduction for student loans phases out for joint filers with MAGI between $125,000 and $155,000 and for single filers with MAGI between $60,000 and $75,000. Although the maximum deduction amount is not indexed for inflation, the income thresholds for the phaseout ranges are adjusted for inflation.

- Taxpayers (regardless of whether they claim the standard deduction or itemize their deductions) can deduct up to $4,000 from their taxable income for qualifying tuition and fees instead of taking a credit. That deduction is scheduled to expire at the end of 2013.

---

1. Certain foreign income and foreign housing allowances that are excluded from taxable income are added to adjusted gross income (AGI) to calculate the modified AGI measure used to determine eligibility for education-related tax credits. (AGI includes income from all sources not specifically excluded by the tax code, minus certain deductions.)
Although not currently available, the Hope tax credit is scheduled to be reinstated in 2018 when the AOTC expires. The Hope credit is nonrefundable (the credit may not exceed the filer’s income tax liability) and can be claimed only for expenses incurred in the first two years of a postsecondary degree or certificate program; during that period, the student must be enrolled at least half-time. Fewer types of expenses qualify for the Hope credit than for the AOTC. In 2008, the last year it was available, the Hope credit was equal to 100 percent of the first $1,200 of qualifying tuition and fees and 50 percent of the next $1,200 for a maximum credit of $1,800 per year. As was the case before the Hope credit expired, the parameters used to calculate the credit amount will be indexed for inflation when the credit is reinstated. On the basis of that adjustment for inflation, CBO estimates that in 2018, the maximum credit will be $2,100. As was previously the case, the reinstated Hope credit will decline for high-income tax filers. In 2018, CBO estimates, the credit will be reduced for joint filers with MAGI between $118,000 and $138,000 and for single filers with MAGI between $59,000 and $69,000.

This option would eliminate the AOTC and the Lifetime Learning tax credit beginning in 2014 and cancel the reinstatement of the Hope tax credit in 2018. (The $4,000 deduction for qualifying tuition and fees described above would have already expired by 2014.) The option would also gradually eliminate the deductibility of interest expenses for student loans. Because students borrowed money with the expectation that a portion of the interest would be deductible over the life of the loan, the interest deduction for student loans would be phased out in annual increments of $250 over a 10-year period. If implemented, the option would raise revenues by $155 billion over the 2014–2023 period, the staff of the Joint Committee on Taxation estimates.

An argument in favor of the option is that the current tax benefits are not targeted to those who need assistance the most. Many low-income families do not have sufficient income tax liability to claim all—or in some cases, any—of the education-related tax benefits. However, the cost of higher education may impose a greater burden on those families as a proportion of their income. Further, some research indicates that lower-income individuals and families may be more sensitive to the cost of higher education than those with higher income and thus more likely to enroll in higher education programs if tuition and fees are subsidized.

A second rationale in favor of the option concerns the administration of education benefits through the income tax system. Education benefits administered through the tax system are poorly timed because families must pay tuition and fees before they can claim the benefits on their tax returns. In contrast, federal spending programs such as the Pell grant program are designed to provide assistance when the money is needed—at the time of enrollment. Further, providing education assistance through various credits and deductions, each with slightly different eligibility rules and benefit amounts, makes it difficult for families to determine which tax preferences provide the most assistance. As a result, some families may not choose the most advantageous educational benefits for their particular economic circumstances.

A drawback of this policy option is that some households would not receive as much assistance for educational expenses unless federal outlays for education assistance were increased. The option would increase the financial burden on families with postsecondary students—particularly middle-income families who do not qualify for current federal spending programs. Another drawback is that despite the current system’s complexity—which creates overlapping tax benefits—some families may find it easier to claim benefits on their tax returns (on which they already provide information about their family structure and income) than to fill out additional forms for assistance through other federal programs.
Revenues—Option 17

Lower the Investment Income Limit for the Earned Income Tax Credit and Extend That Limit to the Refundable Portion of the Child Tax Credit

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Revenues</td>
<td>*</td>
<td>1.2</td>
<td>1.2</td>
<td>1.2</td>
<td>1.3</td>
<td>1.1</td>
<td>1.2</td>
<td>1.2</td>
<td>1.2</td>
<td>1.3</td>
<td>4.9</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>10.9</td>
</tr>
</tbody>
</table>

Source: Staff of the Joint Committee on Taxation.

Notes: This option would take effect in January 2014. The estimates represent the change in the overall budget balance that would result from the sum of changes to revenues and outlays.

* = between zero and $50 million.

Low- and moderate-income people are eligible for certain refundable tax credits under the individual income tax if they meet the specified criteria. Refundable tax credits differ from other tax preferences, such as deductions, in that their value may exceed the amount of income taxes that the person owes. Refundable tax credits thus can result in net payments from the government to a taxpayer: If the amount of a refundable tax credit exceeds a taxpayer’s tax liability before that credit is applied, the government pays the excess to that person. Two refundable tax credits are available only to workers: the earned income tax credit (EITC) and the refundable portion of the child tax credit (referred to in the tax code as the additional child tax credit).

To qualify for the EITC and the refundable portion of the child tax credit, people must meet several income tests. First, they must have income from wages, salaries, or self-employment. Second, their adjusted gross income cannot exceed thresholds that vary with family characteristics. (Adjusted gross income includes income from all sources not specifically excluded by the tax code, minus certain deductions.) For the EITC, the income thresholds for 2013 range from $14,340 for an unmarried worker who does not live with a child to $51,567 for a married couple that files jointly and has three or more children. For the child tax credit, the income threshold for 2013 is $95,000 for an unmarried person with one child and $130,000 for joint filers with one child; the income thresholds increase with the number of children in the family. Finally, eligibility for the EITC is restricted to filers with investment income that is $3,300 or less in 2013. Investment income includes interest (counting tax-exempt interest), dividends, capital gains, royalties and rents from personal property, and returns from passive activities (business pursuits in which the person is not actively involved). The limitations on adjusted gross income and investment income are adjusted, or indexed, for inflation each year.

This option would lower the threshold for the EITC investment income test from $3,300 to $1,650. As under current law, that threshold would be indexed for inflation. Moreover, the option would extend that requirement to the refundable portion of the child tax credit. If implemented, the option would raise $11 billion from 2014 through 2023, according to estimates by the staff of the Joint Committee on Taxation.

The main rationale for the option is that it would better target the credits to people without substantial means by denying the credits to people who have low earnings but have other resources to draw upon. Asset tests—requirements that recipients do not have savings in bank accounts, stocks, and other types of investments whose value is above a specified threshold—serve a similar role in some spending programs that provide benefits to lower-income populations. However, asset tests would be very difficult for the Internal Revenue Service (IRS) to administer because the agency does not collect information on the amount of assets held by individuals. By contrast, the IRS does have extensive information on the income from most of those investments, and much of that information is accurate because it is reported independently to the agency by financial institutions as well as by taxpayers on their returns.

1. A special rule applies to the EITC when a person’s earnings are higher than his or her adjusted gross income (because of investment losses). In that instance, eligibility for the EITC is denied if the earnings exceed the specified thresholds.
An argument against the option is that it would reduce the incentive to save, especially among people whose income from investments is near the threshold amount and who could become (or remain) eligible for the credits under the option by making small reductions in their assets. However, some people would not respond to the lower thresholds by reducing their saving but instead by shifting their investments to less liquid forms (such as cars) that are not subject to the investment test or by changing the timing of the return from their investments (for example, by retaining stocks for longer periods in order to avoid realizing capital gains). For people with very low income, the investment test would probably have little effect because they have little means to save and invest.

Revenues—Option 18

Increase the Maximum Taxable Earnings for the Social Security Payroll Tax

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Outlays</td>
<td>*</td>
<td>*</td>
<td>*</td>
<td>*</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>2</td>
<td>2</td>
<td>3</td>
<td>2</td>
<td>10</td>
</tr>
<tr>
<td>Change in Revenues</td>
<td>-8</td>
<td>40</td>
<td>46</td>
<td>49</td>
<td>51</td>
<td>52</td>
<td>53</td>
<td>55</td>
<td>57</td>
<td>59</td>
<td>194</td>
<td>470</td>
</tr>
</tbody>
</table>

Sources: Staff of the Joint Committee on Taxation; Congressional Budget Office.

Notes: This option would take effect in January 2014. The change in revenues would consist of an increase in receipts from Social Security payroll taxes (which would be off-budget), offset in part by a reduction in individual income tax revenues (which would be on-budget). The outlays would be for additional payments of Social Security benefits and would be classified as off-budget.

* = between zero and $500 million.

Social Security—which consists of Old-Age and Survivors Insurance and Disability Insurance—is financed by payroll taxes on employers, employees, and the self-employed. Only earnings up to a maximum, which is $113,700 in 2013, are subject to the tax. That maximum usually increases each year at the same rate as average wages in the economy.

When payroll taxes for Social Security were first collected in 1937, about 92 percent of earnings from jobs covered by the program were below the maximum taxable amount. During most of the program’s history, the maximum was increased only periodically, so the percentage varied greatly. It fell to 71 percent in 1965 and by 1977 had risen to 85 percent. Amendments to the Social Security Act in 1977 boosted the amount of covered taxable earnings, which reached 90 percent in 1983. That law also specified that the taxable maximum be adjusted, or indexed, annually to match the growth in average wages. Despite those changes, the percentage of earnings that is taxable has slipped in the past decade because earnings for the highest-paid workers have grown faster than average earnings. Thus, in 2011, about 83 percent of earnings from employment covered by Social Security fell below the maximum taxable amount.

This option would increase the taxable share of earnings from jobs covered by Social Security to 90 percent by raising the maximum taxable amount to $177,500 in calendar year 2014. (In later years, the maximum would continue to be indexed as it is now.) Implementing such a policy change would increase revenues by an estimated $470 billion over the 2014–2023 period, according to the staff of the Joint Committee on Taxation. (The estimates include the reduction in individual income tax revenues that would result from a shift of some labor compensation from a taxable to a nontaxable form.)

Because Social Security benefits are tied to the amount of earnings on which taxes are paid, however, some of the increase in revenues from this option would be offset by the additional benefits paid to people with earnings above the maximum taxable amount under current law. On net, the option would reduce federal budget deficits by an estimated $460 billion over the 10-year period.

An advantage of this option is that it would provide more revenue to the Social Security program, which, according to the Congressional Budget Office’s projections, will not have sufficient income to finance the benefits that are due to beneficiaries under current law. If current law remained in place, spending for Social Security would rise from 4.9 percent of gross domestic product (GDP) in 2013 to 6.2 percent by 2038, CBO projects. But Social Security tax revenues, which already are less than spending for the program, would grow more slowly. CBO projects that, in combination, the Old-Age and Survivors Insurance and Disability Insurance trust funds will be exhausted in 2031. Under this option, exhaustion of the combined trust funds would be delayed until 2036.

In addition, this option would make the payroll tax less regressive. People with earnings above the ceiling now pay a smaller percentage of their total earnings in payroll taxes than do people whose total earnings are below the maximum. Making more earnings taxable would increase payroll taxes for those high earners. (That change would
also lead to somewhat higher benefit payments for affected workers.)

A disadvantage of this option is that raising the earnings cap would weaken the link between the taxes that workers pay into the system and the benefits they receive (because the increase in benefits would be modest relative to the increase in taxes). That link has been an important aspect of Social Security since its inception. Another drawback is that people with earnings between the existing taxable limits and those under the option would earn less after taxes for each additional hour worked, which would reduce the incentive to work and encourage taxpayers to substitute tax-exempt fringe benefits for taxable wages. In contrast, people with earnings well above the limit established by this option would not see any reduction in the return on their additional work, but they would have less income after taxes, which would encourage them to work more.

RELATED OPTIONS: Revenues, Options 19 and 21

Revenues—Option 19

Expand Social Security Coverage to Include Newly Hired State and Local Government Employees

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Revenues</td>
<td>0.7</td>
<td>2.2</td>
<td>3.9</td>
<td>5.5</td>
<td>7.0</td>
<td>8.7</td>
<td>10.4</td>
<td>12.3</td>
<td>14.2</td>
<td>16.3</td>
<td>19.3</td>
<td>81.1</td>
</tr>
</tbody>
</table>

Source: Staff of the Joint Committee on Taxation.

Note: This option would take effect in January 2014. The change in revenues would consist of an increase in receipts from Social Security payroll taxes (which would be off-budget), offset in part by a reduction in individual tax revenues (which would be on-budget). In addition, the option would increase outlays for Social Security by a small amount. The estimates do not include those effects on outlays.

Nearly all private-sector workers and federal employees are covered by Social Security, but a quarter of workers employed by state and local governments are not covered. Under federal law, state and local governments can opt to enroll their employees in the Social Security program, or they can opt out if they provide a separate retirement plan for those workers instead. State and local governments may also have their employees participate in Social Security and be part of a separate retirement plan. In contrast, all federal employees hired after December 31, 1983, are covered by Social Security and pay the associated payroll taxes. Furthermore, all state and local government employees hired after March 31, 1986, and all federal government employees are covered by Medicare and pay payroll taxes for Hospital Insurance (Medicare Part A).

Under this option, Social Security coverage would be expanded to include all state and local government employees hired after December 31, 2013. Consequently, all newly hired state and local government employees would pay the Social Security payroll tax. That 12.4 percent tax on earnings, half of which is deducted from employees’ paychecks and half of which is paid by employers, funds the Old-Age, Survivors, and Disability Insurance programs. If implemented, this option would increase revenues by a total of $81 billion over the 2014–2023 period, the staff of the Joint Committee on Taxation estimates. (The estimate includes the reduction in individual income tax revenues that would result from shifting some labor compensation from a taxable to a nontaxable form.)

Paying the Social Security payroll tax for 10 years generally qualifies workers (and their dependents) to qualify for survivors’ benefits. Although extending such coverage to all newly hired state and local employees would eventually increase the number of Social Security beneficiaries, that increase would have little impact on the federal government’s spending for Social Security in the short term. Over the 2014–2023 period, outlays would increase only by a small amount because most people who would be hired by state and local governments during that period would not begin receiving Social Security benefits for many years. (The estimate does not include any effects on outlays.)

In the long term, the additional benefit payments for the expanded pool of beneficiaries would be only about half the size of the additional revenues. That is largely because most of the newly hired workers would receive Social Security benefits anyway under current law for one of two possible reasons: They might have held other covered jobs in the past, or they were covered by a spouse’s employment. As a result, this option would slightly enhance the long-term viability of the Social Security program, which faces the prospect that income from Social Security payroll taxes will not be sufficient to finance the benefits that are due to beneficiaries under current law.

Another rationale for implementing the option concerns fairness. Social Security benefits are intended to replace only a percentage of a worker’s preretirement earnings. That percentage (referred to as the replacement rate) is higher for workers with low career earnings than for workers with higher earnings. But the standard formula for calculating Social Security benefits does not distinguish between people whose career earnings are low and those who just appear to have low career earnings because they spent a portion of their career working in jobs that were not covered by Social Security. To make the
replacement rate more comparable for workers with similar earnings histories, current law reduces the standard benefits for retired government employees who have worked a substantial portion of their career in employment that is not covered by Social Security. However, that adjustment is imperfect and can affect various public employees differently. Specifically, it can result in higher replacement rates for some public employees who were not covered by Social Security throughout their career and in lower replacement rates for other public employees. This option would eliminate those inequities.

Implementing this option would also provide better retirement and disability benefits for many workers who move between government jobs and other types of employment. By facilitating job mobility, the option would enable some workers—who would otherwise stay in state and local jobs solely to maintain their public-employee retirement benefits—to move to jobs in which they could be more productive. Many state and local employees are reluctant to leave their jobs because pensions are structured to reward people who spend their entire careers in the same pension system. If their government service was covered by Social Security, there would be fewer disincentives to moving because they would remain in the Social Security system. State and local governments, however, might respond to greater turnover by reducing their investment in workers—by cutting training programs, for example—causing the productivity of state and local employees to decline.

An argument against such a policy change is that it might place an added burden on some state and local governments, which already face significant budgetary challenges. State and local pension plans are generally designed to be prefunded so that participants’ contributions can be invested to pay future benefits. As long as the plans are fully funded, transferring new employees to the Social Security system would not cause any problems. However, many plans are underfunded and depend on contributions from new participants to make up the shortfall. Under this option, the affected state and local governments would probably restructure their plans in one of two ways. They might exclude newly hired state and local employees from participation—thereby forgoing a possible source of new funding—which would place an additional burden on those governments. Or, they might choose to supplement the Social Security coverage for new employees by formulating a benefit package that, with Social Security included, was equivalent in value to their current plan. But such a package would increase costs to state and local governments because the cost per dollar of Social Security benefits for state and local government employees would probably exceed the cost per dollar for pensions provided by state and local governments. Social Security costs would be greater because that program initially paid benefits to recipients who had not contributed much to the system and because Social Security redistributes benefits to workers with low career earnings. Delaying implementation of the option for a few years would provide state and local governments time to restructure their pension plans. Nevertheless, costs to the affected governments would probably rise.

RELATED OPTION: Revenues, Option 18

Revenues—Option 20

Increase the Payroll Tax Rate for Medicare Hospital Insurance by 1 Percentage Point

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Revenues</td>
<td>44</td>
<td>73</td>
<td>77</td>
<td>82</td>
<td>87</td>
<td>91</td>
<td>95</td>
<td>99</td>
<td>103</td>
<td>108</td>
<td>363</td>
<td>859</td>
</tr>
</tbody>
</table>

Source: Staff of the Joint Committee on Taxation.

Note: This option would take effect in January 2014.

The primary source of financing for Hospital Insurance (HI) benefits provided under Medicare Part A is the HI payroll tax. The basic HI tax is 2.9 percent of earnings: 1.45 percent is deducted from employees’ paychecks, and 1.45 percent is paid by employers. Self-employed individuals generally pay 2.9 percent of their net income in HI taxes. Unlike the payroll tax for Social Security, which applies to earnings up to an annual maximum ($113,700 in 2013), the 2.9 percent HI tax is levied on total earnings.

Under the Affordable Care Act of 2010, a surtax on earnings above $200,000 went into effect beginning in 2013. At that earnings threshold, the portion of the HI tax that employees pay increases by 0.9 percentage points—to a total of 2.35 percent. (For a married couple filing an income tax return jointly, the surtax applies to the couple’s combined earnings above $250,000.) The surtax does not apply to the portion of the HI tax paid by employers, which remains 1.45 percent of earnings, regardless of how much the worker earns.

In recent years, expenditures for the HI program have grown at a much faster pace than revenues derived from the payroll tax. Since 2008, expenditures for HI have exceeded the program’s total income—including interest credited to the Hospital Insurance Trust Fund—so balances in the trust fund have declined. The Congressional Budget Office projects that the balances will continue to fall and that the HI trust fund will be exhausted in the mid-2020s.

This option would increase the basic HI tax on total earnings by 1.0 percentage point. The basic rate for both employers and employees would increase by 0.5 percentage points, to 1.95 percent, resulting in a combined rate of 3.9 percent. The rate paid by self-employed people would also rise to 3.9 percent. For taxpayers with earnings above $200,000 ($250,000 for married couples filing jointly), the HI tax on earnings in excess of the surtax threshold would increase from 3.8 percent to 4.8 percent; employees would pay 2.85 percent, and employers would pay the remaining 1.95 percent.

If implemented, the option would increase revenues by $859 billion over the 2014–2023 period, the staff of the Joint Committee on Taxation projects. (The estimate includes the reduction in individual income tax revenues that would result from a shift of some labor compensation from a taxable to a nontaxable form.)

The main argument for the option is that receipts from the HI payroll tax are currently not sufficient to cover the cost of the program, and increasing that tax would shrink the gap between the program’s costs and the revenues that finance it. A commonly used measure of the long-term financial status of Medicare Part A is the actuarial balance—that is, the present value of revenues (primarily from payroll taxes) plus the current trust fund balance minus the present value of outlays for the program and the desired trust fund outlays (one year’s worth) at the end of a specified period. CBO projects that, under current law, the actuarial imbalance for the HI trust fund over the next 75 years would be 3.3 percent of taxable payroll, which is the difference between projected income (3.6 percent of taxable payroll) and projected costs (6.9 percent of taxable payroll). Eliminating a gap of that size would require, for example, immediately increasing the basic HI payroll tax rate from its current 2.9 percent to 6.2 percent or immediately cutting spending on Part A by almost one-half. Raising the HI tax by 1 percentage point would delay the exhaustion of the HI trust fund by more than a decade and would reduce the long-term gap.

1. Present value is a single number that expresses a flow of current and future income, or payments, in terms of an equivalent lump sum received or paid today. Here, it is calculated over 75 years using a long-term 3 percent real (inflation-adjusted) discount rate.
between projected income and projected costs by almost a third. Another argument in support of the option is that an increase in the payroll tax rate would be simpler to administer than most other types of tax increases because it would require only relatively minor changes to the current tax system.

A drawback of the option is that it would encourage people to reduce the hours they work or to shift their compensation away from taxable earnings to nontaxable forms of compensation. When employees reduce the hours they work or change the composition of their earnings, economic resources are allocated less efficiently than would be the case in the absence of the higher tax rate.

In addition, this option would increase the tax burden of lower-income workers relative to that of workers with higher income. That is because a larger share of the income of lower-income families is, on average, from earnings that are subject to the HI tax. As a result, a percentage point increase in the HI tax would represent a greater proportion of the income of lower-income taxpayers than would be the case for higher-income taxpayers. Moreover, because the option would not make any changes to the Medicare program, the increase in the tax burden would not be offset by greater Medicare benefits when people reached the age of 65.
Revenues—Option 21

Tax All Pass-Through Business Owners Under SECA and Impose a Material Participation Standard

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Revenues</td>
<td>6</td>
<td>11</td>
<td>11</td>
<td>12</td>
<td>13</td>
<td>14</td>
<td>15</td>
<td>15</td>
<td>16</td>
<td>17</td>
<td>53</td>
<td>129</td>
</tr>
</tbody>
</table>

Source: Staff of the Joint Committee on Taxation.

Note: This option would take effect in January 2014. Most of the revenues would be off-budget. In addition, the option would increase outlays for Social Security by a small amount. The estimates do not include those effects on outlays.

Under current law, workers with earnings from businesses owned by other people contribute to Social Security and Medicare Part A through the Federal Insurance Contributions Act (FICA) tax. The tax rate for Social Security is 12.4 percent of the tax base up to $113,700, and that threshold increases each year with average wages. For Medicare Part A, the tax rate is 2.9 percent, and there is no ceiling on that base. The tax bases for both programs are limited to labor income (specifically, wages and salaries), and the taxes are split equally between the employer and the employee.

In contrast, people with earnings from businesses they own themselves are taxed either through FICA or through the Self Employment Contributions Act (SECA) depending on whether the business is incorporated or not. Owners of unincorporated businesses are subject to the SECA tax, and their tax base is self-employment income (which, unlike the FICA base, generally includes some capital income.) The definition of self-employment income depends on whether one is classified as a sole proprietor, a general partner (that is, a partner who is fully liable for the debts of the firm), or a limited partner (a partner whose liability for the firm’s debts is limited to the amount he or she invests). Sole proprietors pay SECA taxes on their net business income (that is, receipts minus expenses). General partners pay SECA taxes on their “guaranteed payments” (payments they are due regardless of the firm’s profits) and on their share of the firm’s net income. Limited partners pay SECA tax solely on any guaranteed payments they receive, and then only if those payments represent compensation for labor services.

The definition of limited partners is determined at the state level and, as a result, varies among states. Since the enactment of federal laws distinguishing between the treatment of general and limited partners under SECA, state laws have expanded eligibility for limited-partner status from strictly passive investors to certain partners who are actively engaged in the operation of businesses. Furthermore, state laws have recognized new types of entities, such as the limited liability company (LLC), whose owners do not fit neatly into either of the two partnership categories.

Unlike owners of unincorporated businesses, owners of privately held corporations pay FICA taxes as if they were employees. That treatment includes owners of S corporations, which are certain privately held corporations whose profits are subject to the individual income tax rather than the corporate income tax. Owners of privately held corporations are required to report their “reasonable compensation” for any services they provide and pay FICA tax on that amount. The net income of the firm, after deducting that compensation, is subject to neither the FICA nor the SECA tax.

This option would require owners of S corporations to pay the SECA tax instead of the FICA tax. In addition, the option would change the definition of self-employment income so that it would no longer depend on whether a taxpayer was classified as a general partner or a limited partner. That distinction would be replaced with a “material participation” standard in which the primary test would be whether the individual engaged in the operation of the business for more than 500 hours during a given year. Partners, LLC members, and S corporation owners categorized as material participants would pay SECA tax on both their guaranteed payments and their share of the firm’s net income. Those not deemed to be

1. If wages exceed certain thresholds ($250,000 for married taxpayers filing joint returns, $200,000 for everybody else), an additional 0.9 percent tax is levied on the amount above the threshold.
material participants would pay SECA tax on their reasonable compensation. All sole proprietors would be considered material participants.

The option would increase taxes on owners of S corporations and on limited partners who are material participants by subjecting their entire share of the firm’s net income to the SECA tax instead of just their reasonable compensation or guaranteed payments. However, the option would lower taxes for general partners who are not material participants by excluding from SECA taxation their share of the firm’s net income that is in excess of their reasonable compensation. On balance, federal revenues would increase by an estimated $129 billion over the period from 2014 through 2023, according to the staff of the Joint Committee on Taxation. By increasing, on net, the earnings base from which Social Security benefits are calculated, the option also would increase federal spending for Social Security over the long term. (The estimates do not include that effect on outlays.)

An advantage of this option is that it would eliminate the ambiguity created by the emergence of new types of business entities that were not anticipated when the laws governing Social Security were last amended. The treatment of partners and LLC members under the SECA tax would be defined entirely by federal law and would ensure that owners who are actively engaged in the operation of a business could not legally exclude a portion of their labor compensation from the tax base. Moreover, because all firms not subject to the corporate income tax would be treated the same, businesses would be more likely to choose their form of organization on the basis of what allowed them to operate most efficiently rather than what minimized their tax liability.

Other arguments in favor of the option are that it would improve compliance with the tax code and reduce complexity for some firms. Under current law, S corporations have a strong incentive to underreport reasonable compensation so as to minimize their FICA tax liability. By subjecting S corporation owners to the SECA tax, the option would eliminate the ability of material participants to reduce their tax liability by underreporting their reasonable compensation. In addition, the option would simplify recordkeeping for S corporations whose owners are all material participants because they no longer have to estimate the reasonable compensation of those owners.

A disadvantage of the option is that it would subject additional income from capital to the SECA tax, making the tax less like FICA, which taxes virtually no income from capital. That could deter some people from starting a business and paying the SECA tax on the profits (opting instead to work for somebody else and pay the FICA tax on their wages). The option could also lead to new efforts to recharacterize business income as either rental income or interest income, neither of which is subject to the FICA or the SECA tax. It could also lead to the use of C corporations (businesses that are subject to the corporate income tax) as a tax shelter. For example, faced with a 15.3 percent SECA tax rate on top of the individual income tax, the owners of an S corporation might choose to pay the corporate income tax instead (even though profit distributions would be taxed again under the individual income tax). If the corporate income tax rate was lowered in the future, that incentive would be magnified. Finally, the option would place an additional administrative burden on many partnerships and LLCs: Those entities would be required to determine reasonable compensation for any members considered to be non-material participants.

RELATED OPTIONS: Revenues, Options 18 and 20
RELATED CBO PUBLICATION: The Taxation of Capital and Labor Through the Self-Employment Tax (September 2012), www.cbo.gov/publication/43644
The unemployment insurance (UI) system is a partnership between the federal government and state governments that provides a temporary weekly benefit—consisting of a regular benefit and, often during economic downturns, extended and emergency benefits—to qualified workers who lose their job through no fault of their own. Funding for unemployment insurance is drawn from payroll taxes imposed on employers both by state governments and by the federal government.

The states administer the UI system, establishing eligibility rules, setting the regular benefit amounts, and paying out those benefits to eligible people. To finance benefits, states impose payroll taxes on employers. State payroll taxes vary, with each state setting a tax rate schedule and a maximum wage amount subject to tax. Revenues from state payroll taxes are deposited into dedicated state accounts within the federal budget.

The federal government sets broad guidelines for the UI system, pays a portion of the administrative costs that state governments incur, and makes advances to states that lack the money to pay UI benefits. In addition, during periods of high unemployment, the federal government has often funded, either fully or partially, supplemental benefits through the extended benefits program, temporary emergency benefits, or both.

Funding for the federal portion of the unemployment insurance system is drawn from payroll taxes imposed on employers under the Federal Unemployment Tax Act (FUTA). FUTA taxes are levied on each worker’s wages up to $7,000 and then deposited into several federal accounts. That amount is not adjusted, or indexed, for inflation and has remained unchanged since 1983. The FUTA tax rate is 6.0 percent, reduced by a credit of 5.4 percent for state taxes paid, for a net tax rate of 0.6 percent—or $42 for each employee earning at least $7,000 annually. On January 1, 1976, a surtax of 0.2 percent went into effect, raising the total FUTA tax rate, net of the state tax credits, to 0.8 percent—for a maximum of $56 per employee. However, that surtax expired on July 1, 2011.

During and after the last recession, the funds in the federal accounts were insufficient to pay the emergency and extended benefits enacted by the Congress, to pay the higher administrative costs that states incurred because of the greater number of people receiving benefits, and to make advances to several states that did not have sufficient funds to pay regular benefits. That shortfall necessitated that advances be made from the general fund of the U.S. Treasury to the federal accounts. Some of those advances must be repaid, a process that the Congressional Budget Office projects will take several years under current law.

This option includes two alternative approaches that would increase revenues from unemployment insurance taxes by roughly the same amount over the 2014–2023 period. The first approach would leave the FUTA tax base unchanged but would raise the net FUTA tax rate by reinstating and permanently extending the 0.2 percent FUTA surtax. CBO estimates that this approach would
generate a steady flow of additional revenues in each year between 2014 and 2023, for a total increase of $14 billion.

The second approach would expand the FUTA tax base but decrease the tax rate. Specifically, the approach would raise the amount of wages subject to the FUTA tax from $7,000 to $14,000 in 2014 (and then index that threshold to the growth in future wages), and it would reduce the net FUTA tax rate, after the 5.4 percent credit for state taxes paid, to 0.33 percent. CBO estimates that this approach would raise revenues by $15 billion over the 2014–2023 period.

The net increase in revenues from the second approach would be attributable to several factors. First, in 2014, the direct revenue gain that would result from expanding the FUTA tax base would roughly offset the revenue losses from lowering the FUTA tax rate; in future years, the growth in the tax base would cause that gain to exceed that loss. Second, revenues from state unemployment insurance taxes, which are counted as part of the federal budget, would rise as well. Because federal law requires that each state’s UI taxes be levied on a taxable wage base that is at least as large as the federal taxable wage base, 27 states would have to increase their taxable wage base to $14,000 under this approach. CBO expects that many states would reduce their UI tax rates in response but would leave those rates high enough to maintain some of the additional revenue. States with low UI account balances would be especially likely to retain some of the additional revenue.

The pattern of additional revenues generated by the second approach would be very irregular. In the initial years, revenues would rise substantially, mostly because expanding the tax base would increase state UI tax revenues. That extra revenue would allow some states to more quickly repay advances made by the federal government. Those repayments, in turn, would make more employers eligible for the full credit for state taxes paid than is the case under current law, causing revenues to fall in the middle years of the budget window. (Employers in states that received advances from the federal government but have yet to repay those funds do not receive the full credit for state taxes paid; in those instances the forgone credit is directed to the state UI account until the advances are repaid.) By the final years of the period, that effect would fade, and revenues would be higher again because of the expanded tax base.

The main advantage of both approaches is that they would improve the financial condition of the federal portion of the UI system. The additional revenue would allow the federal UI accounts to more rapidly repay the outstanding advances from the general fund and would better position those accounts to finance benefits during future recessions. Another argument in support of the second approach is that expanding the tax base would improve the financial condition of state UI tax systems.

Either approach would generally be simpler to implement—especially by employers—than many other proposed changes to the federal tax code. However, expanding the taxable wage base would impose some burden on state governments, requiring them to ensure that their tax bases conformed to the indexed federal tax base.

An argument against both approaches is that employers would generally pass on the additional FUTA taxes to workers in the form of reduced earnings. By reducing workers’ after-tax pay, the tax might induce some people to choose not to enter the workforce. Both approaches would also increase marginal tax rates for some workers by a small amount. (The marginal tax rate is the percentage of an additional dollar of income from labor or capital that is paid in taxes.) On balance, the evidence suggests that increasing marginal tax rates reduces work relative to what would have occurred otherwise. Given the small size of the tax changes in this option, however, the effects on employment would probably be quite small under either approach.

The combination of a single tax rate and low thresholds on the amount of earnings subject to the tax makes the FUTA tax regressive—that is, FUTA taxes measured as a share of earnings decrease as earnings rise. Even so, because workers with lower earnings receive, on average, UI benefits that are a higher fraction of their prior earnings than do workers with higher earnings, those benefits are progressive. If taxes and benefits are considered together, the unemployment insurance system is generally thought to be roughly proportional—neither progressive.

1. That increase would have two types of effects. On the one hand, the higher marginal tax rates would reduce the share of the returns from additional work that people could keep, reducing their incentive to work. On the other hand, because higher marginal tax rates reduce after-tax income, they make it more difficult for people to attain their desired standard of living with a given amount of work, thus possibly causing people to work more.
nor regressive—under current law. Neither approach described in this option would affect UI benefits, and both approaches would raise revenues by nearly the same total amount over the 10-year period. However, the approaches would have different effects on the distribution of tax burdens: Reinstating the surtax would increase FUTA taxes proportionately for all income groups, while expanding the wage base and lowering the FUTA rate would reduce the regressivity of the FUTA tax.

RELATED OPTION: Revenues, Option 6

RELATED CBO PUBLICATION: *Unemployment Insurance in the Wake of the Recent Recession* (November 2012),
www.cbo.gov/publication/43734
Increase Corporate Income Tax Rates by 1 Percentage Point

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Revenues</td>
<td>7</td>
<td>11</td>
<td>11</td>
<td>12</td>
<td>12</td>
<td>12</td>
<td>12</td>
<td>12</td>
<td>12</td>
<td>12</td>
<td>53</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>113</td>
</tr>
</tbody>
</table>

Source: Staff of the Joint Committee on Taxation.
Note: This option would take effect in January 2014.

Most corporations that are subject to the corporate income tax calculate their tax liability according to a progressive rate schedule. The first $50,000 of corporate taxable income is taxed at a rate of 15 percent; income of $50,000 to $75,000 is taxed at a 25 percent rate; income of $75,000 to $10 million is taxed at a 34 percent rate; and income above $10 million is generally taxed at a rate of 35 percent.

Although most corporate income falls within the 35 percent tax bracket, the average tax rate on corporate income (corporate taxes divided by corporate income) is lower than 35 percent because of allowable deductions, exclusions, tax credits, and the lower tax rates that apply to the first $10 million of income. For example, corporations can deduct business expenses, including interest paid to holders of the firm’s bonds, from gross income to compute taxable income. (Dividends paid to shareholders, however, are not deductible.) Most income earned by the foreign subsidiaries of U.S. corporations is not subject to U.S. taxation until it is repatriated in the form of dividends paid to the parent corporation. To prevent income earned abroad from being subject to both foreign and U.S. taxation, the tax code gives U.S. corporations a credit that reduces their domestic tax liability on that income by the amount of income and withholding taxes they have paid to foreign governments. The foreign tax credit is subject to limits that are designed to ensure that the amount of credits taken does not exceed the amount of U.S. tax that otherwise would have been due.

This option would increase all corporate income tax rates by 1 percentage point. For example, the corporate income tax rate would increase to 36 percent for taxable income above $10 million. The option would increase revenues by $113 billion over the 2014–2023 period, the staff of the Joint Committee on Taxation estimates.

The major argument in favor of the option is its simplicity. As a way to raise revenue, increasing corporate income tax rates would be easier to implement than most other types of business tax increases because it would require only minor changes to the current tax collection system.

The option would also increase the progressivity of the tax system to the extent that the corporate income tax is largely borne by owners of capital, who tend to have higher incomes than other taxpayers. But the extent to which the financial burden of the tax ultimately falls on the owners of corporations, owners of all capital assets, or workers is unclear. The United States is an open economy, in which many firms engage in international trade. Because labor tends to be less mobile than capital in open economies, some of the corporate income tax burden might be passed back to workers through reductions in their compensation over a number of years—making an increase in corporate tax rates somewhat less progressive.

An argument against the option is that it would further reduce economic efficiency. The current corporate income tax system already distorts firms’ choices about how to structure the business (for example, whether to operate as a C corporation, an S corporation, a partnership, or a sole proprietorship) and whether to finance investment by issuing debt or by issuing equity. Increasing corporate income tax rates would make it even more advantageous for firms to expend resources to qualify as an S corporation so as a way to reduce their tax liabilities. That is because net income from C corporations—

1. Under current law, surtaxes are imposed on some amounts of corporate income. Income between $100,000 and $335,000 is subject to a surtax of 5 percent, and an additional 3 percent tax is levied on income between $15 million and $18.3 million. Those surtaxes effectively phase out the benefit of the three lower tax rates for corporations with income above certain amounts. As a result, a company that reports more than $18.3 million in taxable income effectively faces a statutory rate equal to 35 percent of its total corporate taxable income.
those that are subject to the corporate income tax—is first taxed at the business level and then again at the individual level after it is distributed to shareholders or investors. By contrast, income from S corporations—which can have no more than 100 owners and are subject to other restrictions—is generally free from taxation at the business level but is taxed under the individual income tax, even if the income is reinvested in the firm. Raising corporate tax rates would also encourage companies to increase their reliance on debt financing because interest payments, unlike dividend payments to shareholders, can be deducted. Carrying more debt might increase some companies’ risk of default. Moreover, the option would discourage businesses from investing, hindering the growth of the economy. An alternative to this option that would reduce such incentives would be to lower the tax rate while broadening the tax base by, for example, reducing or eliminating some exclusions or deductions. That modification, however, would also reduce—and possibly even eliminate—the revenue gains from the option.

Another concern that might be raised about the option is that it would increase the tax rate that corporations—those based in the United States and those based in foreign countries—face when they earn income in the United States. Such an increase would cause the top marginal tax rate (that applied to an additional dollar of income) in the United States to be higher than the top marginal tax rates adopted by most other countries. Under current law, when the federal corporate tax is combined with state and local corporate taxes (which have a top rate averaging 4 percent), the U.S. tax rate on income in the highest bracket averages 39 percent—higher than that in any of the other 33 member countries of the Organisation for Economic Co-operation and Development. (The top statutory rates, however, do not reflect the differences in various countries’ tax bases and rate structures and therefore do not represent the true average tax rates that multinational firms face.) Those higher rates in the United States influence businesses’ choices about how and where to invest; to the extent that firms respond by shifting investment to countries with low taxes as a way to reduce their tax liability at home, economic efficiency declines because firms are not allocating resources to their most productive use. The current U.S. system also creates incentives to shift reported income to low-tax countries without changing actual investment decisions. Such profit shifting erodes the corporate tax base and leads to wasted resources for tax planning. Increasing the top corporate rate to 36 percent (40 percent when combined with state and local corporate taxes) would further accentuate those incentives to shift investment and reported income abroad. However, other factors, such as the skill level of a country’s workforce and its capital stock, also affect corporations’ decisions about where to incorporate and invest.

RELATED OPTION: Revenues, Option 30

Revenues—Option 24

Repeal the “LIFO” and “Lower of Cost or Market” Inventory Accounting Methods

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Revenues</td>
<td>13</td>
<td>25</td>
<td>25</td>
<td>25</td>
<td>14</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>101</td>
<td>112</td>
</tr>
</tbody>
</table>

Source: Staff of the Joint Committee on Taxation.
Note: This option would take effect in January 2014.

To compute its taxable income, a business must first deduct from its receipts the cost of purchasing or producing the goods it sold during the year. Determining those costs requires that the business identify and attach a value to its inventory. Most companies calculate the cost of the goods they sell in a year using the accrual method of accounting, adding the value of the inventory at the beginning of the year to the cost of goods purchased or produced during the year and then subtracting from that total the value of the inventory at the end of the year.

The tax code allows firms to choose from among several approaches for identifying and determining the value of the goods included in their inventory. For itemizing and valuing goods in stock, firms can use the “specific identification” method. That approach, however, requires a very detailed physical accounting in which each item in inventory is matched to its actual cost (that is, the cost to produce or purchase the item). An alternative approach—“last in, first out” (LIFO)—also allows firms to value their inventory at cost but, in addition, permits them to assume that the last goods added to inventory were the first ones sold. Under that assumption, the cost of those more recently produced goods should approximate current market value (that is, the cost of replacing the inventory).

Yet another alternative approach—“first in, first out” (FIFO)—is based on the assumption that the first goods sold from a business’s inventory have been in that inventory the longest. Like firms that adopt the LIFO method, firms using the FIFO approach can also value their goods at cost. But firms that use the FIFO approach have still another choice—the “lower of cost or market” (LCM) method. Instead of assessing their end-of-year inventory at cost, they can assess that inventory on the basis of its market value and use that valuation if it is lower than the cost. In addition, businesses that use the FIFO approach can qualify for the “subnormal-goods” method of inventory valuation if their goods cannot be sold at market prices because they are damaged or flawed.

This option would eliminate the LIFO method of identifying inventory, as well as the LCM and subnormal-goods methods of inventory valuation. Businesses would be required to use the specific-identification or FIFO methods to account for goods in their inventory and to set the value of that inventory on the basis of cost. Those changes—which would be phased in over a period of four years—would increase revenues by a total of $112 billion over the 2014–2023 period, the staff of the Joint Committee on Taxation estimates.

The main rationale for this option is that it would align tax accounting rules with the way businesses tend to sell their goods. Under many circumstances, firms prefer to sell their oldest inventory first—to minimize the risk that the product has become obsolete or been damaged while in storage. In such cases, allowing firms to use alternative methods to identify and value their inventories for tax purposes allows them to reduce their tax liabilities without changing their economic behavior.

An argument for eliminating the LIFO method is that it allows companies to defer taxes on real (inflation-adjusted) gains when the prices of their goods are rising relative to general prices. Firms that use LIFO can value their inventory on the basis of costs associated with newer—and more expensive—inventory when, in fact, the actual items sold may have been acquired or produced at a lower cost at some point in the past. By deducting those higher costs as the price of production, firms are able to defer paying taxes on the amount their goods have appreciated until those goods are sold.

An argument against disallowing the LIFO accounting method is that such a policy change could also result in the taxation of income that arises from inflation, which
would not represent actual changes in a firm's resources and its ability to pay taxes. However, other elements of the corporate income tax do not correct for inflation and, therefore, gains attributable to inflation are taxed.

An argument for eliminating the LCM method of inventory valuation under FIFO is that, when prices are falling, it provides a tax advantage for goods that have not been sold. The LCM method allows a business to compare the market value of each item in its end-of-year inventory with the item's cost and then set the lower of the two as the item's value. The year-end inventory will have a lower total value under LCM than under the cost method if the market value of any item in the inventory is less than its actual cost. Using the LCM method when prices are falling allows the firm to claim a larger deduction for the costs of goods sold, causing the firm's taxable income to fall as a result. In effect, that method allows a firm to deduct from its taxable income the losses it incurred from the decline in the value of its inventory. (That deduction is allowed even though the firm has not sold the goods.) A firm, however, is not required to recognize gains in the value of its inventory when prices are rising, which means that gains and losses are taxed differently. Similarly, firms that use the subnormal-goods method of inventory valuation can immediately deduct the loss, even if the company later sells the good at a profit.

An argument for allowing firms to continue to use the LCM method for tax purposes is that it simplifies inventory valuations by those businesses. To the extent that firms find the LCM method a desirable method of inventory valuation for financial accounting, allowing them to use the same methodology for both financial accounting and tax purposes reduces complexity, particularly for small businesses.
Revenues—Option 25

Repeal Certain Tax Preferences for Extractive Industries

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Revenues</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Repeal the expensing</td>
<td>2.2</td>
<td>3.2</td>
<td>2.9</td>
<td>2.6</td>
<td>2.4</td>
<td>1.9</td>
<td>1.2</td>
<td>0.7</td>
<td>0.5</td>
<td>0.6</td>
<td>13.3</td>
<td>18.3</td>
</tr>
<tr>
<td>of exploration and</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>development costs</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Disallow the use of</td>
<td>1.0</td>
<td>1.5</td>
<td>1.5</td>
<td>1.5</td>
<td>1.6</td>
<td>1.7</td>
<td>1.7</td>
<td>1.7</td>
<td>1.8</td>
<td>1.8</td>
<td>7.0</td>
<td>15.5</td>
</tr>
<tr>
<td>the percentage deple-</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>tion allowance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Both of the above</td>
<td>3.2</td>
<td>4.7</td>
<td>4.4</td>
<td>4.1</td>
<td>3.9</td>
<td>3.5</td>
<td>2.9</td>
<td>2.4</td>
<td>2.2</td>
<td>2.4</td>
<td>20.3</td>
<td>33.8</td>
</tr>
<tr>
<td>policies</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Staff of the Joint Committee on Taxation.

Note: This option would take effect in January 2014.

When calculating their taxable income, firms in most industrial sectors in the United States are generally allowed to deduct a portion of the investment costs they incurred that year and in previous years. The portion of those costs that is deductible depends on prescribed rates of depreciation or, for certain natural resources, depletion. Costs are deducted over a number of years to reflect an asset’s rate of depreciation or depletion.

In contrast, the U.S. tax code treats extractive industries that produce oil, natural gas, coal, and hard minerals more favorably. Two tax preferences in particular give extractive industries an advantage over other industries:

- One preference allows producers of oil, gas, coal, and minerals to “expense” some of the costs associated with exploration and development. Expensing allows companies to fully deduct such costs as they are incurred rather than waiting for those activities to generate income. For extractive companies, the costs that can be expensed include, in some cases, those related to excavating mines, drilling wells, and prospecting for hard minerals. Specifically, current law allows independent oil and gas producers and noncorporate coal and mineral producers to fully expense their costs, and it allows expensing of 70 percent of costs for “integrated” oil and gas producers (companies with substantial retailing or refining activity) and corporate coal and mineral producers, with the companies able to deduct the remaining 30 percent of their costs over 60 months.

- A second preference allows extractive industries to use a “percentage depletion allowance.” Through that allowance, certain extractive companies can deduct from their taxable income between 5 percent and 22 percent of the dollar value of material extracted during the year, depending on the type of resource and up to certain limits. For example, oil and gas companies’ eligibility for the percentage depletion allowance is limited to independent producers who operate domestically; for those firms, only the first 1,000 barrels of oil (or, for natural gas, oil-equivalent) per well, per day, qualify, and the allowance is limited to 65 percent of overall taxable income. For each property they own, firms take a deduction for the greater of the percentage depletion allowance or the amount prescribed by the cost depletion system, which allows for recovery of investment costs as income is earned from those investments. Total deductions can be increased by the percentage depletion allowance because it is not limited to the cost of the property, as are the amount of deductions allowed under cost depletion.

This option includes two different approaches to limiting tax preferences for extractive industries. The first approach would replace the expensing of exploration and development costs for oil, gas, coal, and hard minerals.
with the rules for deducting costs that apply in other industries.\(^2\) That approach would increase revenues by $18 billion over the 2014–2023 period, according to estimates by the staff of the Joint Committee on Taxation (JCT). The second approach would eliminate the percentage depletion allowance. That approach would raise $16 billion over that 10-year period, according to JCT. If the two approaches were combined, revenues would increase by $34 billion over the 2014–2023 period.

The principal argument in favor of this option is that the two tax preferences for extractive industries distort the allocation of society’s resources in several ways. First, for the economy as a whole, the preferences influence the allocation of resources between the extractive industries and other industries in an inefficient manner. Those incentives encourage some investments in drilling and mining that produce a smaller market value of output than the investments would produce elsewhere because, when making investment decisions, companies take into account not only the market value of the output but also the tax advantage that expensing and percentage depletion provide. Second, for the same reason, the preferences also lead to an inefficient allocation of resources within the extractive industries. Third, the preferences encourage producers to extract more resources in a shorter time. In the case of oil, for example, that additional drilling makes the United States less dependent on imported oil in the short run, but it accelerates the depletion of the nation’s store of oil and causes greater reliance on foreign producers in the long run.

An argument against this option is that it treats expenses that might be viewed as similar in different ways. In particular, exploration and development costs for extractive industries can be seen as analogous to research and development costs, which can be expensed by all businesses. Another argument against this option is that encouraging producers to continue exploring and developing domestic energy resources may enhance the ability of U.S. households and businesses to accommodate disruptions in the supply of energy from other countries.

---

2. The option still allows other costs unique to extractive industries, such as those associated with unproductive wells and mines, to be expensed.

RELATED OPTION: Mandatory Spending, Option 1

Revenues—Option 26

Extend the Period for Depreciating the Cost of Certain Investments

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Revenues</td>
<td>6</td>
<td>18</td>
<td>28</td>
<td>33</td>
<td>37</td>
<td>39</td>
<td>35</td>
<td>29</td>
<td>25</td>
<td>23</td>
<td>122</td>
<td>272</td>
</tr>
</tbody>
</table>

Source: Staff of the Joint Committee on Taxation.

An argument in favor of this option is that the current rates of tax depreciation overstate the decline in the economic value of assets because they do not accurately reflect the rate of inflation that is likely to occur over an asset’s lifetime. Because rates of depreciation are set by the tax code and depreciation deductions are not adjusted, or indexed, for inflation, the real (inflation-adjusted) value of the depreciation allowed by tax law depends on the rate of inflation.

Most rates of depreciation in the tax code today were set in the Tax Reform Act of 1986 and, if the average rate of inflation since that time was 5.0 percent, they would approximate the rate of economic depreciation (the decline in an asset’s economic value, including the impact of inflation over time). The Congressional Budget Office estimates, however, that inflation over the next decade will average about 2.3 percent annually. That difference of nearly 3 percentage points means that, if those rates of depreciation stay the same, businesses will be able to deduct larger amounts of depreciation from taxable income—and thus have a lower tax liability—than they could if the deduction accurately measured economic depreciation.

Another argument in favor of this option is that it would equalize effective tax rates on the income generated by different types of investment. (Effective tax rates measure the impact of statutory tax rates and other features of the tax code in the form of a single tax rate that applies over the life of an investment.) Equipment and structures are two of the main types of tangible capital for which businesses take depreciation deductions, and the effective tax rates are currently quite different. Under the law currently in effect for 2014, if inflation was 2.3 percent and the real discount rate (which adjusts for the change in the value of a dollar over time) for businesses was 6.2 percent, the average effective tax rates on income from corporate investment would be 26.4 percent for equipment and

---

1. Most structures, including residential and office buildings, have a lifetime that is greater than 20 years for the purposes of calculating tax depreciation and thus would be unaffected by this option. However, some structures, such as electric power plants and barns, have a shorter lifetime under current law; the option would extend the lifetime of those structures as well.
29.4 percent for structures. In contrast, under this option, those rates would be 30.1 percent for equipment and 30.4 percent for structures. That near parity would mitigate the incentive that exists in the tax code for companies to invest more in equipment and less in structures than they might if investment decisions were based on economic returns.

Those effective tax rates would differ if inflation was different, however. If the rate of inflation was a percentage point lower, the effective tax rate under this option would be 28.1 percent for equipment and 29.2 percent for structures. Conversely, if inflation was a percentage point higher, the rates for equipment and structures would be 31.9 percent and 31.4 percent, respectively. Therefore, if inflation differed from CBO’s expectations, new distortions between investment in equipment and structures would emerge over the long run.

An argument against this option is that low tax rates on income generated by capital would encourage investment. From that perspective, effective tax rates might best be equalized by easing taxation on all forms of capital rather than by raising the effective tax rate on all capital or on a type of capital that is now favored. Moreover, by raising effective tax rates on business investment, this option would exacerbate the current tax bias in favor of owner-occupied housing relative to business investment.

Revenues—Option 27

Repeal the Deduction for Domestic Production Activities

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Revenues</td>
<td>6</td>
<td>17</td>
<td>18</td>
<td>20</td>
<td>21</td>
<td>21</td>
<td>21</td>
<td>22</td>
<td>22</td>
<td>23</td>
<td></td>
<td>83</td>
<td>192</td>
</tr>
</tbody>
</table>

Source: Staff of the Joint Committee on Taxation.
Note: This option would take effect in January 2014.

The American Jobs Creation Act of 2004 allows businesses to deduct from their taxable income a percentage of what they earn from qualified domestic production activities. The deduction rose in steps to 9 percent for tax year 2010 and thereafter. The Emergency Economic Stabilization Act of 2008 reduced the deduction rate for oil-related qualified production activities to 6 percent for tax years after 2009.

Various activities qualify for the deduction:

- Lease, rental, sale, exchange, or other disposition of tangible personal property, computer software, or sound recordings, if they are manufactured, produced, grown, or extracted in whole or significant part in the United States;
- Production of films (other than those that are sexually explicit);
- Production of electricity, natural gas, or potable water;
- Construction or renovation of real property; and
- Performance of engineering or architectural services.

The list of qualified activities specifically excludes the sale of food or beverages prepared at retail establishments; the transmission or distribution of electricity, natural gas, or potable water; and many activities that would otherwise qualify except that the proceeds come from sales to a related business.

The deduction for domestic production activities was created in part to replace the tax code’s extraterritorial income exclusion—which allowed businesses to exclude income from certain types of transactions that generate receipts from trade with foreign countries. According to the World Trade Organization, that exclusion violated its agreements by subsidizing exports. The deduction was intended to reduce the taxes on income from domestic production without violating the organization’s rules.

This option would repeal the deduction for domestic production activities. Doing so would increase revenues by $192 billion from 2014 through 2023, the staff of the Joint Committee on Taxation estimates.

One argument in favor of this option is that it would reduce economic distortions. Although the deduction is targeted toward investments in domestic production activities, it does not apply to all domestic production. Whether a business activity qualifies for the deduction is unrelated to the economic merits of the activity. Thus, the deduction gives businesses an incentive to invest in a particular set of domestic production activities and to forgo other, perhaps more economically beneficial, investments in domestic production activities that do not qualify.

In addition, to comply with the law, businesses must satisfy a complex and evolving set of statutory and regulatory rules for allocating gross receipts and business expenses to the qualified activities. Companies that want to take full advantage of the deduction may incur large tax-planning costs (for example, fees to tax advisers). Moreover, the complexity of the rules can cause conflict between businesses and the Internal Revenue Service regarding which activities qualify under the provision.

An argument against implementing this option is that simply repealing the deduction for domestic production activities would increase the cost of domestic business investment and could reduce the amount of such investment. Alternatively, the deduction could be replaced with a revenue-neutral reduction in the top corporate tax rate (a cut that would reduce revenues by the same amount that eliminating the deduction would increase them). That alternative would end the current distortions.
between activities that qualify for the deduction and those that do not. It also would reduce the extent to which the corporate tax favors noncorporate investments over investments in the corporate sector and foreign activities over domestic business activities.
Revenues—Option 28

Repeal the Low-Income Housing Tax Credit

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Revenues</td>
<td>0.2</td>
<td>0.7</td>
<td>1.4</td>
<td>2.4</td>
<td>3.5</td>
<td>4.5</td>
<td>5.5</td>
<td>6.6</td>
<td>7.6</td>
<td>8.9</td>
<td>8.2</td>
<td>41.3</td>
</tr>
</tbody>
</table>

Source: Staff of the Joint Committee on Taxation.

Note: This option would take effect in January 2014.

Real estate developers who provide rental housing for low-income households may qualify for the low-income housing tax credit (LIHTC), which is designed to encourage investment in affordable housing. The credit covers a portion of the costs incurred for the construction of new housing units, the substantial rehabilitation of existing units, and the purchase of land on which new housing units will be built.

Each year, the federal government allocates funding to the states for LIHTCs on the basis of a per-resident formula. State or local housing authorities review proposals submitted by developers and select those projects that will receive credits. To qualify for the credit, developers must agree to meet two requirements for at least 30 years: First, they must set aside either 20 percent of a project’s rental units for households whose income is below 50 percent of the area’s median income or 40 percent of the units for households whose income is below 60 percent of the median. Second, they must agree to limit the rent they charge on the units occupied by low-income households to 30 percent of the area’s median income. (The calculations used to determine if those requirements are satisfied include adjustments for household size.) In addition, the buildings have to meet local health, safety, and building codes.

LIHTCs generally can be taken for projects for 10 years and can be worth up to 70 percent of the construction or rehabilitation costs allocable to the set-aside units, or up to 30 percent of those units’ share of a building’s purchase price. (The Housing and Economic Recovery Act of 2008 set a temporary floor on the annual credit equal to 9 percent of the capital costs of constructing a building placed in service before December 31, 2013; that floor has led to the issuance of some credits that exceed 70 percent of construction costs over 10 years.) Projects located in census tracts determined by the Department of Housing and Urban Development to have a large proportion of low-income households can qualify for credits worth up to 130 percent of costs.

This option would repeal the low-income housing tax credit starting in 2014, although projects granted credits before 2014 could continue to claim them until their eligibility expired. Repealing the LIHTC would increase revenues by $41 billion from 2014 through 2023, according to estimates by the staff of the Joint Committee on Taxation.

One argument for repealing the low-income housing tax credit is that other approaches are available to help low-income households obtain safe, affordable housing, generally at less cost to the government. For instance, the Housing Choice Voucher program—sometimes referred to as Section 8 after the part of the legislation that authorized it—provides vouchers that allow eligible families to pay some or all of the rent for housing they choose, provided the dwelling meets minimum standards for habitation. Such vouchers are typically a less expensive way to provide housing assistance than the LIHTC primarily because the costs of constructing a new building or substantially renovating an existing building are higher than the costs of simply using an existing building in most housing markets where low-income households are situated. Further, because households with very low income often cannot afford even the reduced rents in the set-aside units of LIHTC projects without additional subsidies, vouchers are especially helpful to those households.

For that reason, policymakers might be interested in increasing housing vouchers if they reduced the value of or repealed the LIHTC. An increase in housing vouchers along with repeal of the LIHTC would, of course, result in less deficit reduction than repeal alone. The net effect on the deficit would depend on the extent of the expansion of the voucher program. One possible scenario is to expand the voucher program to cover the same number
of households currently served by the LIHTC; in that case, deficits would still be reduced, on balance. But the number of low-income households qualifying for housing assistance substantially exceeds the number supported through vouchers and the LIHTC. Therefore, another possible scenario is to use all of the savings from repeal of the LIHTC to expand the voucher program, which would increase the total number of households receiving housing support; in that case, deficits would be unaffected, on balance.

A rationale against implementing the option is that, unlike tenant-based vouchers, project-based LIHTCs support the construction of new buildings and the substantial rehabilitation of existing buildings, which can help turn around blighted neighborhoods. Vouchers would typically have a smaller impact on any one location than LIHTCs because recipients do not generally cluster very closely together. For example, one study found that, in New York City between 1987 and 2000, the use of LIHTCs to replace abandoned buildings and construct buildings on empty lots in blighted neighborhoods increased property values within a few blocks of the subsidized projects; those increased property values did not extend to neighborhoods that were farther away, however.1 Because those benefits seem to be limited to the immediate neighborhoods, such projects might be more appropriately funded by local or state governments rather than the federal government.

Modify the Rules for the Sourcing of Income From Exports

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Revenues</td>
<td>0.4</td>
<td>0.8</td>
<td>0.8</td>
<td>0.8</td>
<td>0.7</td>
<td>0.5</td>
<td>0.5</td>
<td>0.5</td>
<td>0.6</td>
<td></td>
<td>3.6</td>
<td>6.4</td>
</tr>
</tbody>
</table>

Source: Staff of the Joint Committee on Taxation.
Note: This option would take effect in January 2014.

To prevent the income that U.S. corporations earn abroad from being subject to both foreign and U.S. taxation, the federal government provides a credit that reduces those companies' domestic tax liability by the amount of taxes they have paid to foreign governments. Under the rules governing that tax credit, it cannot exceed the amount of U.S. tax those businesses otherwise would have owed on their foreign income, nor can it be used to reduce taxes on income earned in the United States. However, if tax rates are higher in a host country than they are in the United States, and a corporation consequently pays more in foreign taxes than it would owe to the U.S. government, it accrues what are known as excess foreign tax credits under the U.S. tax code. A business can then use those excess credits to offset U.S. taxes on income earned in low-tax countries.

To calculate the limit on foreign taxes—which would also affect the amount of excess credits—a firm's income must be allocated between foreign and domestic sources. For the purposes of determining the foreign tax credit, the U.S. tax code distinguishes between two categories of income derived from the sale of goods:

- Income resulting from the sale of goods that a U.S. firm buys from another business and then resells abroad; and
- Income resulting from the sale of goods that a U.S. firm manufactures and then sells directly to buyers in other countries.

Income in the first category is governed by the U.S. tax code's “title passage rule,” which specifies that such earnings be “sourced” in the country where the sale occurs. However, for the second category of income, a special rule applies: When the goods are produced in the United States and then sold by that firm to foreign buyers, half of the resulting income is sourced in the United States; the rest of the income is subject to the title passage rule and allocated to the country where the sale took place.

The special rule for determining the source of income from the sales of goods that were manufactured domestically and then sold abroad by U.S. firms allows those firms to classify up to half of their exports as foreign sourced—even though the value of those goods was generally created or added in the United States. The result is that a business can classify more of its income from exports as foreign than could be justified solely on the basis of where the goods were produced. A multinational corporation can then use any excess foreign tax credits to offset U.S. taxes on that income. The income allocation rules give those companies an incentive to produce goods domestically for sale by their overseas subsidiaries.

Under this option, the title passage rule would no longer apply to income from the sale of goods manufactured in the United States and then sold abroad. Instead, all income from such transactions would be sourced to the United States. That change would increase revenues by $6 billion over the 2014–2023 period, the staff of the Joint Committee on Taxation estimates.

One rationale for the option is that export incentives, such as those embodied in the title passage rule, do not boost domestic investment and employment overall or affect the trade balance. They do increase profits—and thus investment and employment—in industries that sell substantial amounts of their products abroad. However, the value of the U.S. dollar is boosted as a result, making foreign goods cheaper and thereby reducing profits, investment, and employment for U.S. companies whose products compete with imported goods. Thus, export incentives distort the allocation of resources by misaligning the prices of goods relative to their production costs, regardless of where the goods are produced.
Another argument in favor of the option is that it also would end a feature of U.S. tax law that allows businesses to avoid taxes on certain types of income earned abroad. Foreign tax credits were intended to prevent the income of U.S. businesses from being taxed twice. But the title passage rule allows domestic export income that is not subject to foreign taxes to be exempted from U.S. taxes as well, so the income escapes corporate taxation altogether.

A rationale against this option is that the application of the title passage rule to exports of goods manufactured in the United States reduces the amount of taxes that many U.S. multinational corporations pay, narrowing the gap between the total taxes paid by those firms and companies from lower-tax jurisdictions that operate in the same foreign markets. (However, U.S. multinational firms that do not have excess foreign tax credits receive no benefit from the title passage rule.) Another argument against the option is that allocating some income under the title passage rule would, to some extent, be less complicated than doing so under the normal rules for income allocation.

RELATED OPTION: Revenues, Option 30

Revenues—Option 30
Determine Foreign Tax Credits on a Pooling Basis

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Revenues</td>
<td>0.9</td>
<td>2.4</td>
<td>3.3</td>
<td>4.4</td>
<td>4.9</td>
<td>4.3</td>
<td>4.1</td>
<td>5.3</td>
<td>6.8</td>
<td>7.6</td>
<td>15.9</td>
<td>43.9</td>
<td></td>
</tr>
</tbody>
</table>

Source: Staff of the Joint Committee on Taxation.

Note: This option would take effect in January 2014.

The U.S. government taxes both the domestic income and foreign income of businesses that are incorporated in the United States and operate abroad as well as in this country. Often, such corporations must also pay income taxes to their foreign host countries. The income that foreign subsidiaries of U.S. multinational corporations earn is not subject to U.S. taxation until it is paid to the U.S. parent company—that is, the tax is deferred until the income is repatriated. Once that income is repatriated, those companies are assessed U.S. corporate income taxes on income that exceeds their expenses. However, current law provides for a system of credits for taxes paid to foreign governments that generally allows those businesses some relief from what otherwise would amount to double taxation of that income.

Under current law, a company’s foreign tax credit cannot exceed the taxes a company would pay to the United States on its income from that foreign country. Income that is repatriated from a country with a higher corporate tax rate than that in the United States generates “excess credits” (credits from foreign tax liabilities that cannot be used because they exceed the amount owed to the U.S. government). In contrast, income that is repatriated from a country with a lower tax rate generates credits that are not sufficient to offset the entire U.S. tax owed on that income. Under those circumstances, the company would face a residual tax in the United States, absent any further provisions of tax law.

However, U.S. tax law allows firms to combine the income and credits from high- and low-tax-rate countries on income tax returns. Thus, the excess credits arising from the taxes paid on income earned in high-tax countries can be applied to the income repatriated from low-tax countries, effectively offsetting some or all of the U.S. tax liability on income from low-tax countries. One consequence of this system is that, for any given amount of foreign income that it repatriates, a company can increase the size of its foreign tax credit by repatriating more income from countries with higher tax rates and less from countries with lower tax rates.

Under this option, a company’s foreign tax credit would be determined by pooling the company’s total income and taxes from all foreign countries. The total credit would equal the product of the total taxes paid to foreign governments and the percentage of total foreign income that was repatriated. The credit would not exceed the total amount of U.S. taxes owed on repatriated income. The staff of the Joint Committee on Taxation estimates that the option would increase revenues by $44 billion over the 2014–2023 period.

A result of the option is that the overall credit rate—the credit as a percentage of total repatriated income—would not depend on the distribution of the repatriated income but would be the average tax rate on earnings in all foreign countries. In contrast, under current law, a company’s overall credit rate is higher if a larger share of its repatriated income is from countries with higher tax rates. Hence, the foreign tax credit would be smaller under the pooling option than under current law for companies that repatriate a greater share of their earnings from countries with higher-than-average tax rates.

One argument in favor of this option is that it would restrict companies’ ability to use excess credits from countries with high taxes to offset the U.S. corporate tax on income from countries with low taxes. The current method for computing excess credits makes it advantageous for firms to design and use accounting or other legal strategies to report income and expenses for their U.S. and foreign operations in ways that reduce their overall tax liabilities. By basing the credit on total foreign income and taxes, this option would reduce the incentive for companies to strategically choose subsidiaries from which to repatriate income so as to reduce the amount of
taxes they owed—and thus also reduce the incentive for firms to devote resources to strategic tax planning rather than to more productive activities.

An argument against the option would be that it would increase incentives to invest in low-tax countries and to retain more of the resulting earnings abroad. Firms would be encouraged to shift investment from high-tax to low-tax countries because of the decline in the value of excess credits. The option would also increase incentives to keep profits from those investments abroad to avoid the higher U.S. taxes on repatriated income. However, many other factors—such as the skill level of a country’s workforce and its capital stock—also affect corporations’ decisions about where to invest.

RELATED OPTIONS: Revenues, Options 23 and 29

Revenues—Option 31
Increase Excise Taxes on Motor Fuels by 35 Cents and Index for Inflation

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Revenues</td>
<td>30</td>
<td>42</td>
<td>44</td>
<td>45</td>
<td>46</td>
<td>47</td>
<td>48</td>
<td>49</td>
<td>50</td>
<td>51</td>
<td>207</td>
<td>452</td>
</tr>
</tbody>
</table>

Source: Staff of the Joint Committee on Taxation.

Note: This option would take effect in January 2014.

Revenues from federal excise taxes on motor fuels are credited to the Highway Trust Fund to pay for highway construction and maintenance as well as for investment in mass transit. Those taxes currently are set at 18.4 cents per gallon of gasoline and 24.4 cents per gallon of diesel fuel produced.1 (State and local excise taxes bring total average tax rates nationwide to about 49 cents per gallon of gasoline and about 55 cents per gallon of diesel fuel.)

This option would increase federal excise taxes on gasoline and diesel fuel by 35 cents per gallon, to 53.4 cents per gallon of gasoline and 59.4 cents per gallon of diesel fuel. In future years, those values would be adjusted to reflect changes in the price index for gross domestic product between 2014 and the most recent year for which data for that price index were available. According to the staff of the Joint Committee on Taxation, the option would increase federal revenues by $452 billion over 10 years. (Because higher excise taxes would raise businesses’ costs, they would reduce the tax base for income and payroll taxes. The estimates shown here reflect reductions in revenues from those sources.)

One rationale for increasing excise taxes on motor fuels is that the rates currently in effect are not sufficient to fully fund the federal government’s spending on highways. A second rationale is that increasing excise taxes on motor fuels would have relatively low collection costs because such taxes are already being collected.

A further rationale for this option is that economic efficiency is promoted when users of highway infrastructure are charged according to the marginal (or incremental) costs of their use, including the “external costs” that are imposed on society. Because current fuel taxes do not cover all of those marginal costs, raising fuel taxes by the amount specified in this option would more accurately reflect the external costs created by the consumption of motor fuel. Some of those costs—including the costs of pollution, climate change, and dependence on foreign oil—are directly associated with the amount of motor fuel consumed. However, the larger fraction of those costs is related to the number of miles that vehicles travel, the road congestion that arises from driving at certain times and in certain locations, noise, accidents, and—primarily because of heavy vehicles—pavement damage. (As vehicles become more fuel efficient, the share of external costs attributable to the number of miles traveled will rise.) Various studies suggest that, in the absence of a tax on the number of vehicle miles traveled or on other factors that generate external costs, the external costs of motor fuels amount to at least $1 per gallon, indicating that for drivers to cover the costs they impose on society, excise tax rates on motor fuels would have to be substantially higher than the current rates. If the cost of fuel was higher, people would drive less or purchase vehicles that used fuel more efficiently, thus reducing some of the external costs; in contrast, paying for highways and mass transit through general revenues provides no incentive for the efficient use of those transportation systems.

An argument against this option is that it would probably be more economically efficient to base a tax on the number of miles that vehicles travel or other measurable factors that generate external costs. For example, imposing tolls or implementing congestion pricing (charging fees for driving at specific times in given areas) would be better ways to alleviate congestion. Similarly, a levy on the number of miles driven could be structured to correspond more closely to the costs of repairing damaged pavement than could a tax on motor fuels. However, creating the systems necessary to administer a tax on the number of vehicle miles traveled would be much more complex than increasing the existing excise taxes on fuels. Moreover, because fuel consumption has some external

1. A portion of the tax—0.1 cent—is credited to the Leaking Underground Storage Tank Trust Fund.
costs that do not depend on the number of miles traveled, economic efficiency would still require taxes on motor fuels even if other fees were assessed at their efficient levels.

Some other arguments against raising taxes on motor fuels involve issues of fairness. Such taxes impose a proportionately larger burden, as a share of income, on middle- and lower-income households (particularly those not well-served by public transit) than they do on upper-income households. Those taxes also impose a disproportionate burden on rural households because the benefits of reducing vehicle emissions and congestion are greatest in densely populated, mostly urban, areas. Finally, to the extent that the trucking industry passed on the higher cost of fuel to consumers—in the form of higher prices for transported retail goods, for instance—those higher prices would further increase the relative burden on people in low-income and rural households who live some distance from manufacturers.

Revenues—Option 32

Increase All Taxes on Alcoholic Beverages to $16 per Proof Gallon

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Revenues</td>
<td>4.7</td>
<td>6.3</td>
<td>6.4</td>
<td>6.4</td>
<td>6.5</td>
<td>6.6</td>
<td>6.6</td>
<td>6.7</td>
<td>6.8</td>
<td>6.9</td>
<td>30.3</td>
<td>63.8</td>
</tr>
</tbody>
</table>

Source: Staff of the Joint Committee on Taxation.
Note: This option would take effect in January 2014.

In 2012, the federal government collected $9.7 billion in revenue from excise taxes on distilled spirits, beer, and wine. The different alcoholic beverages are taxed at different rates. Specifically, the alcohol content of beer and wine is taxed at a much lower rate than the alcohol content of distilled spirits because the taxes are determined on the basis of different liquid measures. Distilled spirits are measured in proof gallons (a standard unit for measuring the alcohol content of a liquid). The current excise tax levied on those spirits, $13.50 per proof gallon, translates to about 21 cents per ounce of alcohol. Beer, by contrast, is measured by the barrel, and the current tax rate of $18 per barrel translates to about 10 cents per ounce of alcohol (under the assumption that the average alcohol content of beer is 4.5 percent). The current levy on wine is $1.07 per gallon, or about 8 cents per ounce of alcohol (assuming an average alcohol content of 11 percent). Last raised in 1991, current excise tax rates on alcohol are far lower than historical levels when adjusted for inflation.

This option would standardize the base on which the federal excise tax is levied by using the proof gallon as the measure for all alcoholic beverages. The tax would be raised to $16 per proof gallon, thus increasing revenues by $64 billion over the 2014–2023 period, the staff of the Joint Committee on Taxation estimates. (Because excise taxes reduce producers’ and consumers’ income, higher excise taxes would lead to reductions in revenues from income and payroll taxes. The estimates shown here reflect those reductions.)

A tax of $16 per proof gallon would equal about 25 cents per ounce of alcohol. Under this option, the federal excise tax on a 750-milliliter bottle (commonly referred to as a fifth) of distilled spirits would rise from about $2.14 to $2.54. The tax on a six-pack of beer would jump from about 33 cents to 81 cents, and the tax on a 750-milliliter bottle of wine would increase by a similar amount, from about 21 cents to 70 cents.

Experts agree that the consumption of alcohol creates costs for society that are not reflected in the pretax price of alcoholic beverages. Examples of those “external costs” include spending on health care that is related to alcohol consumption and covered by the public, losses in productivity stemming from alcohol consumption that are borne by others besides the consumer, and the loss of lives and property that results from alcohol-related accidents and crime. Calculating such costs is difficult. However, one study found that the external economic costs of alcohol abuse exceeded $130 billion in 2006—an amount far greater than the revenues currently derived from taxes on alcoholic beverages.1

One argument in favor of raising excise taxes on alcoholic beverages is that they would reduce alcohol use—and thus the external costs of that use—and make consumers of alcoholic beverages pay a larger share of such costs. Research has consistently shown that higher prices lead to less alcohol consumption, even among heavy drinkers.

Moreover, raising excise taxes to reduce consumption might be desirable, regardless of the effect on external costs, if lawmakers believed that consumers underestimated the harm they do to themselves by drinking. Heavy drinking is known to cause organ damage and cognitive impairment; and the links between highway accidents and drinking, which are especially strong among the young, are well-documented. Substantial evidence also indicates that the use of alcohol from an early age can lead to heavy consumption later in life. When deciding how much to drink, people—particularly young people—may not adequately consider such long-term risks to their health.

An increase in taxes on alcoholic beverages would have disadvantages as well. It would make a tax that is already regressive—one that takes up a greater percentage of income for low-income families than for middle- and upper-income families—even more so. In addition, it would affect not only problem drinkers but also drinkers who imposed no costs on society and who thus would be unduly penalized. Furthermore, higher taxes would reduce consumption by some moderate drinkers whose intake of alcohol is believed to have health benefits. (Moderate alcohol consumption, particularly of wine, has been linked to lower incidence of heart disease, obesity, and stroke and to increases in life expectancy in middle age.) With regard to the argument that some drinkers underestimate the personal costs of alcohol consumption, some opponents of raising taxes on alcohol argue that the government should not try to modify consumers’ private behavior. Finally, as to effects on the federal budget, in the longer term, overall savings to the federal government from this tax would be at least partially offset by additional spending, as healthier people lived longer and relied more on federal health care, disability, and retirement programs. Those longevity-related offsets would grow over time.

RELATED OPTION: Health, Option 16

Revenues—Option 33

Impose a Tax on Financial Transactions

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Revenues</td>
<td>0</td>
<td>12</td>
<td>18</td>
<td>19</td>
<td>20</td>
<td>21</td>
<td>21</td>
<td>22</td>
<td>23</td>
<td>24</td>
<td>68</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>180</td>
</tr>
</tbody>
</table>

Source: Staff of the Joint Committee on Taxation.
Note: This option would take effect in January 2015.

The United States is home to large financial markets, with hundreds of billions of dollars in stocks and bonds—collectively referred to as securities—traded on a typical business day. The total dollar value, or market capitalization, of U.S. stocks was roughly $20 trillion in April 2013, and about $250 billion in shares is traded on a typical day. The value of outstanding bond market debt was about $38 trillion at the end of 2012, and average trading volume in debt, mostly concentrated in Treasury securities, amounts to over $800 billion on a typical day.

In addition, large volumes of derivatives—contracts that derive their value from another security or commodity and include options, forwards, futures, and swaps—are traded on U.S. financial markets every business day. None of those transactions are taxed in the United States, although most taxpayers who sell securities for more than they paid for them owe tax on their gains.

This option would impose a tax on the purchase of most securities and on transactions involving derivatives. For purchases of stocks, bonds, and other debt obligations, the tax generally would be 0.01 percent of the value of the security. For purchases of derivative contracts, the tax would be 0.01 percent of all payments to be made under the terms of the contract, including the price paid when the contract was written, any periodic payments, and any amount to be paid when the contract expires. Trading costs for institutional investors tend to be very low—in many cases less than 0.10 percent of the value of the securities traded—so this option would generate a notable increase in trading costs for those investors.

The tax would not apply to the initial issuance of stock or debt securities, transactions in debt obligations with fixed maturities of no more than 100 days, or currency transactions (although transactions involving currency derivatives would be taxed). The tax would be imposed on transactions that occurred within the United States and on transactions that took place outside of the country as long as any party to an offshore transaction was a U.S. taxpayer (whether a corporation, partnership, citizen, or resident). The tax would apply to transactions occurring after December 31, 2014. This option would be effective a year later than the other revenue options analyzed in this report to provide the government and firms with sufficient time to develop and implement the new reporting systems that would be necessary to accurately collect the tax.

The tax would increase revenues by $180 billion from 2015 through 2023, according to estimates by the staff of the Joint Committee on Taxation. Those revenues would be lower if implementation of the option was phased in because of delays in developing the new reporting systems. (Because a financial transaction tax would reduce the tax base of income and payroll taxes, it would lead to reductions in revenues from those sources. The estimates shown here reflect those reductions.) The additional revenues from the option would depend importantly on the extent to which trading of securities fell in response to the tax.

One argument in favor of a tax on financial transactions is that it might reduce the amount of short-term speculation and computer-assisted high-frequency trading, and direct the resources now dedicated to those activities to more productive uses. Excessive speculation can destabilize markets and lead to disruptive events, such as the October 1987 stock market crash and the more recent “flash crash” that occurred when the stock market temporarily plunged on May 6, 2010.

However, the tax would discourage all short-term trading, not just speculation—including some transactions by well-informed traders and transactions that stabilize markets. Empirical evidence suggests that, on balance, a transaction tax could make asset prices less stable: In particular, a number of studies have concluded that higher
transaction costs lead to more, rather than less, volatility in prices. (However, much of that evidence is from studies conducted before the rise of high-frequency trading programs, which now account for a significant share of trading in the stock market.)

The tax could have a number of negative effects on the economy stemming from its effects on trading and asset prices. However, because the tax would be only 0.01 percent of the value of the securities traded, most of those effects would probably be small. First, the tax could reduce private investment (leaving aside the effects of higher tax revenue on federal borrowing and thus on the funds available for investment). Specifically, the tax would raise the costs of financing investments to the extent that it made transactions more costly, financial markets less liquid, and financial risk management more expensive. Second, the transactions tax would reduce the value of existing financial assets because investors would not be willing to pay as much for assets that became more expensive to trade, lowering household wealth. And third, the cost to the Treasury of issuing federal debt would probably increase (again, leaving aside the effects of deficit reduction) because investors would pay less for Treasury securities that were less liquid.

In addition, traders would have an incentive to reduce the tax they must pay by moving their trading out of the country (although offshore trades by U.S. taxpayers would be taxed). Such effects would be mitigated if other countries enacted financial transaction taxes, as 11 members of the European Union are considering.

RELATED OPTIONS: Revenues, Options 3 and 34

RELATED CBO PUBLICATION: Letter to the Honorable Orrin G. Hatch responding to questions about the effects of a tax on financial transactions that would be imposed by the Wall Street Trading and Speculators Tax Act, H.R. 3313 or S. 1787 (December 12, 2011), www.cbo.gov/publication/42690
During the financial crisis that occurred between 2007 and 2009, the federal government provided substantial assistance to major financial institutions, effectively protecting many uninsured creditors from losses but at great potential cost to taxpayers. (Ultimately, that assistance proved not to be very costly.) That action reinforced investors’ perceptions that large financial firms are “too big to fail”—in other words, so important to the financial system and the broader economy that their creditors are likely to be protected by the government in the event of large losses.

In the wake of that crisis, legislators and regulators adopted a number of measures designed to prevent the failure of large, systemically important financial institutions and to resolve any future failures without putting taxpayers at risk. One of those measures, included in title II of the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010, established an orderly liquidation authority under the direction of the Federal Deposit Insurance Corporation (FDIC). That authority is intended to allow the FDIC to quickly and efficiently settle the obligations of a systemically important financial institution. Such institutions can include companies that control one or more banks (also known as bank holding companies) or firms that are predominantly engaged in lending, insurance, securities trading, or other financial activities. In the event that a large financial institution fails, the FDIC will be appointed to liquidate the company’s assets in an orderly manner and thus maintain critical operations of the failed institution in an effort to avoid consequences throughout the financial system.

Despite the new safeguards, if one or more large financial institutions were to fail, particularly during a period of broader economic distress, the FDIC might need to borrow funds from the Treasury to implement its orderly liquidation authority. Title II mandates that those funds be repaid either through recoveries from the failed firm or through a future assessment on the surviving firms. As a result, individuals and businesses dealing with those firms could be affected by the costs of the assistance provided to the financial system. For example, if a number of large firms failed and substantial cash infusions were needed to resolve those failures, the assessment required to repay the Treasury would have to be set at a very high amount. Under some circumstances, the surviving firms might not be able to pay that assessment without making significant changes to their operations or activities. Those changes could result in higher costs to borrowers and reduced access to credit at a time when the economy might be under significant stress.

Under this option, an annual fee would be imposed beginning in 2014 on financial institutions covered by title II—that is, bank holding companies (including foreign banks operating in the United States) with $50 billion or more in total assets and nonbank financial companies designated by the Financial Stability Oversight Council for enhanced supervision by the Federal Reserve Board of Governors. The annual fee would be 0.15 percent of firms’ total liabilities as reported in their financial statements, subject to certain adjustments, such as excluding deposits insured by the FDIC and certain reserves required by insurance policies. The sums collected would be deposited in a fund that would be available for the FDIC’s use in exercising its orderly liquidation authority. If implemented on January 1, 2014, such a fee would generate revenues totaling $73 billion from 2014 through 2023, the staff of the Joint Committee on Taxation (JCT) estimates. (Such a fee would reduce the tax base of income and payroll taxes, leading to reductions in income and payroll tax revenues. The estimates shown here reflect those reductions.)

In its current-law baseline projections for the 2014–2023 period, the Congressional Budget Office incorporated the probability that the orderly liquidation authority would
have to be used and that an assessment would have to be levied on surviving firms to cover some of the government’s costs. CBO’s projections include $9 billion in receipts from such an assessment over the 2014–2023 period. Implementing this option would reduce the likelihood that such an assessment would be needed during that period. Therefore, in estimating the budgetary impact of the option, the amount of revenues ($9 billion) that the assessment was projected to generate was subtracted from the amount ($73 billion) the new fee is projected to generate, yielding net additional revenues of $64 billion from 2014 through 2023.

At 0.15 percent, the fee would probably not be so high as to cause financial institutions to significantly change their financial structure or activities. The fee could nevertheless affect institutions’ tendency to take various business risks, but the net direction of that effect is uncertain; in some ways, it would encourage greater risk-taking, and in other ways, less risk-taking. One approach might be to vary the amount of the fee so that it reflected the risk posed by each institution, but it might be difficult to assess that risk precisely.

The main advantage of this option is that it would help defray the economic costs of providing a financial safety net by generating revenues when the economy is not in a financial crisis, rather than in the immediate aftermath of one. Another advantage of the option is that it would provide an incentive for banks to keep assets below the $50 billion threshold, diminishing the risk of spillover effects to the broader economy from a future failure of a particularly large institution (although at the expense of potential economies of scale). Alternatively, if larger financial institutions reduced their dependence on liabilities subject to the fee and increased their reliance on equity, their vulnerability to future losses would be reduced. The fee also would improve the relative competitive position of small and medium-sized banks by charging the largest institutions for the greater government protection they receive.

The option would also have several disadvantages. Financial institutions might pass much of the cost of the fee to their customers, employees, and investors. In addition, unless the fee was risk-based, stronger financial institutions that posed less systemic risk—and consequently paid lower interest rates on their debt as a result of their lower risk of default—would face a proportionally greater increase in funding costs than would weaker financial institutions. Finally, the fee could reduce the profitability of larger institutions, which might create an incentive for them to take greater risks in pursuit of higher returns to offset their higher costs.

RELATED OPTION: Revenues, Option 33

RELATED CBO PUBLICATIONS: The Budgetary Impact and Subsidy Costs of the Federal Reserve’s Actions During the Financial Crisis (May 2010), www.cbo.gov/publication/21491; and letter to the Honorable Charles E. Grassley providing information on the President’s proposal for a financial crisis responsibility fee (March 2010), www.cbo.gov/publication/21020
Revenues—Option 35

Impose a Tax on Emissions of Greenhouse Gases

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Revenues</td>
<td>63</td>
<td>98</td>
<td>100</td>
<td>103</td>
<td>107</td>
<td>111</td>
<td>114</td>
<td>118</td>
<td>121</td>
<td>125</td>
<td>471</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1,060</td>
</tr>
</tbody>
</table>

Sources: Staff of the Joint Committee on Taxation; and Congressional Budget Office.

Note: This option would take effect in January 2014.

The accumulation of greenhouse gases (GHG) in the atmosphere—particularly carbon dioxide (CO₂) released as a result of burning fossil fuels (such as coal, oil, and natural gas) and because of deforestation—could generate damaging and costly changes in the climate around the world. Although the consequences of those changes are highly uncertain and would probably vary widely across the United States and the rest of the world, many scientists think there is at least a risk that large changes in global temperatures will trigger catastrophic damage. Among the less uncertain effects of climate change on humans, some would be positive, such as reduced deaths from cold weather and improvements in agricultural productivity in certain areas; however, others would be negative, such as declines in the availability of fresh water in areas dependent on snow melt and the loss of property from storm surges as sea levels rise. Reducing global emissions of greenhouse gases would decrease the extent of climate change and the expected costs and risks associated with it. The federal government has begun to regulate some of those emissions, but it does not directly tax them.

This option would place a tax of $25 per metric ton on most emissions of greenhouse gases in the United States—specifically, on most energy-related emissions of CO₂ (for example, from electricity generation, manufacturing, and transportation) and some other GHG emissions from large manufacturing facilities. Emissions would be measured in CO₂ equivalents (CO₂e), which reflect the amount of carbon dioxide that would cause an equivalent amount of warming. The tax would increase at an annual real (inflation-adjusted) rate of 2 percent. During the first decade the tax was in effect, the Congressional Budget Office estimates, emissions from sources subject to the tax would fall by roughly 10 percent.

According to estimates by the staff of the Joint Committee on Taxation and CBO, federal revenues would increase by $1.06 trillion over the same period. (The tax would increase businesses’ costs, which would reduce the tax bases for income and payroll taxes. The estimates shown here reflect the resulting reductions in revenues from those sources.)

The size of the tax used for these estimates was chosen for illustrative purposes, and policymakers who wanted to pursue this approach might prefer a smaller tax or a larger one. The appropriate size of a tax on greenhouse gas emissions, if one was adopted, would depend on the value of limiting the magnitude of climate change and its associated costs, the way in which the additional revenues were used, the effect on emissions overseas, and the additional benefits and costs that resulted from the tax.

One argument in support of the option is that it would reduce emissions of greenhouse gases at the lowest possible cost per ton of emissions because each ton would be subject to the same tax. That uniform treatment would increase the cost of producing and consuming goods and services in proportion to the amount of greenhouse gases emitted as a result of that production and consumption. Those higher production costs, and corresponding increases in prices for final goods and services, would create incentives throughout the U.S. economy to undertake reductions of greenhouse gases that cost up to $25 per metric ton of CO₂e to achieve. An alternative approach to reducing GHG emissions that is currently being pursued by the federal government is to issue regulations based on various provisions of the Clean Air Act (CAA). However, standards issued under the CAA (for example, specifying an emissions rate for a given plant or an energy-efficiency standard for a given product) would offer less flexibility than a tax and, therefore, would achieve any given amount of emission reductions at a higher cost to the economy than a tax.
Another argument in favor of a GHG tax is that such a program could generate “co-benefits.” Co-benefits would occur when measures taken to reduce GHG emissions—such as generating electricity from natural gas rather than from coal—also reduced other pollutants not explicitly limited by the cap, thereby reducing the harmful effects associated with those emissions. One study estimated that reductions in other pollutants that would occur as a by-product of a $29 tax per ton of CO₂ emissions could be worth between $10 and $20 per ton in terms of the benefits to human health. However, measures taken to decrease CO₂ emissions could also create additional costs depending on how the emissions were reduced. For example, increased nuclear generation could exacerbate the problem of lack of adequate long-term storage capacity for nuclear waste.

An argument against a tax on GHG emissions is that curtailing U.S. emissions would burden the economy by raising the cost of producing emissions-intensive goods and services while yielding benefits for U.S. residents of an uncertain magnitude. For example, most of the benefits of limiting climate change might occur outside of the United States, particularly in developing countries that are at greater risk from changes in weather patterns and an increase in sea levels. Another argument against this option is that reductions in domestic emissions could be partially offset by increases in emissions overseas.

An alternative approach for reducing emissions of greenhouse gases would be to establish a cap-and-trade program that set caps on such emissions in the United States. Under such a program, allowances that conveyed the right to emit 1 metric ton of CO₂e apiece would be sold at open auction, and the cap would probably be lowered over time. If the caps were set to achieve the same cut in emissions that was anticipated from the tax, then the program would be expected to raise roughly the same amount of revenue between 2014 and 2023 as the tax analyzed here. Both a tax on GHG emissions and a cap-and-trade program for those emissions would represent market-based approaches to cutting emissions and would achieve any desired amount of emissions reduction at a lower cost than the regulatory approach described above. In contrast with a tax, a cap-and-trade program would provide certainty about the quantity of emissions from sources that are subject to the cap (because it would directly limit those emissions), but it would not provide certainty about the costs that firms and households would face for the greenhouse gases that they continued to emit.


Revenues—Option 36

Increase Federal Civilian Employees’ Contributions to Their Pensions

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Revenues</td>
<td>0.6</td>
<td>1.4</td>
<td>2.1</td>
<td>2.2</td>
<td>2.2</td>
<td>2.2</td>
<td>2.2</td>
<td>2.2</td>
<td>2.1</td>
<td>2.1</td>
<td>8.5</td>
<td>19.3</td>
</tr>
</tbody>
</table>

Note: This option would take effect in January 2014.

The federal government provides most of its civilian employees with an annuity in retirement through either the Federal Employees Retirement System (FERS) or its predecessor, the Civil Service Retirement System (CSRS). Those annuities are jointly funded by the employees and the federal agencies that hire them. About 85 percent of federal employees participate in FERS, and most of them contribute 0.8 percent of their salary toward their future annuities. The Middle Class Tax Relief and Job Creation Act of 2012 increased the contribution rate to 3.1 percent for most employees hired after December 31, 2012. Federal employees who are still covered by CSRS generally contribute 7 percent of their salary and accrue larger annuities. Agency contributions for FERS and CSRS do not have any effect on total federal spending or revenues because they are intragovernmental payments, but employee contributions are counted as federal revenues. (Annuity payments made to FERS and CSRS beneficiaries represent federal spending.)

Under this option, employees who enrolled in FERS or CSRS before 2013 would contribute an additional 1.2 percent of their salary toward their retirement annuities, while agency contributions would remain the same. (That increase in contributions would represent a larger share of employees’ after-tax income because the contributions are subject to federal income and payroll taxes.) The rise in contributions would be phased in over the next three years. The amount of future annuities would not change under the option, and the option would not affect employees hired in 2013 or later who already make or will make larger contributions under the Middle Class Tax Relief and Job Creation Act. The option would increase federal revenues by $19 billion from 2014 through 2023, the Congressional Budget Office estimates.

An argument in favor of this option is that federal employees receive, on average, more compensation—in terms of both wages and benefits—than private-sector workers with similar education and experience and in similar occupations. In fact, a substantial number of private-sector employers no longer provide health insurance for their retirees or defined benefit retirement annuities, choosing instead to offer only defined contribution retirement plans that are less costly; in contrast, the federal government provides a defined benefit retirement plan, a defined contribution retirement plan, and health insurance in retirement. Therefore, even if federal employees had to contribute somewhat more toward their annuities, their total compensation would, on average, still be higher than that available in the private sector.

Another argument in favor of the option is that, because it would not change the compensation of federal employees hired after 2012, it would probably not affect the quality of new recruits. Because new recruits are typically younger than other workers, and federal compensation compares less favorably to that available in the private sector for younger workers, some new recruits could be particularly susceptible to competition from private-sector employers.

An argument against this option is that it would reduce the number of highly qualified federal employees by motivating some of them to leave for the private sector and by encouraging some of them to retire earlier. Although federal employees receive more compensation, on average, than their private-sector counterparts, some highly qualified federal employees have more lucrative job opportunities in the private sector than in the federal government. More of those employees would leave for the private sector under this option.

Another argument against the option is that it would reduce the income of federal employees who have already forgone across-the-board pay increases for three consecutive years. Federal employees who have not received salary increases based on merit or length of service have seen the
The option would also further accentuate the difference in the timing of compensation provided by the federal government and the private sector. Because many private-sector employers no longer provide health insurance for their retirees or defined benefit retirement annuities, a significantly greater share of total compensation in the private sector is paid to workers immediately, whereas federal employees receive a larger portion of their compensation in retirement. If that shift by private firms indicates that workers prefer to receive more of their compensation immediately, then shifting federal compensation in the opposite direction—which this option would do by reducing current compensation while maintaining retirement benefits—would be detrimental to the recruitment of federal employees. If lawmakers wanted to reduce the total compensation of federal employees while increasing the share of that compensation provided immediately, they could consider modifying the formula used to calculate federal annuities (Mandatory Spending Option 10 in this report) or making other changes.