ECONOMIC GROWTH AND JOB CREATION: BACKGROUND AND PROPOSALS RELATING TO INCENTIVES FOR CONSUMPTION AND INVESTMENT

Prepared for
Hearings scheduled before the

SENATE FINANCE COMMITTEE

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JOINT COMMITTEE ON TAXATION

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CONTENTS

INTRODUCTION

On Tuesday, February 11, 2003 the Senate Committee on Finance will hold a hearing to examine proposals for economic growth and job creation through incentives for increased consumption of goods and services. On Wednesday, February 12, 2003, the committee will hold a hearing to examine proposals for economic growth and job creation through incentives for increased investment spending. This pamphlet, prepared by the staff of the Joint Committee on Taxation,[1] provides background data on the macroeconomic performance of the U.S. economy, discusses the use of changes in tax policy as a fiscal policy tool, and describes certain proposals before the committee.

Part I provides background data on the U.S. economy. Part II discusses how fiscal policy affects aggregate demand and aggregate supply. Part III provides present law and descriptions of proposals related to changes in the Internal Revenue Code that may affect consumption spending or investment spending.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Economic Growth And Job Creation: Background and Proposals Relating to Incentives for Consumption and Investment* (JCX-9-03), February 10, 2003.

I. TRENDS IN THE UNITED STATES ECONOMY

A. Overview

In general terms, aggregate output and the price level of that output result from the interaction of the nation's aggregate demand for goods and services and the nation's aggregate supply for producing goods and services. In the short run, the economy's capacity often is fixed. It is not possible to make more than marginal additions to the economy's supply of physical capital (e.g., the stock of land, buildings, and machinery) in the short term.

During periods of slow economic growth or recession, the economy's supply of physical capital is often underutilized. As a consequence, policymakers generally emphasize policies that affect aggregate demand when they are concerned about short-run economic performance. Such policies might include increased government expenditures, tax changes designed to alter consumer demand for consumption goods or business demand for new plant and equipment, or monetary policies designed to reduce interest rates to encourage consumer and business borrowing.

In the long run, aggregate supply is variable. Policymakers concerned about future economic performance generally emphasize policies that increase aggregate supply in the long run. Such policies might include increasing the level of national saving by increasing government saving (i.e., increasing the level of a surplus or decreasing the level of a deficit), or changing tax policy to increase individual saving and business investment.[2]

This part of the pamphlet reviews data on the economic performance of the American economy. The data on short-run economic performance emphasize comparison of selected macroeconomic variables to previous periods of recession in the postwar era and show that the most recent recession, while it ultimately may be determined to be longer than the average postwar recession, has been less severe in many respects than previous recessions.

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[2] Policies may affect both aggregate demand and aggregate supply. For example, policies that affect current business demand for new plant and equipment might alter both current aggregate demand and long-run aggregate supply.

B. Short-Run Economic Performance

No precise definition of "recession" exists in economics.[3] Analysts frequently designate periods as recessions by comparing many measures of economic activity to their levels in other periods. As a consequence, analysts examine many variables to ascertain if the economy is in recession. Among variables commonly examined are the rate of growth of real gross domestic product ("GDP"), employment, industrial production, wholesale and retail sales, the capacity utilization rate, interest rates, trade and real income. Moreover, because multiple variables are compared, some measures of economic performance in periods deemed to be recessions may surpass the same measures from another time period when the economy was not deemed to have been in recession.

Growth of real GDP

Figure 1 details the rate of real GDP[4] growth over the period 1977-2002.[5] The figure reveals that the declines in real GDP recently experienced are modest in comparison to the recessions of 1981-82 or 1990-91.

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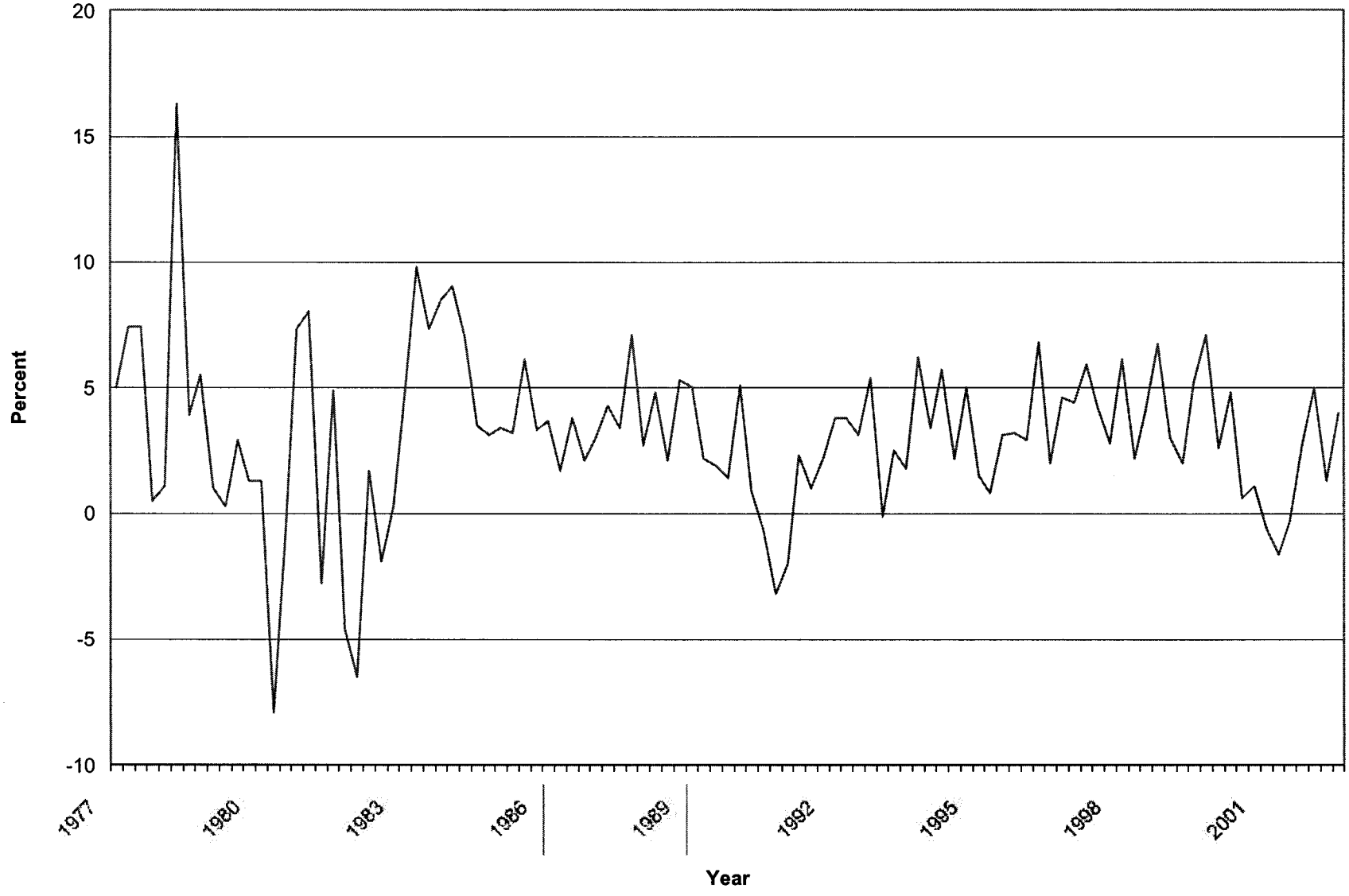
[3] Definition of a recession as two consecutive quarters of negative growth in real GDP is commonly, albeit mistakenly, attributed to the National Bureau of Economic Research. The National Bureau of Economic Research is a non-profit research organization whose objective is to ascertain and to present to the public important economic facts and their interpretations in a scientific and impartial manner. The National Bureau of Economic Research Business Cycle Dating Committee decides turning points by looking at a variety of indicators, not solely GDP. In particular, GDP is a quarterly concept, while peaks and troughs are monthly (see Table 1 in text). Thus, while the National Bureau of Economic Research has identified March of 2001 as a peak of business activity, real GDP had peaked in the fourth quarter of 2000. Consequently, identifying peaks and troughs involves professional judgments. See National Bureau of Economic Research, "The NBER's Recession Dating Procedure."

However, the definition of two consecutive quarters of decline in real GDP represents a fairly accurate description of a rule of thumb used by economists to identify recessions.

[4] When there is inflation, nominal or current dollar GDP may continue to rise while real or constant dollar GDP declines. Real GDP represents the constant dollar value of goods and services produced in the economy. Declines in real GDP represent declines in real output.

[5] Figure 1 measures the growth rate as the annual rate of change in real GDP from the level of GDP prevailing in the preceding quarter. Data for Figure 1 are from the National Income and Product Account ("NIPA") as reported by the Bureau of Economic Analysis of the U.S. Department of Commerce.

Figure 1.–Rate of Growth of Real GDP, First Quarter 1977 to Third Quarter 2002



According to the National Bureau of Economic Research's commonly accepted dating of business cycles, nine recessions occurred in the post-World War II era prior to 2001. Excluding the economic downturn accompanying the de-mobilization following the Korean War, the number of peacetime recessions prior to the 2001 recession is seven. Table 1 lists these recessions.

The National Bureau of Economic Research measures the length of recessions by reference to the number of months between the peak of business activity prior to its subsequent decline and the subsequent trough in business activity. Table 1 follows this convention in presenting the duration of post-World War II recessions. By this peak-to-trough measure, recessions in the postwar period have averaged 11 months in duration. The National Bureau of Economic Research has identified a peak in March 2001. The National Bureau of Economic Research has yet to date the trough of the most recent recession. Consequently, a precise measure of the duration of the most recent recession cannot be made at the present time. With respect to determining the end of the recession that began in 2001, the National Bureau of Economic Research has stated, "The first step will be to determine if the period of weakness that began in late 2002 amounts to a recession....The second step would be to determine if the recession starting in late 2002 was a continuation of the recession that we have already determined began in March 2001. We would decide in favor of a single, longer recession if we determined that economic activity in the period from March 2001 through late 2002 never surpassed its peak in March 2001. Here, we would have to reconcile the conflicting behavior of output and employment. Output surpassed its previous peak in late 2001, while employment rose only slightly from its lowest level of April 2002 to the highest level it reached in 2002, in August. At that time, employment was still 1.2 percent below its peak in March 2001."[6]

[6] See The NBER's Business-Cycle Dating Procedure. Business Cycle Dating Committee, National Bureau of Economic Research, January 13, 2003.

Table 1.– Post World War II Recessions in the United States

Peak[1]	Trough[1]	Duration in months
November 1948	October 1949	11
July 1953	May 1954	10
August 1957	April 1958	8
April 1960	February 1961	10
December 1969	November 1970	11
November 1973	March 1975	16
January 1980	July 1980	6
July 1981	November 1982	16
July 1990	March 1991	8
March 2001	(Not yet determined)	(Not yet determined)
Average		**11**

[1] Peaks and troughs as identified by the National Bureau of Economic Research.

Source: National Bureau of Economic Research.

Unemployment and capacity utilization

As noted above, economists typically do not rely on a single measure of economic activity to gauge whether the economy is in recession. For example, increases in unemployment generally accompany declines in real GDP, but positive real GDP growth need not immediately be followed by a reduction in unemployment. Unemployment usually remains high during the beginning of the recovery period.[7] As a consequence, the NBER peak-to-trough measure of business activity may not correspond to the popular perception of recession based on unemployment.

Figure 2 reports the civilian unemployment rate monthly from January 1977 through December 2002 as reported by the Bureau of Labor Statistics. Figure 3 reports the Federal Reserve's capacity utilization rate.[8] The latter measures the level of employment of the

[7] The measured unemployment rate is computed by dividing the number of individuals who are not employed, but who are actively seeking employment, by the total labor force, both employed and unemployed. Individuals who are out of work but who ceased to seek employment actively are called "discouraged workers." Discouraged workers are not counted as part of the labor force.

Individuals who have moved from full-time to part-time employment are counted as employed. For these two reasons, the unemployment rate may not be the most accurate single measure of job loss. However, this measure has been consistently applied across all postwar recessions.

[8] The capacity utilization rate is equal to the index of current industrial production divided by a capacity index. The capacity index attempts to measure "practical" capacity, that is,

economy's capital resources in manufacturing, mining, and utilities. The recessions of 1981-82 and 1990-91 are reflected clearly by the spikes in the civilian unemployment rate. Downward spikes in the capacity utilization rate also accompanied these recessions. Measured by the unemployment rate, the economic decline of the past year has been modest. The December 2002 unemployment of 6.0 percent is below the peak unemployment of the 1990-91 recession (7.8 percent in June 1992) and below the peak unemployment rate of the 1981-82 recession (10.8 percent of November and December 1982). The Bureau of Labor Statistics estimated that in January 2003 the unemployment rate had declined to 5.7 percent. Measured in absolute numbers, unemployment at present is less severe than in the 1981-82 recession or the 1990-91 recession. The Bureau of Labor Statistics estimates that the unemployed numbered 8.6 million persons in December 2002.[9] The Bureau of Labor Statistics estimated that 12.0 million persons were unemployed in December 1982 and 10.0 million persons were unemployed in June 1992. Capacity utilization presents a different picture. The decline in capacity utilization of the past year is less severe than the decline of the early 1980s, but has exceeded the decline of the early 1990s.

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the greatest level of output that plants can maintain within a framework of a realistic work schedule, taking account of normal downtime, and assuming sufficient availability of inputs to operate the machinery and equipment in place. Thus, the capacity utilization rate may be thought of as a measure of idle factories and mines, with a lower rate indicating greater idleness.

[9] The data reported in the text on the number of individuals unemployed and employed and the data in Figure 2, Figure 4, and Figure 5 are from the Bureau of Labor Statistics of the U.S. Department of Labor as reported in January 2003. These data will not be directly comparable to data released after February 6, 2003 by the Bureau of Labor Statistics because of changes statistical method. In particular, the Bureau of Labor Statistics has estimated the civilian labor force to be substantially larger than the estimates used for prior data. The Bureau of Labor Statistics explains this as follows: "Beginning in January 2003, population controls based on the results of Census 2000 were used in the monthly CPS [Current Population Studies] estimation process, and data for the 3 prior years were revised to reflect these new controls. (Previously, estimates for January 1990 through December 2002 were based on 1990 Census population controls adjusted for the estimated undercount.) The Census 2000-based controls increased the size of the civilian noninstitutional population by over 3 million. As a result, they also increased the estimates of employment and unemployment. Since the increases were roughly proportional, however, the overall unemployment rate did not change significantly. In addition to the shift to Census 2000-based controls, the U.S. Census Bureau introduced another large upward adjustment (+941,000) to the CPS population controls in January 2003 as part of its annual update of population estimates. BLS [Bureau of Labor Statistics] does not anticipate revising historical data to reflect this additional adjustment." U.S. Department of Labor, Bureau of Labor Statistics, "Employment Situation Summary," February 7, 2003.

Figure 2.–Civilian Unemployment Rate, Monthly, 1977-2002

Figure 3.–Capacity Utilization as Reported in Each December 1977-2002

Measured unemployment can increase even if the economy is expanding if the number of entrants into the labor force seeking work exceeds the number of new job openings. In the current recession, as in the recessions of 1981-82 and 1990-91, the economy has experienced job loss. Figure 4 reports civilian employment monthly for the period January 1977 through December 2002. The most recent peak in civilian employment occurred in December 2000 when the Bureau of Labor Statistics estimated that 135.9 million persons were employed. Employment declined from that peak to 133.5 million in January 2002. The Bureau of Labor Statistics estimated civilian employment at just under 134 million in December 2002. Measuring from peak to trough, the recent job losses have been somewhat larger in aggregate, but less in percentage terms, than the job losses experienced in the early 1980s when employment fell from a peak of 101.0 million in April 1981 to a low of 99.0 million in December 1982. The recent job losses have been larger, in the aggregate and in percentage terms, than the job losses experienced in the early 1990s, when employment fell from a peak of 119.2 million in March 1990 to a low of 117.4 million in May 1991.

The national unemployment rate and employment figures may mask important sectoral or regional differences. Figure 5 reports employment in manufacturing monthly for the period January 1977 through December 2002. During the recent period of greatest aggregate employment loss (December 2000 to January 2002), manufacturing employment fell from 18.4 million to 16.9 million. The loss of 1.4 million manufacturing jobs comprised more than half of the total national job loss of 2.4 million during that period. From January 2002 through December 2002, total employment has grown, but the Bureau of Labor Statistics estimates that an additional 477,000 manufacturing jobs have been lost.

Figure 4.–Civilian Employment, Monthly, 1977-2002
[in Millions]

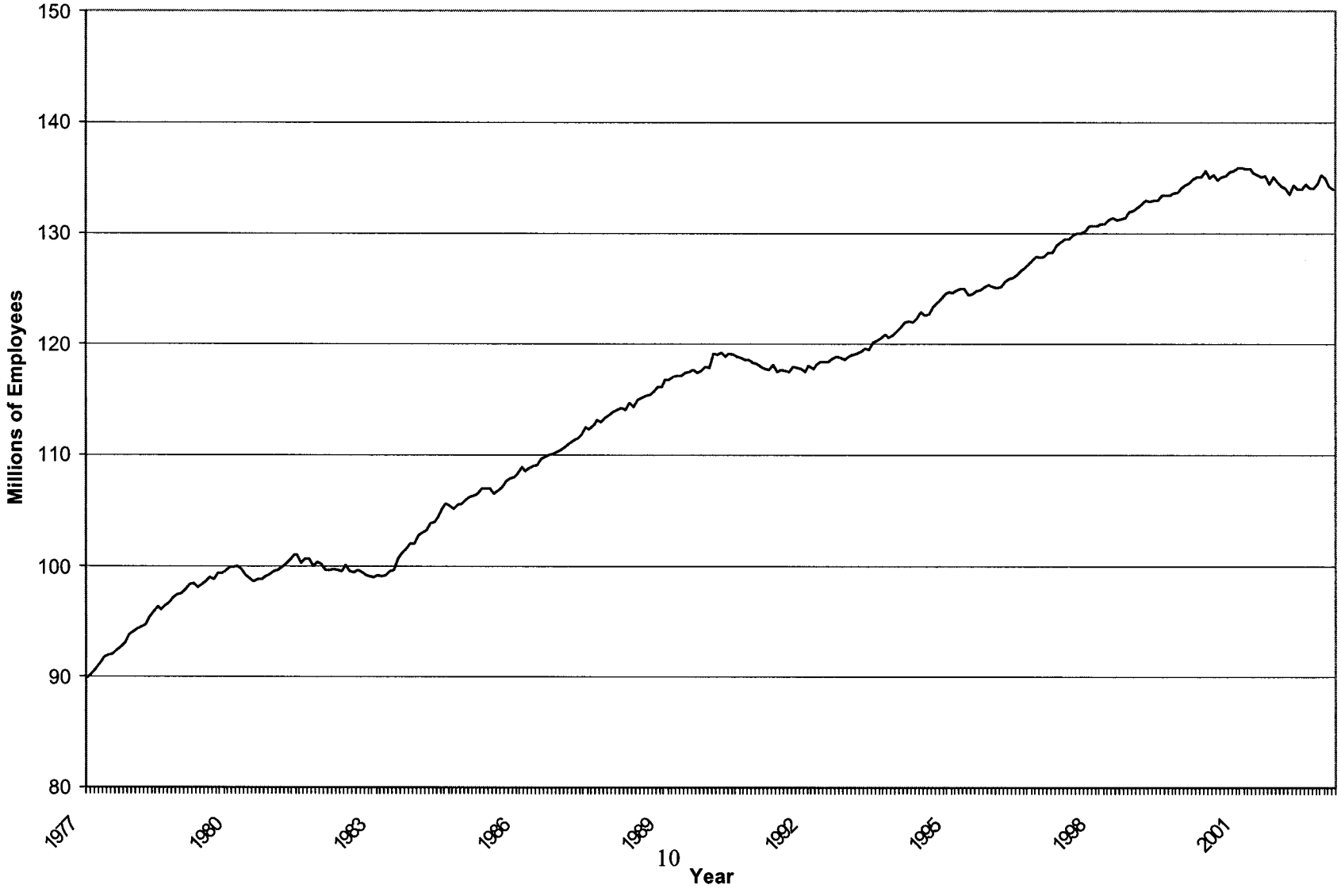
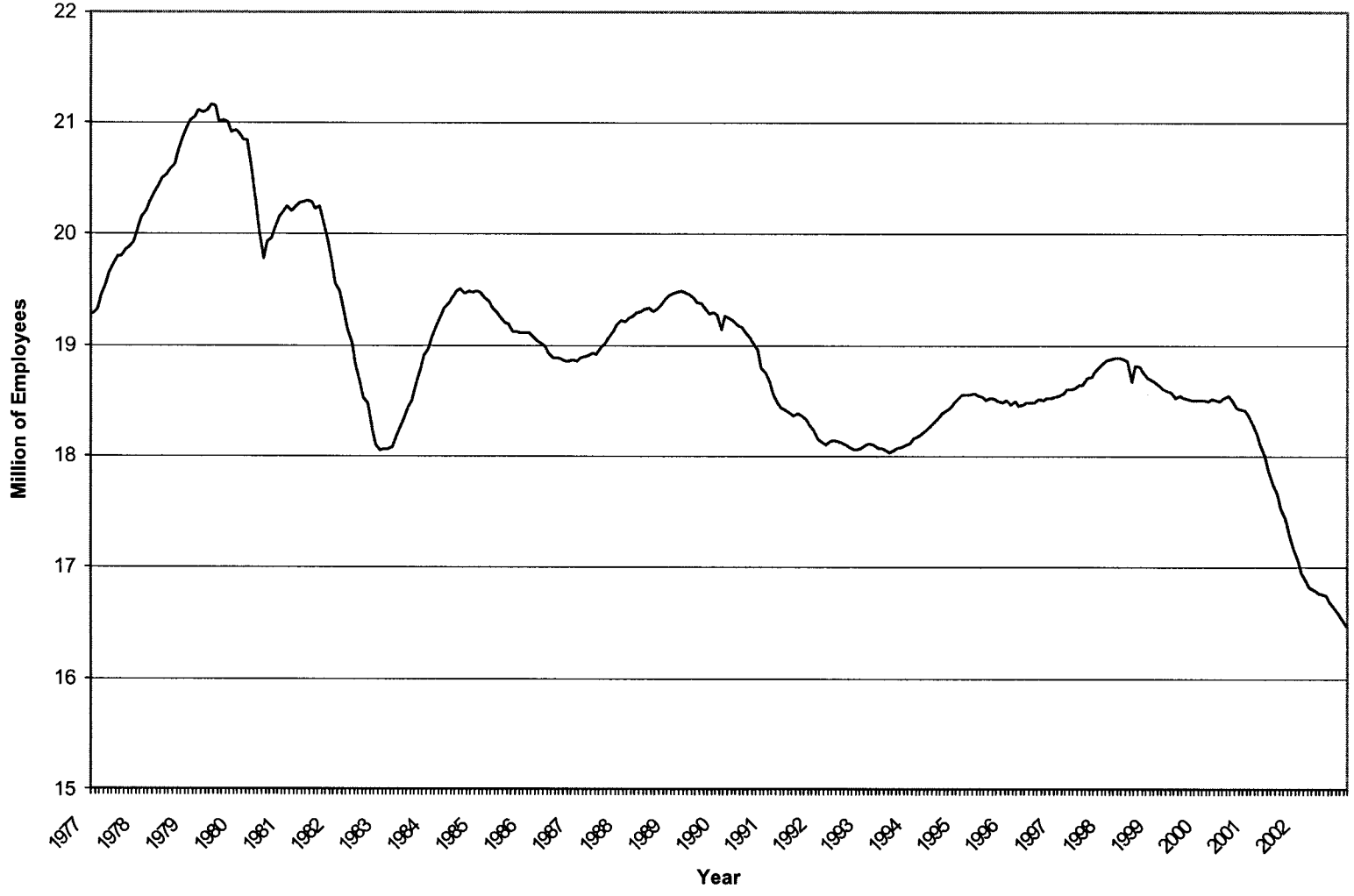


Figure 5.–Manufacturing Employment, Monthly, 1977-2002, [in Millions]



Consumption spending

Figure 6, two pages following, reports the annual nominal value of personal consumption expenditures from 1977 through 2002.[10] The trend over the past 25 years shows little significant year-to-year change in growth. The Bureau of Economic Analysis estimates that personal consumption expenditures for 2002 exceeded $7.3 trillion dollars and that real, inflation adjusted, personal consumption expenditures grew at an annual rate of 2.4 percent in 2002, following real growth rates of 0.3 percent in 2001 and 3.8 percent in 2000. However, the BEA estimates the real growth rate in the fourth quarter of 2002 at 0.7 percent.

Investment spending

Aggregate investment spending has been more variable over the past 25 years than personal consumption spending. Figure 7, three pages following, reports the annual nominal value of gross private domestic investment from 1977 through 2002.[11] Figure 7 shows that during the current recession, like the recessions of the early 1980s and early 1990s private investment declined. The Bureau of Economic Analysis calculates that after growing at a real annual rate of 6.2 percent in 2000, investment spending fell at a rate of 10.7 percent in 2001 before starting to increase during 2002 at the real annual rate of 0.5 percent. The Bureau of Economic Analysis estimates annual gross private domestic investment at $1.6 trillion as of the fourth quarter of 2002.

Inflation rate

Many analysts count the inflation rate as a measure of economic hardship. However, economists generally expect the existence of unemployed resources to exert downward pressure on prices. Figure 8, four pages following, measures inflation by changes in the consumer price index ("CPI") from 1997 through November 2002.[12] Using this measure, the average monthly inflation rate in 2001 was 1.28 percent and in 2002 was 2.47 percent. Measured inflation generally has been below five percent on an annualized basis in every month since 1992. The

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[10] Data for Figure 6 are from the NIPA as reported by the Bureau of Economic Analysis of the U.S. Department of Commerce. These data include the Bureau of Economic Analysis's preliminary estimates for the fourth quarter of 2002 as reported in the "BEA News Release" of January 30, 2003, BEA 03-02.

[11] Data for Figure 7 are from the NIPA as reported by the Bureau of Economic Analysis of the U.S. Department of Commerce. These data include the Bureau of Economic Analysis's preliminary estimates for the fourth quarter of 2002 as reported in the "BEA News Release" of January 30, 2003, BEA 03-02.

[12] The figure measures inflation monthly as the annualized rate of change in the CPI over a three-month period. That is, the inflation rate reported for January 1996 is the annualized rate of change in the CPI for the period January 1996 through April 1996. Similarly, the inflation rate reported for February 1996 is measured as the annualized rate of change in the CPI for the period February 1996 through May 1996. Inflation for other months is calculated in the same manner.

U.S. economy was in a higher inflation environment prior to the 1981-82 recession and the 1990-91 recession than was the case prior to the current economic downturn.

Figure 6.–Personal Consumption Expenditures, 1977-2002

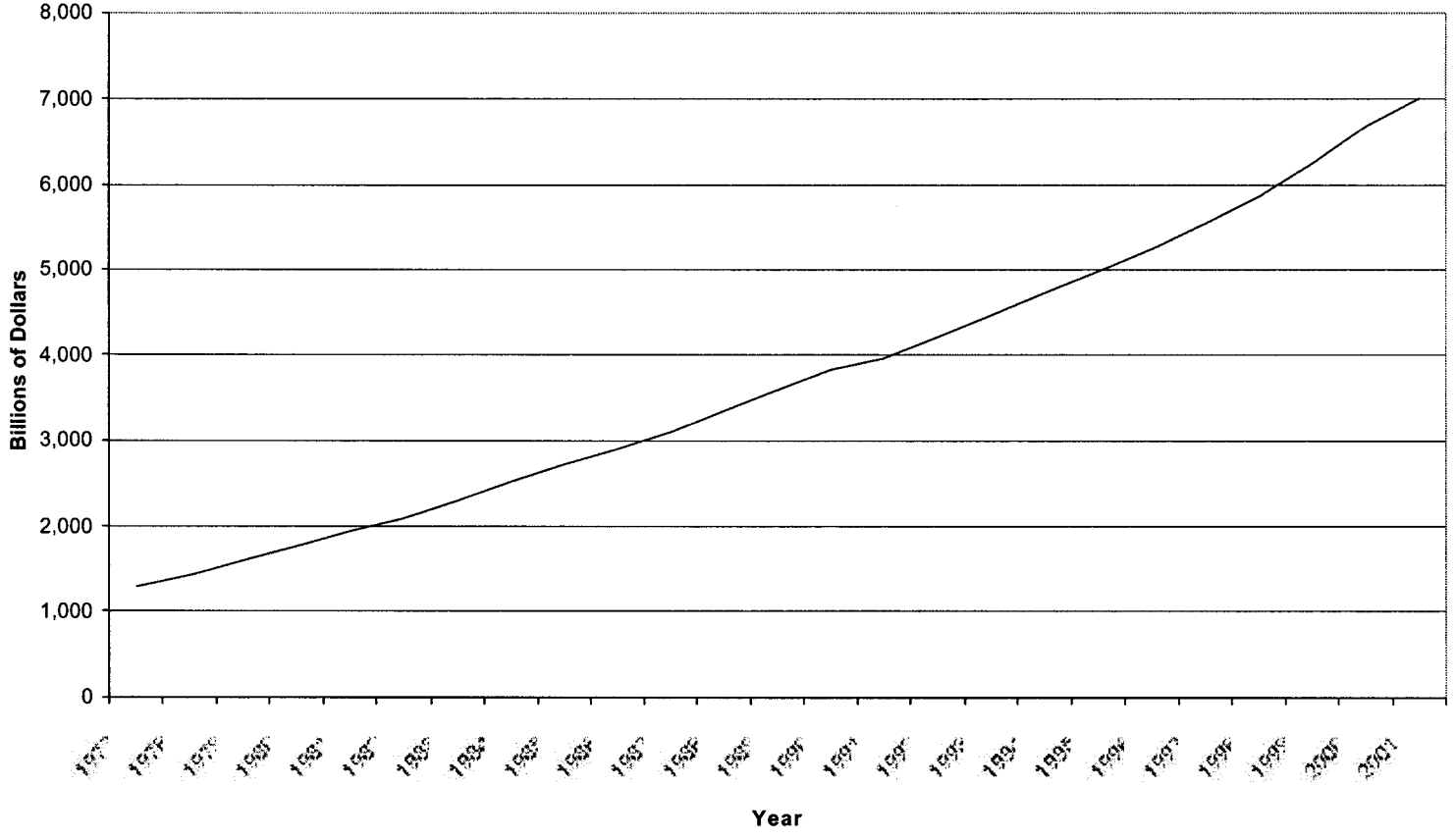


Figure 7.–Nominal Gross Private Fixed Investment, 1977-2002

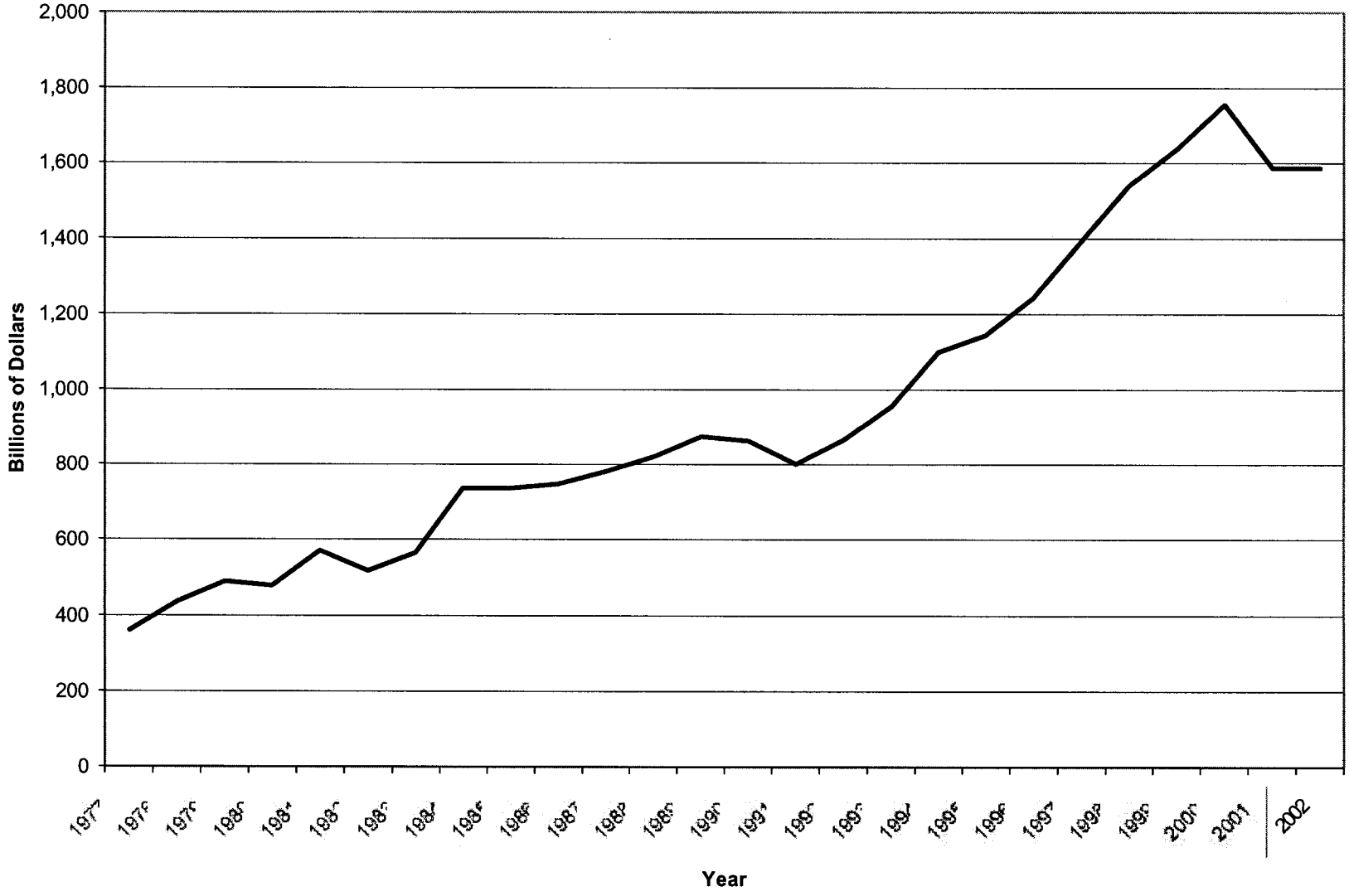
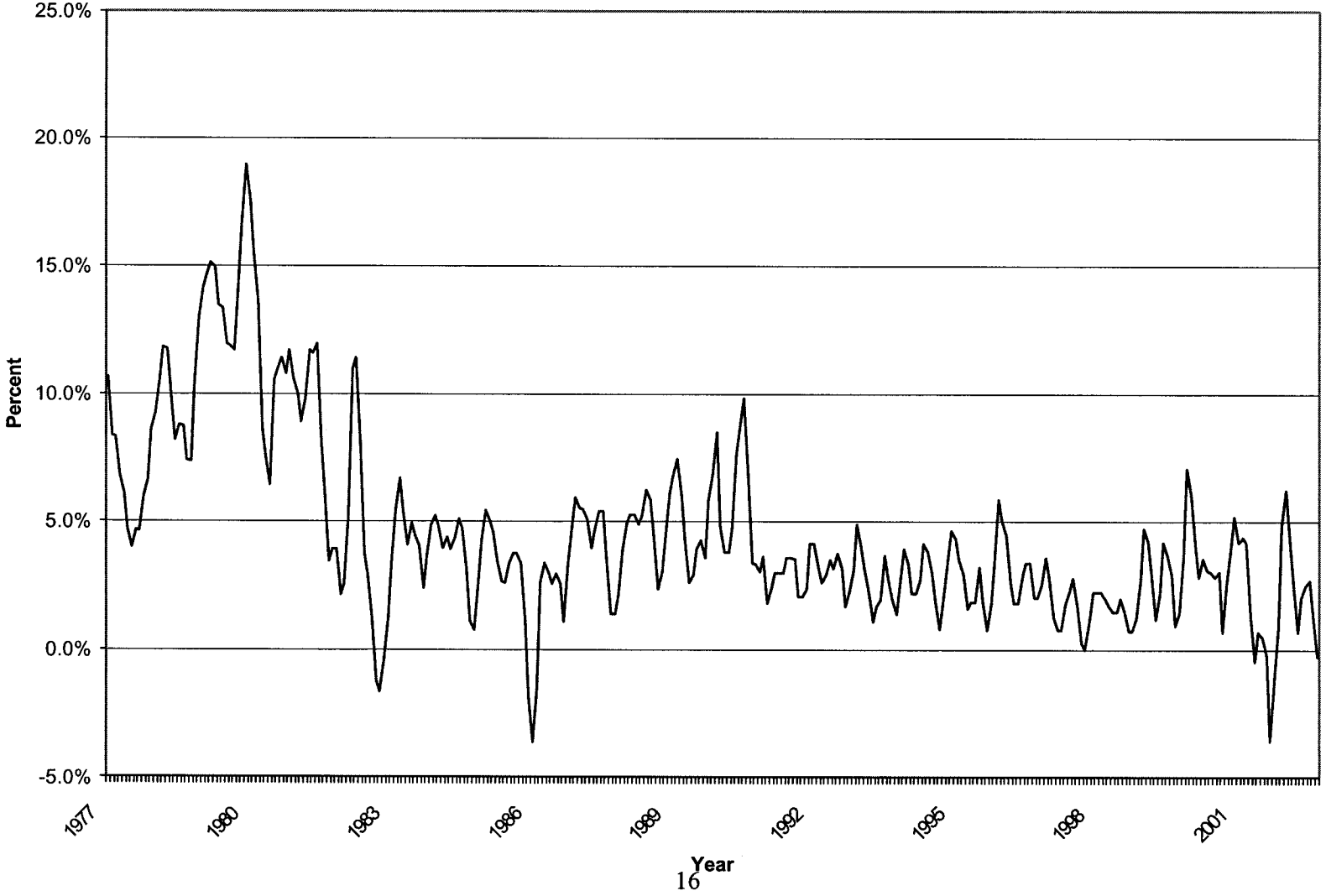


Figure 8.–Inflation Rate as Measured by Three-Month Changes in the CPI, January 1977 through November 2002



Interest rates

Many economists view the role of aggregate demand in the economy as important in determining the depth and length of an economic downturn. Thus, economists analyze consumer spending and business investment spending when interpreting the economy's aggregate performance. For purchases such as homes and automobiles where the consumer often borrows funds to finance the purchase, the level of interest rates can be an important determinant of total cost and, consequently, an important determinant of aggregate consumer demand.[13] Of course, interest costs also are important to business investment decisions and, thus, have an additional effect on aggregate demand in the economy.

It is important to distinguish nominal interest rates from real interest rates. A real interest rate is the inflation-adjusted interest rate. Economists stress that because consumers and businesses pay off loans with nominal dollars (*i.e.*, with dollars that reflect any inflation that may have occurred subsequent to incurring the debt), it is real interest rates that are most important to determining aggregate demand. As Figure 9 shows, while nominal interest rates generally have trended downward since peaks in 1981 (13.92 percent for 10-year Treasury bonds and 14.04 percent for three-month Treasury securities), the course of real interest rates plotted in Figure 10 has been substantially different. The recession of the early 1980s witnessed some of the highest real interest rates experienced in the post-World War II era. Real short-term interest rates near zero have characterized both the 1990-91 recession and the current recession.

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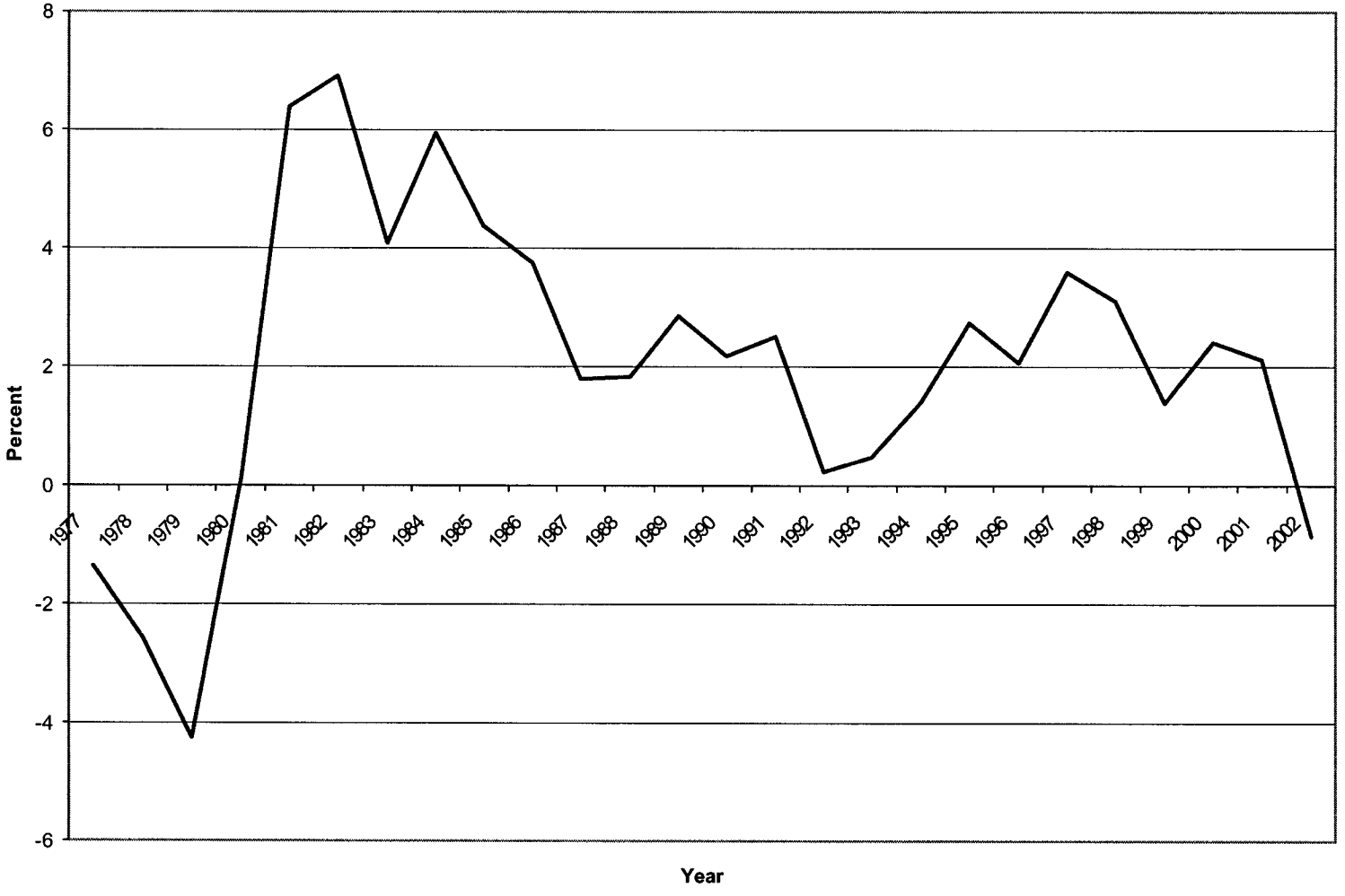
[13] Figure 9 reports average annual yields on 10-year Treasury bonds and average annual yields on three-month Treasury securities in the secondary market as computed by the Board of Governors of the Federal Reserve. The real interest rate in Figure 10 is computed by subtracting the average annualized monthly inflation rate, as computed by changes in the Consumer Price Index as in Figure 8, from the nominal three-month Treasury security rate.

By this calculation, actually measures what economists call the *ex post* real interest rate, that is, the real interest that an investor actually would have earned after accounting for inflation. Economists stress that investment decisions and consumer decisions actually depend upon an *ex ante* real interest rate. An *ex ante* real interest rate is the real interest rate investors and consumers think prevails, accounting for their expectation of future inflation. To the extent that consumer and investor expectations of inflation differ from actual inflation experience, the *ex ante* and *ex post* inflation rates are different. Furthermore, Figure 10 shows the short-term real interest rate, while expected long term real interest rates have more bearing on longer term investment decisions.

Figure 9.–Average Market Yield on 10-Year Treasury Bonds and 3-Month Treasury Bills, 1977-2002

Figure 10.–Real Short-Term Interest Rates, 1977-2002



Stock market valuation

Some economists stress that the overall value of the equity markets can be an important determinant of both current aggregate demand and future aggregate supply. Increasing values in the equity markets increase the net worth of individuals. There is some evidence that aggregate consumer demand increases with increases in net worth. In addition, increasing values in the equity markets can make it attractive for businesses to issue new equity to finance investment in plant and equipment. The increase in plant and equipment adds not only to current aggregate demand, but increases the economy's future economic capacity (aggregate supply). As is well known, the equity markets have slumped since reaching peaks in 2000. Figure 11, below, reports the average value of the Standard and Poors 500 Stock Index and the Nasdaq Composite Stock Index annually for the period 1992-2001. Figure 12, provides monthly values of these two indices from January 2001 through November 2002.

Consumer sentiment

Another factor influencing consumer spending and business investment is expectations about the future: for consumers, expectations about their future financial well being, and for businesses, expectations about future demand for their products. For example, if consumers expect declines in their future economic well being, they often will reduce their expenditures today.

Figure 13 displays the University of Michigan's Index of Consumer Sentiment for 1978 through 2002.[14] After reaching historic highs in the latter half of the 1990s and 2000, the index dropped sharply in 2001 to levels comparable to those recorded during the latter half of the 1980s and the middle portion of the 1990s. The decline in consumer sentiment did not reach the levels experienced in the late 1970s and early 1980s, or the levels of the early 1990s. Furthermore, the decline has been less precipitous than that experienced in 1990.

[14] The Survey Research Center at the University of Michigan makes periodic surveys of consumer attitudes and expectations. The overall index of consumer sentiment is composed of five individual indices: current personal finances; expected personal finances; expected business conditions over the next 12 months; expected business conditions over the next five years; and current buying conditions for durable goods.

Figure 11.–Average Value of Standard and Poors 500 Stock Index and Nasdaq Composite Stock Index, 1992-2001

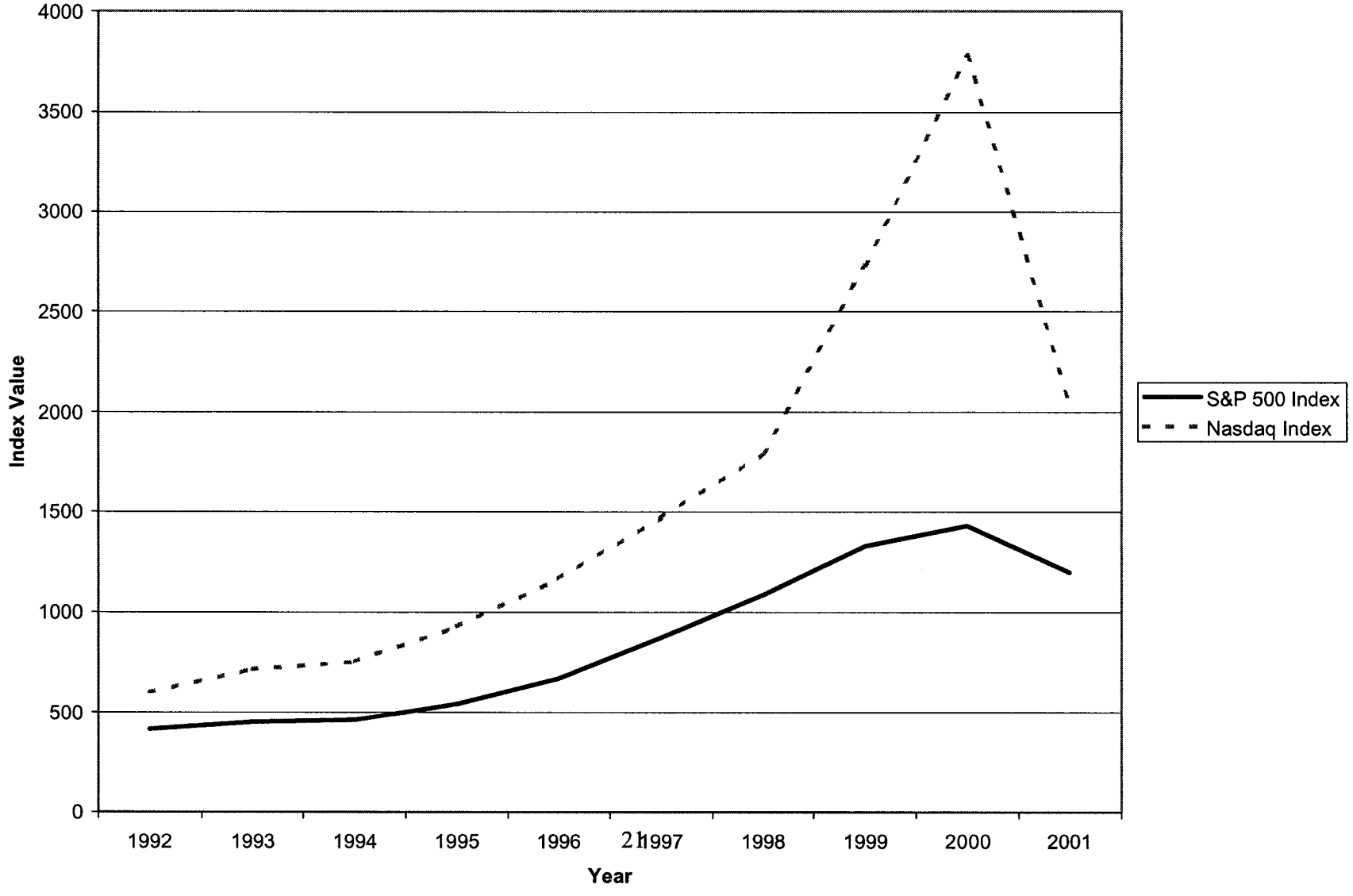


Figure 12.–Standard and Poors 500 Stock Index and Nasdaq Composite Stock Index, Monthly, January 2001 through November 2002

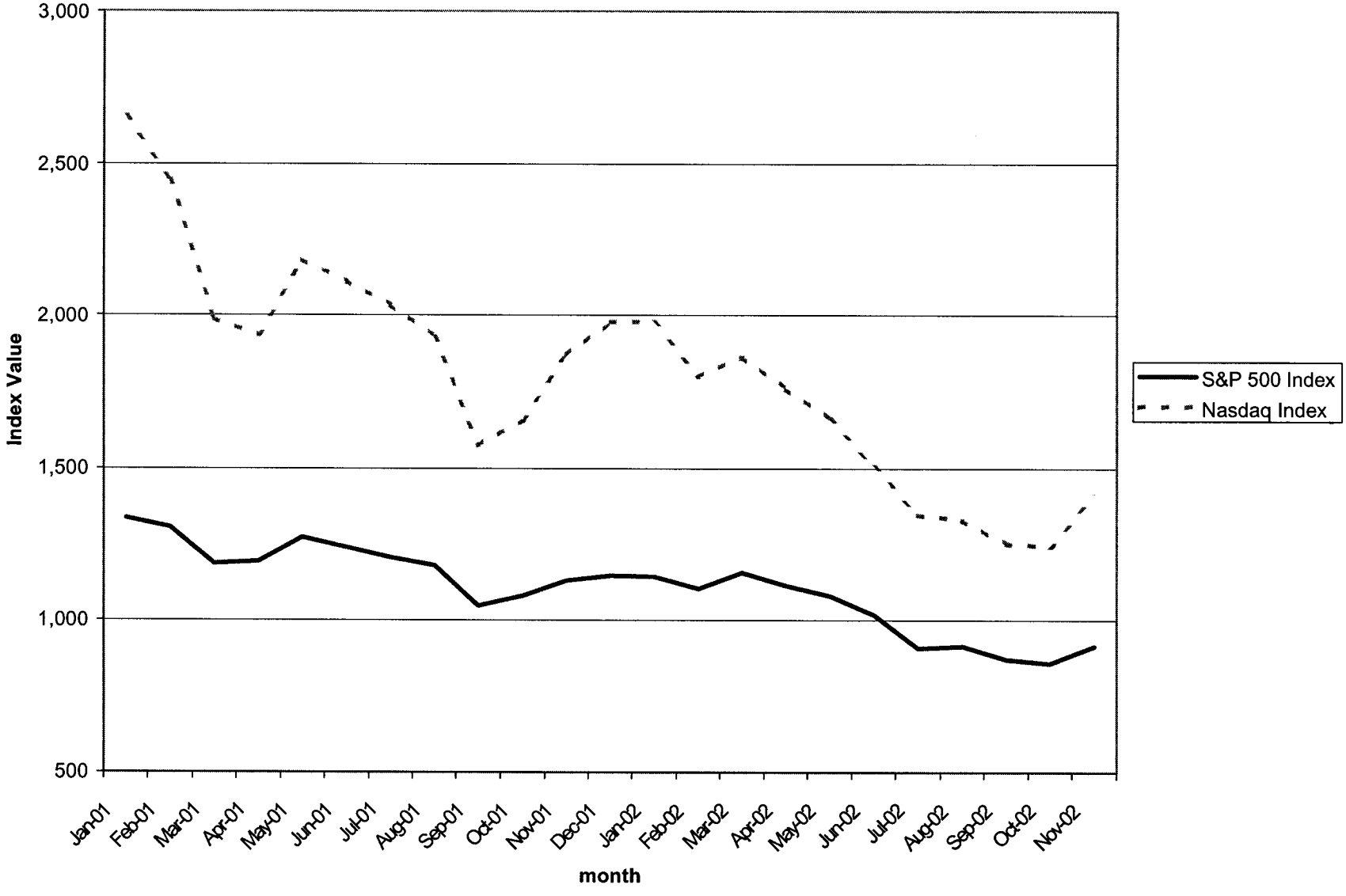
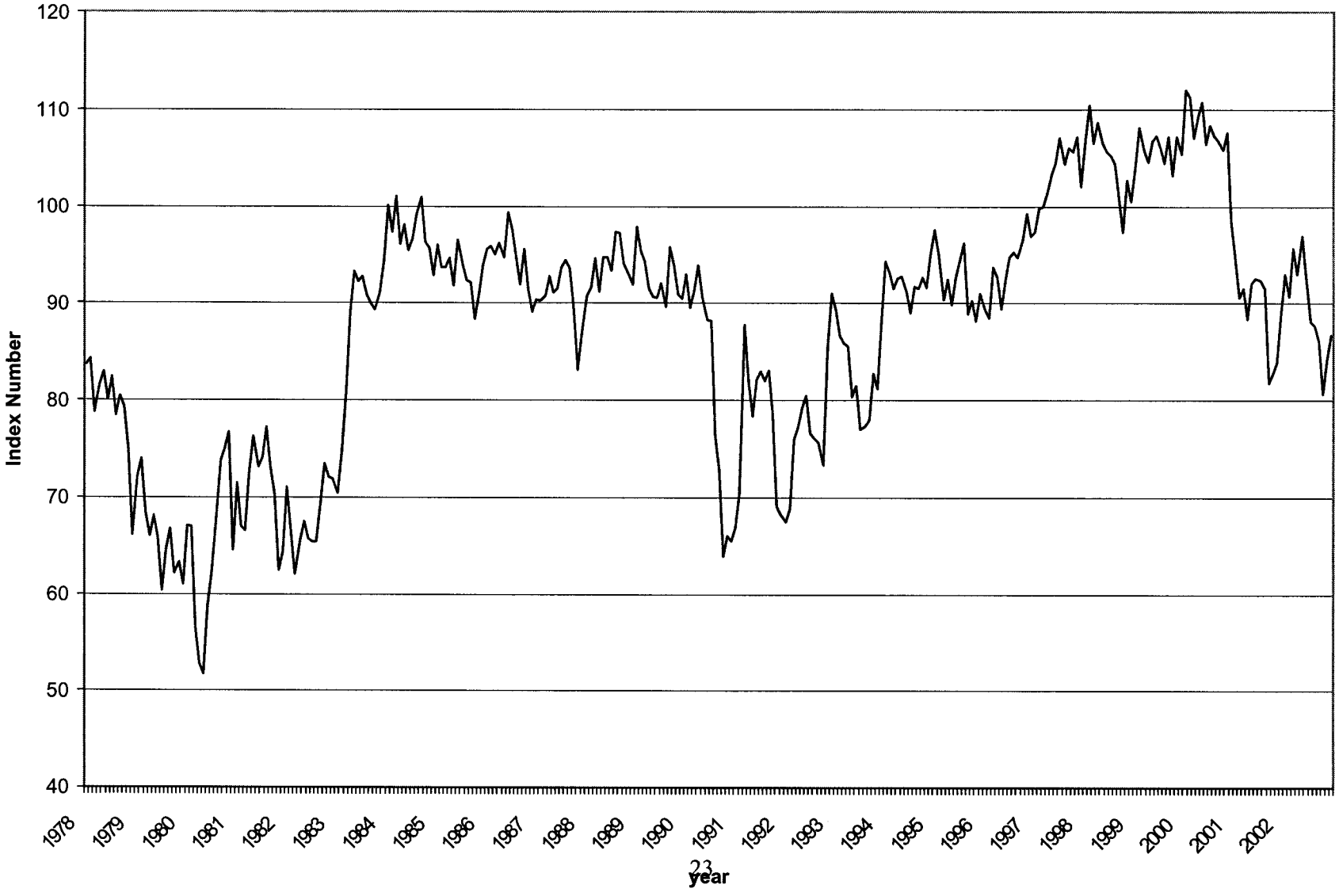


Figure 13.–Index of Consumer Sentiment



Federal deficits

A well-known Keynesian[15] prescription for addressing an economy in recession is to increase aggregate demand with stimulative fiscal policies. While many economists now doubt the efficacy of such policy,[16] the current size of the Federal deficit relative to GDP may limit such a policy in any event. Many observers view the Federal deficit as an indicator of the magnitude of Federal stimulus to aggregate demand. However, the actual size of the Federal deficit provides an inaccurate measure of the stimulative effects of a given set of government policies, because even with no change in government policy, the size of the deficit will change in a recession as the economic downturn reduces tax revenues and increases spending. Nevertheless, the size of the federal deficit at any given time reflects the stimulus provided from current policy given the specific economic conditions at that time.[17]

Figure 13 reports the Federal deficit as a percentage of GDP.[18] As the figure indicates, the Federal budget has recently returned to a deficit after four years of surplus. For the recently concluded fiscal year 2002, the Federal budget deficit was 1.5 percent of GDP. For the 25-year period from 1977 to 2002 that is depicted on Figure 13, the Federal budget averaged a deficit of 2.5 percent of GDP. The Office of Management and Budget predicts a 2003 budget deficit of $304.2 billion, or 2.8 percent of GDP.

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[15] "Keynesian" policies are generally those associated with influencing aggregate demand through fiscal policy. See below, Part II, for a more thorough discussion.

[16] See Part II below for a discussion of this point.

[17] Some economists have commented that the deficit is not an accurate measure of Federal fiscal policy stimulus. They argue that such measures of the deficit include timing of outlays the liability for which may have occurred earlier and that the timing of the outlay has no real effect on the economy.

[18] *Historical Tables, Budget of the U.S. Government, FiscalYear 2004*, Table 1.1 and Table 1.2.

Figure 14.–Surplus (Deficit as Percent of GDP)

Measuring the cost of recession

One measure of the economic cost of a recession is the amount of output lost to the economy. Gross Domestic Product (GDP) represents two measures of well-being. First, GDP represents the total output of the economy. Hence, it measures the goods and services available for consumption. Second, GDP closely approximates the total income earned by persons.[19] Hence, it measures the nation's ability to purchase goods and services. If the economy's resources of labor and capital were fully employed, measured GDP would be greater. Conceptually, the difference between actual and full-employment GDP can be thought of as representing lost consumption or lost income.

The Congressional Budget Office has attempted to measure the economy's potential, or full-employment, GDP. The difficulty with implementing this concept as a measure of the cost of a recession is the difficulty in defining full-employment. The Congressional Budget Office currently estimates full-employment as consistent with a 5.2 percent unemployment rate.[20] Figure 15, below, presents the Congressional Budget Office's estimates of the difference between full-employment GDP and actual GDP for the period 1977-2002. Negative values represent the "cost" of the economy being at less than full employment. Because the unemployment rate averaged less than the Congressional Budget Office's estimate of full-employment for the period 1997 through 2001, that is, the economy was at greater than full employment, actual GDP exceeded the Congressional Budget Office's estimate of full-employment GDP. Only in 2002 did actual GDP drop back below estimated full-employment GDP. The Congressional Budget Office estimates the difference between full-employment and actual GDP for 2002 at $91 billion.[21] The actual GDP in 1992 was $181 billion less than an estimated full-employment GDP of $6.4 trillion, and in 1982 the actual GDP was $204 billion less than an estimated full-employment GDP of $3.4 trillion.[22]

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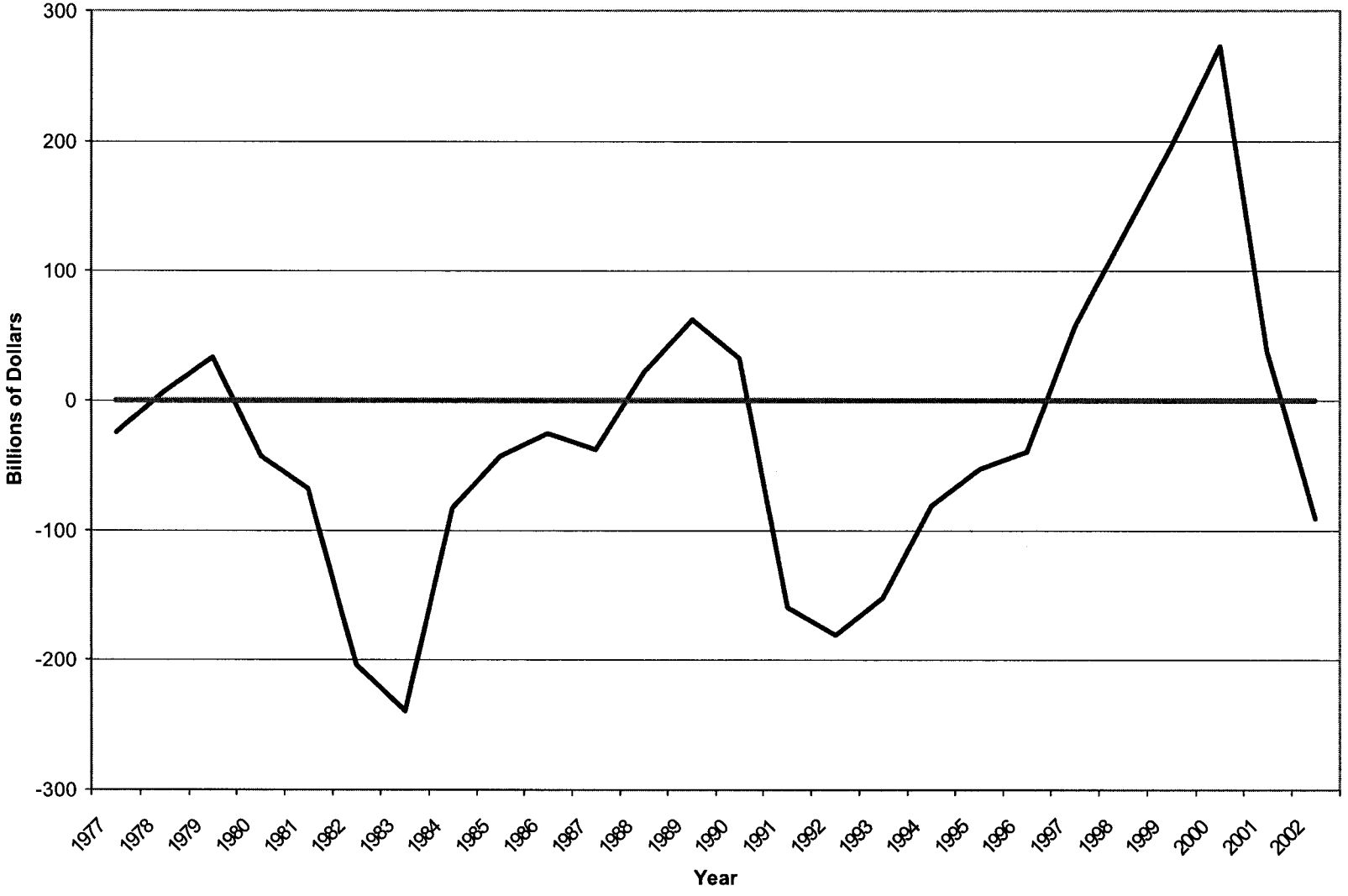
[19] The total income of U.S. persons is the gross national product ("GNP").

[20] United State Congress, Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2004-2013*, January 2003. Typically the benchmark for computing full-employment GDP is estimating how many individuals would be employed if the unemployment rate in the economy were consistent with a nonaccelerating inflation rate. The Congressional Budget Office has estimated the nonaccelerating inflation rate of unemployment to have fallen from a 6.3 percent unemployment rate in 1979 to a 5.2 percent unemployment rate in 1996 through 2002.

[21] *Ibid.*, p. 158

[22] *Ibid.*

Figure 15.–Actual GDP Minus "Full-Employment" GDP, 1977-2002



II. WHAT FISCAL POLICY CAN DO: SUPPLY VS. DEMAND INCENTIVES

A. Macroeconomic Goals and Policies

Aggregate demand and aggregate supply

Part I presented data on the aggregate output of the economy (GDP), documented the recent downturn, and showed the gap between its current level and its potential. The theoretical construct for understanding how the level of GDP and the aggregate price level are determined is the interaction of aggregate demand and aggregate supply.

Aggregate demand measures the total amount of goods and services that households, firms, and governments are willing to buy at given aggregate price levels. It is the sum of consumers' expenditures for goods and services, firms' expenditures on domestic investment goods, government purchases of goods and services, and exports net of imports.

Aggregate supply measures the total amount of goods and services that households, firms, and governments are willing to produce at given aggregate price levels. In the long run, the aggregate supply is equal to potential GDP--the amount of goods and services that could be produced in a given year with full employment of the economy's resources. Aggregate supply is thus determined by the amount of resources available to the economy--natural resources, labor, capital--and the technological know-how to use those resources. In the short run, aggregate supply need not coincide with potential GDP (which is equal to the productive capacity of the economy). Resources may be underused or the economy may be producing beyond normal capacity.

In the long run, increases in potential GDP (aggregate supply) per capita determine the growth rate of per capita consumption possibilities. The higher the growth rate of potential GDP per capita, the more goods and services there are to meet the needs and desires of the households in the economy and the higher the standard of living for those households. Encouraging long-run growth in aggregate supply will thus improve future households' well-being.

As the long-run aggregate supply changes over time, the distribution of income may also change. Policymakers concerned about the distribution of output across households must recognize that redistributive policies are not costless. Tax and transfer policies to change the distribution of goods and services may result in a slower long-run growth of aggregate supply and hence a smaller amount of goods and services available to the economy. The question of how much one is willing to trade off slower growth for a more even distribution of goods and services is a contentious one. Economics cannot offer a judgment as to the "right" answer to this tradeoff.[23]

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[23] Arthur M. Okun used the analogy of a "leaky bucket" to describe the problem facing those who want to redistribute goods and services. Redistribution would proceed as if by transfers using a leaky bucket. In the process of redistribution, potential output is lost. Arthur M. Okun, *Equality and Efficiency*, (Washington, D.C.: Brookings Institution, 1975).

Macroeconomic policies[24] targeted to increasing aggregate supply are designed to increase potential GDP and thus the long-run productive capacity of the economy. For example, investment incentives can lead to an increase in the economy's aggregate amount of capital. With more capital, natural resources and labor can be more productive, so the economy's capacity to produce goods and services increases. Improved education and training for the workforce can increase the quality of a given amount of labor and thus increase capacity. Technological advances can allow increased output from a given stock of resources.

Policies targeted to increasing aggregate demand are designed to move the economy closer to full employment of current capacity. When labor, capital, and natural resources lie idle, an increase in aggregate demand will result in unplanned inventory reductions for producers. In the process of replenishing those inventories, previously idle or underused resources will be called into action. The government can increase aggregate demand directly through increases in its purchases of goods and services, such as through additional public works programs or weapons procurement. The government can also act indirectly through tax cuts or increased transfer payments to individuals in order to increase consumers' disposable incomes. If those increased disposable incomes translate into increased consumption expenditures, then aggregate demand will increase. Government incentives for business fixed investment can lead to increased aggregate demand through increased orders for capital goods.

Targeting possible policies to perceived problems

Before a choice of policies is made, one needs to be clear about the economic problems to be addressed. In general, aggregate supply incentives address the long-run growth of capacity (potential GDP), while aggregate demand incentives address the immediate, short-run problem of underutilization of existing capacity.

If the standard of living provided by the economy in the long run is seen as a major problem, then policy ought to be directed toward increasing aggregate supply. Higher aggregate supply will increase the per capita consumption possibilities of the economy in the long run. One might oppose policies that would address the recent recession if in the process those policies also would hinder the long-run growth of aggregate supply. Instead, one may want to allow recovery to take its course while concentrating policy on attempts to improve the long-run outlook for the economy.

If the recent recession is seen as the major problem, rather than sluggish long-run growth of the economy, then policies targeted to increasing aggregate demand may be appropriate. This is the standard Keynesian prescription of fighting economic contractions by stimulating

[24] This discussion in this pamphlet is limited to the consideration of government fiscal policies that can affect either aggregate demand or aggregate supply. It should be noted that monetary policy, largely the responsibility of the Federal Reserve Board, can also be employed to affect aggregate demand. In the short run, monetary policy may be able to increase aggregate demand by reducing interest rates to stimulate business investment and individuals' durable goods consumption.

aggregate demand,[25] usually with the government directly increasing its purchases of goods and services or indirectly increasing the private sector's purchases of consumption and/or investment goods through tax cuts or targeted incentives. When resources in the economy are fully utilized, then the government stimulus is removed, lest inflation be kindled.

One needs to be clear about the ills to be attacked because a package of actions cobbled together could end up with individual elements working at cross purposes to one another. For example, policies to increase consumption might be appropriate to boost aggregate demand and push the economy toward full employment. Such policies would be inappropriate if inadequate long-run growth in aggregate supply were seen to be the problem. In fact, they would be counterproductive, since increased consumption would come at the expense of national saving. In this case, policies to increase savings would be appropriate to increase aggregate supply. An increased pool of savings might reduce equilibrium interest rates and allow a greater number of investment projects to be financed, thus increasing the size of the capital stock in the long run. But increasing savings could be counterproductive if the recent recession were seen as the main problem. Individuals would be able to increase private savings only by reducing consumption, thus decreasing aggregate demand in the short run. If one believes that both problems of long-run sluggish growth in potential GDP and short-run underutilization of capacity exist, then one also must recognize that policies intended to combat one of the problems may exacerbate the other.

The policymaker's decision is complicated in that some policies may be intended to affect aggregate supply but will also have an effect on aggregate demand and vice versa. It may be difficult to target just one of the two. Moreover, a policy could have a desirable short-run outcome and an undesirable long-run outcome. For example, stimulating consumption through an individual income tax cut could help achieve better utilization of the economy's current capacity, but may inhibit the long-run growth of capacity because the increased consumption comes at the expense of private savings.

Some policies may be able to address both underutilization of current resources and sluggish growth in potential GDP. Increased investment would increase both aggregate demand and aggregate supply. For example, increased spending on either private or public capital goods would increase aggregate demand directly,[26] and would increase aggregate supply through the addition to the capital stock.

The design of the investment incentives is important, however. In order to accomplish both goals, the incentives must work on the margin, that is, inducing investment that would not otherwise have taken place. Current use of capacity would increase as production geared up to meet the increased demand for investment goods. Future productive capacity would be increased as the new investment took place and the capital stock was increased beyond what would have

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[25] "Keynesian" policies are generally those associated with influencing aggregate demand through fiscal policy. See below for a more thorough discussion.

[26] As noted above, firms' expenditures on domestic investment and government spending on goods and services are both components of aggregate demand.

occurred in the absence of the incentives. If instead the investment incentives induced no new investment but simply paid benefits to investment that would have occurred anyway, then only aggregate demand would increase. Economists would call such an investment incentive "inframarginal" because it does not change the effective cost of acquiring an additional (i.e., marginal) unit of capital. The benefit such an incentive provides will increase current demand by increasing the income of the firms and individuals who receive it. But if national savings is reduced, as would happen if this inframarginal investment incentive is financed by government borrowing, then the long-run growth of potential GDP will be slowed even more.

B. Management of Short-Run Fluctuations in Aggregate Demand through Fiscal Policy

Overview

The term "fiscal policy" is usually associated with changes in the government's budget deficit. Fiscal policy intended to stabilize the short-term fluctuations in the nation's total demand for goods and services is generally referred to as "Keynesian policy."[27] Keynesian fiscal policy may take the form of a change in government spending or a change in the amount of tax or of a combination of expenditure and tax changes. Keynesian policy may be "automatic" as in the case of programs already in place that increase transfer payments and reduce taxes during a recession. Alternatively, fiscal policies may be "discretionary" as in the case of statutory increases in public works or reductions in tax that are intended to stimulate the economy in a recession. Examples of discretionary tax policies that might stimulate demand include reductions in individual income tax rates, increases in tax credits, increases in personal exemptions, cuts in social security taxes, cuts in excise taxes, increased business tax credits, and more accelerated methods of depreciation.

In the 1960s and 1970s, it was commonly assumed that government policies could reduce unacceptably high unemployment with little impact on inflation,[28] and that it might be possible to "fine tune" the economy.[29] This view of the possibilities of macroeconomic policy came into question in part because it is not supported by developments in macroeconomic theory and in part because the track record of discretionary fiscal policy reveals that in many cases policies intended to dampen business cycles actually contributed to destabilizing the economy.[30] In contrast to its central role during the 1960s and 1970s, Keynesian economics played a relatively minor role in economic decisionmaking in the 1980s and 1990s.

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[27] In reference to economist John Maynard Keynes, author of *The General Theory of Employment, Interest and Money* (London: Macmillan, 1936).

[28] *See*, for example, *1962 Economic Report of the President*, pp. 37-38.

[29] *See*, James Tobin, *The New Economics One Decade Older* (Princeton: Princeton University Press, 1974), pp. 36-37.

[30] N. Gregory Mankiw, "A Quick Refresher Course in Macroeconomics" *Journal of Economic Literature*, Vol. XXVII (December 1990), pp. 1645-1660.

C. The Standard Keynesian Macroeconomic Framework

Distinction between recessions caused by changes in aggregate demand and aggregate supply

The experience of the 1970s has made clear to economists that recessions may be caused by movements in either aggregate supply or aggregate demand. The rapid increases in oil prices in 1973 and 1979 caused large and sudden reductions in aggregate supply. The distinction between a recession caused by a change in aggregate demand and one caused by a change in aggregate supply is important because different and often opposite macroeconomic policies are appropriate depending upon a recession's nature and causes.

The role of demand in business cycles

In the private sector, three major components of aggregate demand are consumption expenditures by domestic households, capital expenditures by domestic businesses, and net exports to foreigners. Government expenditure on goods and services is a fourth major component of aggregate demand.

If the cause of a recession is a decline in aggregate demand, the standard policy prescription is government action to increase aggregate demand. For example, consider the case where the economy had aggregate demand that initially was sufficient to fully utilize all its productive capacity. Suppose, however, that business expectations about future profitability declined so businesses reduced investment spending. In this case, there is a decline in aggregate demand that could result in a recession. The remedy typically prescribed would be an attempt to increase aggregate demand through an increase in government spending or a reduction in taxes.

Fiscal policy and aggregate demand

The government can increase aggregate demand directly by increasing government expenditures on goods and services. Alternatively, aggregate demand of the private sector may be stimulated by tax cuts. Individual tax cuts may increase consumption expenditures, and business tax cuts may increase capital expenditures. Budget policy is only one of two methods of stimulating aggregate demand. The government, through various actions of the Federal Reserve Board, may also attempt to increase aggregate demand through increases in the money supply or reductions in interest rates.

Keynesian policies are appropriate only when an economy is not utilizing its full capacity. If the economy is near full capacity, fiscal stimulus is less likely to be effective in increasing real national income because demand already may be adequate to utilize fully existing capacity. In this case, fiscal stimulus would not increase income because national income generally cannot exceed the value of the economy's output when it is operating at full capacity. Furthermore, increases in aggregate demand when the economy is already fully employing its resources would result in inflation.

Multiplier effects

A central consideration in the implementation of any fiscal stimulus is the degree that national income increases as the result of increases in government spending or reductions in taxes. It might be the case that, for example, a $1 billion increase in government expenditures increases national income by more than $1 billion. This occurs because the $1 billion of government expenditures (if spent on domestic goods and services) may result in $1 billion of income to the domestic producers of the goods and services purchased by the government and the $1 billion of earnings, in turn, may be spent on domestic goods and services. This second round of expenditures will most likely be less than $1 billion, say $800 million, since some of that income will be saved or spent on imported goods. The second round of $800 million in expenditures can raise income by $800 million which induces another, but smaller, round of expenditure. Thus, an initial government expenditure induces many rounds of expenditure, but each successively smaller. If all individuals in the economy devote 80 cents of each additional dollar of income to domestic expenditures, a $1 billion increase in government expenditures could increase national income by $5 billion. This is known as the "multiplier effect" of fiscal policy.

Although these potential increases in national income are multiples of an increase in the budget deficit, there are many reasons to expect that multiplier effects are relatively small. First of all, Keynesian policy is only effective to the extent the economy is operating below full capacity, and many economists now believe that the economy will not operate below full capacity for extended periods. Furthermore, as will be discussed more fully below, even if current demand were substantially below aggregate supply, tax cuts may not have as large an effect on demand as portrayed in these simple models because higher interest rates and higher prices could crowd out any fiscal stimulus.

Potential effects of revenue-neutral changes

Fiscal policies that are intended to affect aggregate demand usually involve changes in the government budget deficit. However, given the differences in various policy multipliers, there is potential for policy combinations with both expansionary and contractionary elements to provide on net some fiscal effects without any overall change in the size of the government budget deficit. The fiscal effects of these balanced budget policies may be either positive or negative. In either case, their effects on output will tend to be substantially less than policies that affect the deficit.

Tax cuts financed by reduced spending.–The effect on aggregate demand of a change in government spending is considered generally to be greater than the fiscal effect of change in taxes of an equal dollar amount. Therefore, a tax cut that is financed with cuts in government spending could be mildly contractionary. This would occur because the household sector saves and purchases imports with some portion of their tax benefit (say, 10 cents of every dollar of tax reduction), and therefore its increase in spending does not entirely offset the reduction in government spending. Macroeconomists refer to the policies that combine tax changes and offsetting changes in spending as "balanced-budget" Keynesian policies. Even under the most favorable conditions, "balanced-budget multipliers" are generally believed to have values no greater than one, i.e., a $1 billion reduction in taxes matched by a $1 billion reduction in

government expenditures could reduce national income by $1 billion at most and, conversely, a $1 billion increase in taxes matched with a $1 billion increase in government spending could increase national income by no more than $1 billion.[31] Thus, although fiscal policy that does not increase the deficit may potentially have some effect on aggregate demand, this effect is relatively small and could be either expansionary or contractionary.

Fiscal effects of redistributive tax policies.–The effects of tax changes on the consumption of low-income households are generally considered to be larger than the effects on the consumption of high-income households because low-income households are generally considered to consume more of their current income than do high-income households. Therefore, it is sometimes asserted that tax cuts for low-income households financed by tax increases on the high-income households could be mildly expansionary in the short-run if such a change elicited net increases in spending. This line of reasoning is subject to many caveats (which are discussed below).[32]

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[31] *See* Walter A. Salant, "Taxes, Income Determination, and the Balanced Budget Theorem," in Robert A. Gordon and Lawrence R. Klein, eds., *Readings in Business Cycles* (Homewood, Ill. R.D. Irwin, 1965). It is important to bear in mind that these are short-run multipliers only, and that most economists believe that in the long run such balanced budget fiscal policy does not increase the size of the economy but rather only affects the size of the government sector compared to the private sector.

[32] *See* also, Shapiro, Matthew and Slemrod, Joel, "Consumer Response to Tax Rebates," National Bureau of Economic Research working paper # 8672, December 2001, and "Did the 2001 Tax Rebate Stimulate spending? Evidence From Taxpayer Surveys," National Bureau of Economic Research working paper # 9308, October 2002, for recent research on the stimulative effects of the tax rebates provided in the Economic Growth and Tax Relief Reconciliation Act of 2001, which cast some doubt on the size of the short-term marginal propensity to consume increased income from tax cuts, and thus on the short-term stimulative effects of tax cuts.

D. Limitations of the Standard Keynesian Framework

1. Theoretical shortcomings of the standard framework

(a) Potential "crowding out" of the private sector in the credit markets

Adverse impact on interest rates

Effect on investment and consumer durables.–The simplified analysis described above ignores the impact of fiscal policy on financial markets. An increase in aggregate demand usually will increase the demand for money and credit and, therefore, potentially may increase interest rates and cause the rationing of credit. The most obvious manifestation of this "crowding out" effect is that spending or tax cuts that are financed with increased issuance of government bonds may increase the rate of interest in the government bond markets. This rise in the government bond rate in turn will raise rates for bonds issued by corporations and State and local governments as well as rates for consumer, mortgage, and business loans. Such a tightening of credit markets can reduce business investment and personal consumption expenditure. This especially may be true for interest-sensitive sectors such as housing and consumer durables, and for capital goods purchased by small businesses and other businesses that may have difficulty in obtaining credit.

Effect on trade.–Besides the contractionary effects of higher interest rates on consumer durables and investment goods, higher interest rates may also have a negative effect on net exports. Higher domestic interest rates attract foreign investment, which drives up the value of the dollar. An appreciation of the dollar reduces the cost of imports to U.S. residents and raises the price of U.S. exports in foreign markets. If these price changes result in a net reduction in exports, there would be a contraction in the aggregate demand for U.S. goods and services.

Any reduction of expenditures due to higher interest rates will at lest partially offset the initial fiscal-policy stimulus. Under certain conditions, if the fiscal stimulus sufficiently tightens credit conditions and expenditures are particularly sensitive to higher interest rates, then the fiscal stimulus could be completely eliminated. Although complete crowding out seems unlikely when the economy is in recession, the amount of any fiscal stimulus provided by the budget policies described above could be substantially reduced by the negative effects of higher interest rates.

Potential "accommodation" by the Federal Reserve

Because of these potentially adverse effects of fiscal policy on credit markets, it often is suggested that fiscal policy would be most effective if accompanied by expansionary monetary policy. Expansionary monetary policy could keep interest rates low and credit abundant despite increased demand for money and loanable funds. This type of accommodating monetary policy may alleviate any tightening of credit, especially in the short run. However, this pairing of monetary policy with fiscal policy is not necessarily desirable. Many economists believe that,

whatever improvements in credit conditions are provided by expansionary monetary policy, they are not sustained in the long run and are earned only at the cost of a higher rate of inflation.[33]

(b) Government debt and national wealth

Even if there is no crowding out in the credit markets, many economists believe that increases in deficits do not stimulate aggregate demand. According to this school of thought, fiscal policy changes provide no net stimulus because individuals receiving a tax cut or the income from increased government expenditures recognize that additional disposable income realized today will be offset by tax increases in the future that will be assessed to support the current increase in the deficit.[34] For example, it is widely believed that consumption is a function of consumers' wealth, which includes the value of assets net of debt obligations plus the present value of future earnings. Because cuts in capital taxes increase the value of capital and cuts in wage taxes increase the present value of future earnings, tax cuts, especially permanent tax cuts, are believed to increase wealth and therefore increase consumption. However, many economists would argue that wealth is really not increased when increased future tax obligations (necessary to fund the current debt) are taken into account.

It may be improbable that all consumers fully take into account increased future tax obligations that result from an increase in the current government deficit. However, it does seem plausible that an increase in personal wealth resulting from a tax cut financed by an increase in public debt is less stimulative than a real increase in wealth resulting from higher pre-tax income.

(c) Prices and expectations

Standard Keynesian analysis assumes that increases in aggregate demand have little or no impact on the level of prices. When changes in the price level are taken into account, expansionary Keynesian policy may increase inflation as well as the level of employment. This is more likely the closer the economy is to full employment (as defined above). Therefore, any benefits of increased output and employment of Keynesian policy must be weighed against the costs of potentially higher inflation.

The ability of prices and wages to adjust to fiscal stimulus weakens the whole conceptual basis of Keynesian analysis. If prices adjust (as they should in an efficient market economy),

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[33] Milton Freidman, "The Role of Monetary Policy," *American Economic Review*, vol. 58 (March 1968), pp. 1-17.

[34] This proposition is known as the "Ricardian equivalence" theorem. For more discussion, see Robert Barro, "Are Government Bonds Net Wealth?" *Journal of Political Economy*, vol. 82, November-December 1974. Ricardian equivalence does not necessarily hold in an economy where consumers and businesses are unable to obtain sufficient credit to meet their demands. In that case, when the government borrows to put cash in the hands of its citizens through lower taxes or increased spending it is, in effect, borrowing on their behalf. Accordingly, government borrowing may have some impact on output even though consumers perceive the future tax liability because in effect they get a loan for consumption through the government that they would not otherwise be able to obtain.

there really can be no unemployment except that which is "voluntary," or that which is temporary, existing only while sluggish wages and prices adjust. If involuntary unemployment is only temporary, the benefit of fiscal policy may only be short-lived. Critics of the use of activist macroeconomic policy argue that because wages and prices will adjust anyway, there is no substantial benefit from any attempt at activist fiscal management of the economy.[35]

If wages and prices adjust rapidly to changes in circumstances, critics of activist policy argue that stimulating aggregate demand may only serve to increase inflation. Fiscal stimulus may temporarily increase employment because when the price level increases in response to increased demand, workers are offered higher wages, but do not immediately realize that these apparent gains have been offset by a higher cost of living. During this period there may be an expansion of production because "workers are fooled" by higher nominal wages, but this expansion is only temporary until workers realize their real wages have not increased. In the long run, the fiscal policy multipliers are zero; thus, there is no long-run increase in employment from Keynesian aggregate demand stimulus.[36]

2. Practical problems of implementing fiscal policy

(a) Keynesian policies are inappropriate for recessions due to supply shocks

All of the traditional Keynesian responses discussed here are responses to "demand-shock" recessions. As noted above, not all recessions are the result of deficiencies in aggregate demand. The two major recessions of the 1970s were primarily the result of major oil price increases that increased the cost of production, thus reducing aggregate supply. There is also some evidence that the 1990-91 recession, at least in part, was the result of the spike in oil prices resulting from the August 1990 Iraqi invasion of Kuwait.[37]

Fiscal policies are poorly suited to help fight recessions that solely are the result of supply shocks. If a supply-side recession is not recognized as such and expansionary fiscal policies are implemented, the result may be more harmful than beneficial. For example, if expansionary fiscal policies were pursued in response to high unemployment during a supply-shock recession, the result could be little increase in employment and a further acceleration of inflation because the economy might already be at full employment.

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[35] These economists also argue that even if it is theoretically possible for government policy to help direct the economy toward full employment and therefore derive at least some short-term benefit from policy, practical implementation problems make this possibility unlikely. This is discussed in more detail below.

[36] When economists incorporate "rational expectations" into their models, unless macroeconomic policy is random, workers on average will anticipate policy and will not be fooled by it. Therefore, macroeconomic policy cannot increase employment, even in the short run. Only erratic policy changes that workers cannot anticipate can have an effect on real output of goods and services, and these changes will only be temporary.

[37] *See* the *1991 Economic Report of the President*, pp. 80-81.

(b) Uncertainty about the correct amount of fiscal stimulus

Even if the recession is of the demand variety, there are numerous practical problems with the implementation of fiscal policy.

Closing the gap between actual and potential GDP

Fiscal policy cannot be guided simply by reaction to the levels of inflation, employment, or economic growth. For example, it is difficult to judge what level of unemployment justifies government intervention. Although at first it may seem desirable to eliminate unemployment entirely, most economists agree that there is some "natural" rate of unemployment. Economists note that this unemployment results from normal job turnover as workers cannot usually start a new job as soon as an old job ceases. Any attempt to utilize expansionary fiscal policy to reduce unemployment below the natural rate would be inflationary. Similarly, not all inflation can or should be reduced by contractionary fiscal policy. The oil price increases of the 1970s had little to do with excess aggregate demand, and any efforts to reduce this inflation with contractionary fiscal policy would have only exacerbated unemployment and prolonged the recession by decreasing aggregate demand in an economy already subject to a supply shock.

Fiscal policy can only increase employment in a recession to the degree aggregate demand falls short of output achievable at full capacity. (This shortfall is sometimes known as the "deflationary gap.") Fiscal policy can only reduce inflation in an economic expansion to the extent there is an excess of aggregate demand over the output of an economy at full capacity (the "inflationary gap"). Ideally, fiscal policy would be designed to close the gap between actual GDP and "potential GDP" of an economy utilizing its full productive capacity. (This gap over the 1977-2002 period is illustrated in Figure 15 of Part I.) Unfortunately, precise measurement of GDP requires some time for data collection, and often the figures first released are revised. Furthermore, potential GDP is a concept that can never be estimated precisely. In sum, the goal of Keynesian fiscal policy is to close the gap between actual and potential GDP, but that gap can never be measured precisely.

Even if the size of the gap between actual and potential GDP were known, implementation of activist fiscal policy still could not proceed smoothly because of the uncertainty about the degree to which a given change in fiscal policy can close the gap since there is a great deal of uncertainty about the size of fiscal policy multipliers. Empirical evidence from econometric models provides some evidence, but no two models yield the same results.[38] Furthermore, these multipliers will vary according to whether the economy is an expansion or a recession, and according to whether the policy is a temporary or permanent change. Because of this "multiplier uncertainty," even advocates of fiscal policy acknowledge that policymakers should only attempt to partially close the gap between actual and potential GDP.[39]

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[38] *See* Gary Fromm and Lawrence R. Klein, "A Comparison of Eleven Econometric Models of the United States," *American Economic Review*, vol. 63 (May, 1973), p. 392, Table 6.

[39] *See* William Brainard, "Uncertainty and the Effectiveness of Policy," *American Economic Review*, vol. 57 (May 1967), pp. 411-425.

Uncertain effect of taxes on consumption

If fiscal policy is implemented through changes in taxes (as opposed to changes in government expenditures), the degree of uncertainty about the effects of fiscal policy is greater since it is difficult to gauge the effect of tax changes on private behavior. One difficulty arises because of widely acknowledged differences between temporary and permanent tax cuts. Because consumption is believed to be a function largely of lifetime or "permanent" income, tax cuts that are small and temporary are not believed to have a significant impact on consumption expenditures, except to the degree that consumers are unable to obtain credit and the tax cut increases their cash flow. Economists generally believe that a permanent income tax reduction will have a substantially larger effect than a temporary income tax reduction.[40]

Uncertain effects of taxes on investment

The effects of tax cuts for business expenditures on investment are also the subject of controversy. There is a long-standing dispute in the economics profession as to whether tax reductions for capital spending--such as the availability of accelerated methods of depreciation or investment tax credits--have any substantial impact on investment expenditures.[41] These investment incentives reduce the cost of capital, but there is no consensus about the responsiveness of investment to changes in the cost of capital. Whatever the impact, it is likely that temporary incentives for investment have different impacts than permanent incentives. To stimulate aggregate demand, temporary tax credits may have more potential than permanent tax credits (even if they have no long-term impact on the overall productive capacity of the economy) because they can cause businesses to accelerate investment spending.[42]

(c) Policy lags and uncertainty about the timing of fiscal policy

In addition to the significant theoretical and practical objections to using fiscal policy to mitigate business cycles, perhaps the greatest difficulty involves the timing of policy changes. Unfortunately, macroeconomic indicators are difficult to interpret and implementation of macroeconomic policies is clumsy. Therefore, even if fiscal policy can be justified theoretically, difficulties in practical implementation may greatly limit its utility as anti-recessionary policy.

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[40] Alan S. Blinder, "Temporary Income Tax Changes and Consumer Spending," *Journal of Political Economy*, February, 1981.

[41] For example, *see* Dale W. Jorgenson, "Econometric Studies of Investment Behavior: A Survey," *Journal of Economic Literature*, Vol. 9, December 1971; and Robert Eisner, "Econometric Studies of Investment Behavior: A Comment," *Economic Inquiry*, Vol. 12, 1974, pp. 91-103. Also, *see*, Alan J. Auerbach and Kevin Hassett, "Investment, Tax Policy, and the Tax Reform Act of 1986," in Joel Slemrod, editor, *Do Taxes Matter? The Impact of the Tax Reform Act of 1986*, (Cambridge, MA: The MIT Press, 1990), for a discussion of factors that make it difficult to discern the effects of tax policy on investment.

[42] Similarly, an explicitly temporary reduction (or an announced future increase) in excise taxes may be effective in quickly shifting aggregate demand as consumers speed up purchases in anticipation of higher taxes.

Recognition lag.–The first problem is timely recognition of the need for fiscal policy. It may takes several weeks or months for reliable economic data to be collected. Then a pattern regarding the direction of the economy may not be discernible for several additional months. Although macroeconometric forecasting models may provide some ability to foresee economic conditions, the accuracy of these models may not be sufficient to warrant changes in policy.

Implementation lag.–The second potential problem involves the time between recognition of need for fiscal policy and the actual implementation of change. It may take many months for a major tax bill to work its way through the legislative process and onto the President's desk.[43] In addition, there may be a lag between the date of enactment and the effective date of the legislative provisions.[44]

Effectiveness lag.–Even after a fiscal policy is enacted, the bulk of its effects on the economy may not occur for many more months.[45] Furthermore, different policies will have different effectiveness lags. For example, a widely anticipated, explicitly temporary incentive for investment that may be placed into service relatively quickly may have a shorter effectiveness lag than a permanent tax incentive for self-constructed capital assets.

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[43] The policy implementation lag could be reduced by structural changes in the tax policymaking process. For example, tax cuts, whose form could be agreed upon in advance, could be made contingent upon triggers in certain economic indicators, for example, two successive quarters lacking real economic growth. In order to increase the responsiveness of fiscal policy to changing economic conditions, the Kennedy Administration proposed stand-by authority for certain government capital expenditures and tax cuts pre-approved by Congress. If certain economic conditions were met, the President could then exercise this authority. *See*, *1962 Economic Report of the President*, pp. 72-76. The Nixon Administration also proposed streamlining procedures for enactment of temporary tax surcharges and tax credits in order to allow quick implementation of fiscal policy. *See*, *1973 Economic Report of the President*, p. 75.

[44] For example, a simple change in individual income tax rates, which could be implemented through revised withholding tables, would require the Internal Revenue Service ("IRS") to draft, print, and mail new withholding tables and instructions to approximately 10 million employers. In addition, third-party software vendors, who sell programs to compute employee withholding, would need to modify and distribute new software that incorporates these changes. It is likely that these actions would take at least two months to complete. The tax rebates authorized by the Economic Growth Tax Relief and Reconciliation Act of 2001 required two months to be paid out, and the first payments were not made until approximately seven weeks from the Act becoming law. Other tax changes, such as new tax credits or changes in exemptions, which would require the IRS to revise the W-4 form and send it out to over 100 million employees, could take considerably longer. The implementation lag could be considerably lengthened by the slow response from individual employers and taxpayers.

[45] Although some effects may take place as soon as a policy is enacted, large-scale econometric models typically do not register peak effects of permanent tax changes for one to three years. See Gary Fromm and Lawrence R. Klein, "A Comparison of Eleven Econometric Models of the United States," *American Economic Review*, vol. 63 (May, 1973), p. 392, Table 6.

These potentially lengthy lags can easily push the effects of a fiscal stimulus enacted in response to a recession well into the period of economic recovery. If that occurs, the fiscal policy may, in fact, be destabilizing and inflationary. In order to be effective, countercyclical policies must be timed with a fair degree of accuracy. The history of discretionary fiscal policy since World War II provides little reassurance to those who look to government policy as a means of fighting recessions.[46]

Automatic stabilizers

In addition to discretionary fiscal-policy changes, business cycles may also be dampened by fiscal-policy changes that are not the result of any change in law. These "automatic stabilizers" include the automatic reduction of tax receipts and increase in transfer payments that result during a recession. Automatic stabilizers have a distinct advantage over discretionary changes in that they generally are not subject to recognition and implementation lags. To the extent that Keynesian policies were thought to be effective, expansion of countercyclical expenditure programs and development of a more procyclical tax structure could reduce macroeconomic fluctuations.

[46] For a summary and evaluation of discretionary fiscal policy in the postwar United States, see Robert J. Gordon, *Macroeconomics* (Boston: Little Brown, 1981), pp. 517-521.

E. Effects of Tax Policies on Aggregate Supply

The productive capacity of an economy, or its aggregate supply, is determined by the amount and quality of its labor, capital, and natural resources and the level of its technology. Tax policies may be able to increase an economy's aggregate supply by increasing the economic return to working, saving, and investing. For instance, lowering income and payroll taxes increases the return to working; lowering taxes on interest, dividends, and capital gains increases the return to saving; lowering business taxes increases the return to investment. It is possible that by increasing the return to working, saving, and investment, people may choose to engage in these activities more. However, it is also possible that these policies may not induce increases in these activities. A reduction in the size of the Federal budget deficit may also increase aggregate supply to the extent national saving increases.

1. Effects of aggregate supply incentives on work effort, saving, and investment

Even in theory, the effects of aggregate supply incentives on private behavior are ambiguous. Policies that lower income taxes, lower payroll taxes, or provide tax credits based on earnings increase the after-tax return individuals receive from working. This can have two effects on work effort. First, since each hour of work yields a greater return (i.e., a higher after-tax wage), people might choose to work more. Second, since these tax cuts increase people's disposable income, they might choose instead to work less--for instance, by working fewer hours per week, taking more vacation time, or giving up a part-time job. Either effect may predominate. Thus, payroll and income tax cuts have a theoretically ambiguous impact on work effort and on productive capacity.

Similarly, a reduction in taxes on capital income (interest, dividends, and capital gains) increases the rate of return to saving. One effect of the increased return to saving is to encourage people to save more. However, the tax cut also increases current (and future, if the tax cut is permanent) income; people may respond to this increased income by choosing to consume more and work less, thereby depressing saving and work effort.

Further, there are two ways tax policies can encourage investment. First, tax policies that increase domestic saving may also increase domestic investment by making more credit available to domestic firms. It is likely that an increase in domestic saving resulting from tax cuts on capital income will be channeled into both increased domestic and foreign investment. Second, domestic investment itself (as opposed to saving) can be encouraged. Investment by domestic businesses can be encouraged by lowering the corporate income tax rate, providing an investment tax credit, or increasing the value of depreciation deductions. Each of these aggregate supply policies reduces the effective tax rate on investment.

It is possible that the inframarginal effects of investment incentives may reduce overall investment. When a firm's taxes are reduced, its after-tax profits increase. This increase in profits will lead to higher share prices and higher dividend payments, increasing the income and wealth of stockholders. If stockholders respond to this increased income by increasing consumption, then saving will decrease, and overall investment may decrease as well. However, this demand-side effect is probably less strong with investment incentives than with saving or work incentives, both because some of the shareholders of United States firms are foreigners

(much of their increased consumption will take placed outside the United States) and because individuals' consumption may respond less to increases in the value of their shares than to reductions in their income taxes.

These examples illustrate the two effects generally associated with reductions in tax rates. The first effect (the "substitution effect") is that associated with increasing the return on the marginal unit of work, saving, or investing. By increasing the return on the margin, consumers are induced to increase work effort or their amount of saving, and firms are induced to increase investment. The second effect (the "income effect") is that tax cuts generally increase the inframarginal return, that is, the total after-tax wages received from work effort already undertaken, the total after-tax income received from past and already planned saving, and the total profits received from existing investments. Thus, the tax cuts also increase the take-home income of consumers. Because increased income is generally believed to reduce labor supply and to increase consumption, the inframarginal effects of tax cuts work in a direction opposite to that of the marginal effect, and work in the same direction as standard demand-inducing tax policies.

2. Effects on national saving

Beyond the effects on private saving, policies that provide incentives to increase aggregate supply also may affect government saving. Because national saving is equal to the sum of government and private saving, judgments concerning aggregate supply policies must take into account their effects on both private and public saving.

The effects of supply policies on public saving can be viewed as the sum of the revenue impact of the policy without consideration of behavioral responses to the tax cut and the revenue effect of the behavioral responses. The increased income that people receive as a result of reduced tax rates on their wages or their capital income is equivalent to a transfer of income from the government to taxpayers. If this transfer is financed by increased borrowing (i.e., by increasing the deficit), then government saving declines. Individuals may also respond to both the increased income and the increased after-tax rate of return by changing their work effort or their amount of saving. These changes also affect government revenue. If tax cuts increase work effort, saving, or investment, the government may collect additional tax revenue. If tax cuts reduce these activities, then government revenues could fall even more.

Thus, the effects of supply policies on national saving and on growth depend on the degree to which the policies increase the return to activities already being undertaken (i.e., how much they increase inframarginal returns) and on the magnitude of the behavioral effects associated with the increased marginal rate of return. To be effective, policies designed to increase aggregate supply should provide higher returns from marginal increases in work, saving, and investment, while minimizing the increased return to activities already being undertaken.

3. Policies to increase investment

In a closed economy (a hypothetical economy that does not engage in international trade or investment), all individual saving is ultimately invested in the economy, and saving is equal to investment. In an open economy (where goods and capital can flow freely from one country to

another), investment and saving need not be the same. Saving by United States residents may be invested in the United States or abroad, and saving by foreigners may be invested in the United States. However, there is a strong empirical relationship between a country's saving rate and its investment rate. Thus, policies that stimulate the United States saving are likely to stimulate United States investment as well. However, other policies can more directly stimulate United States investment. In particular, tax policies that increase the return to investing in the United States may be more effective at increasing the amount of United States investment. This increased investment is likely to be financed both by foreign and domestic saving.

When firms make investment decisions, they must decide whether the investment yield will be as great as the yield on the next best alternative use of the investment funds (the "opportunity cost" of the funds). This opportunity cost of investment funds is called the cost of capital. When the cost of capital is low, a greater number of investments will be determined to be profitable. Thus, the lower is the cost of capital, the higher the level of investment.

The cost of capital for corporations is determined by the rate of return they have to offer to shareholders and debt holders, as well as by the corporate tax on investment income. The higher the corporate tax, the more an investment has to earn before taxes in order to provide any given rate of return to shareholders.

Corporate taxes reduce the after-tax return from equity-financed investments, and thus increase the cost of capital. Generous depreciation allowances and investment tax credits may reduce the tax liability associated with investment income and may therefore decrease the cost of capital.

Because a country's saving rate is closely related to its investment rate, policies that increase the marginal rate of return to private investment at the cost of increased public borrowing (i.e., decreased public saving) may not actually stimulate investment. Tax policy's effectiveness at increasing investment depends on the magnitude of the effect of tax cuts on investment returns, and on the degree to which particular policies reduce marginal taxes on investment without reducing government revenues and public saving. Policies that reduce taxes on existing capital provide windfall benefits to capital owners and reduce government revenues. If such benefits are financed by government borrowing, then national savings will fall, potentially denying funds for new investment.

III. DESCRIPTION OF PROPOSALS

A. Accelerate Reductions in Individual Income Tax Rates

Present Law

In general

Under the Federal individual income tax system, an individual who is a citizen or a resident of the United States generally is subject to tax on worldwide taxable income. Taxable income is total gross income less certain exclusions, exemptions, and deductions. An individual may claim either a standard deduction or itemized deductions.

An individual's income tax liability is determined by computing his or her regular income tax liability and, if applicable, alternative minimum tax liability.

Regular income tax liability

Regular income tax liability is determined by applying the regular income tax rate schedules (or tax tables) to the individual's taxable income. This tax liability is then reduced by any applicable tax credits. The regular income tax rate schedules are divided into several ranges of income, known as income brackets, and the marginal tax rate increases as the individual's income increases. The income bracket amounts are adjusted annually for inflation. Separate rate schedules apply based on filing status: single individuals (other than heads of households and surviving spouses), heads of households, married individuals filing joint returns (including surviving spouses), married individuals filing separate returns, and estates and trusts. Lower rates may apply to capital gains.

For 2003, the regular income tax rate schedules for individuals are shown in Table 2, below. The rate bracket breakpoints for married individuals filing separate returns are exactly one-half of the rate brackets for married individuals filing joint returns. A separate, compressed rate schedule applies to estates and trusts.

Table 2.–Individual Regular Income Tax Rates for 2003

If taxable income is:	**But not over:**	**Then regular income tax equals:**
		Single individuals
$0	$6,000	10% of taxable income
$6,000	$28,400	$600, plus 15% of the amount over $6,000
$28,400	$68,800	$3,960.00, plus 27% of the amount over $28,400
$68,800	$143,500	$14,868.00, plus 30% of the amount over $68,800
$143,500	$311,950	$37,278.00, plus 35% of the amount over $143,500
Over $311,950		$96,235.50, plus 38.6% of the amount over $311,950

Heads of households

$0.....$10,000	10% of taxable income
$10,000.....$38,050	$1,000, plus 15% of the amount over $10,000
$38,050.....$98,250	$5,207.50, plus 27% of the amount over $38,050
$98,250.....$159,100	$21,461.50, plus 30% of the amount over $98,250
$159,100.....$311,950	$39,716.50, plus 35% of the amount over $159,100
Over $311,950.....	$93,214, plus 38.6% of the amount over $311,950

Married individuals filing joint returns

$0.....$12,000	10% of taxable income
$12,000.....$47,450	$1,200, plus 15% of the amount over $12,000
$47,450.....$114,650	$6,517.50, plus 27% of the amount over $47,450
$114,650.....$174,700	$24,661.50, plus 30% of the amount over $114,650
$174,700.....$311,950	$42,676.50, plus 35% of the amount over $174,700
Over $311,950.....	$90,714, plus 38.6% of the amount over $311,950

Ten percent regular income tax rate

Under present law, the ten-percent rate applies to the first $6,000 of taxable income for single individuals, $10,000 of taxable income for heads of households, and $12,000 for married couples filing joint returns. Effective beginning in 2008, the $6,000 amount will increase to $7,000 and the $12,000 amount will increase to $14,000.

The taxable income levels for the ten-percent rate bracket will be adjusted annually for inflation for taxable years beginning after December 31, 2008. The bracket for single individuals and married individuals filing separately is one-half for joint returns (after adjustment of that bracket for inflation).

Reduction of other regular income tax rates

Prior to the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") the regular income tax rates were 15 percent, 28 percent, 31 percent, 36 percent, and 39.6 percent. EGTRRA added the ten-percent regular income tax rate, described above, and retained the 15-percent regular income tax rate. Also, the 15-percent regular income tax bracket was modified to begin at the end of the ten-percent regular income tax bracket. EGTRRA also made other changes to the 15-percent regular income tax bracket.[47]

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[47] See the discussion of the provision regarding marriage penalty relief in the 15-percent regular income tax bracket, below.

Also, under EGTRRA, the 28 percent, 31 percent, 36 percent, and 39.6 percent rates are phased down over six years to 25 percent, 28 percent, 33 percent, and 35 percent, effective after June 30, 2001. Accordingly, for taxable years beginning during 2001, the rate reduction comes in the form of a blended tax rate. The taxable income levels for the rates above the 15-percent rate in all taxable years are the same as the taxable income levels that apply under the prior-law rates.

Table 3, below, shows the schedule of regular income tax rate reductions.

Table 3.–Scheduled Regular Income Tax Rate Reductions

Calendar Year	28% rate reduced to:	31% rate reduced to:	36% rate reduced to:	39.6% rate reduced to:
2001[1]-2003	27%	30%	35%	38.6%
2004-2005	26%	29%	34%	37.6%
2006 and later	25%	28%	33%	35%

[1] Effective July 1, 2001.

Alternative minimum tax

The alternative minimum tax is the amount by which the tentative minimum tax exceeds the regular income tax. An individual's tentative minimum tax is an amount equal to (1) 26 percent of the first $175,000 ($87,500 in the case of a married individual filing a separate return) of alternative minimum taxable income ("AMTI") in excess of a phased-out exemption amount and (2) 28 percent of the remaining AMTI. The maximum tax rates on net capital gain used in computing the tentative minimum tax are the same as under the regular tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments. The exemption amounts are: (1) $49,000 ($45,000 in taxable years beginning after 2004) in the case of married individuals filing a joint return and surviving spouses; (2) $35,750 ($33,750 in taxable years beginning after 2004) in the case of other unmarried individuals; (3) $24,500 ($22,500 in taxable years beginning after 2004) in the case of married individuals filing a separate return; and (4) $22,500 in the case of an estate or trust. The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of other unmarried individuals, and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

Description of Proposal[48]

Ten percent regular income tax rate

The proposal accelerates the scheduled increase in the taxable income levels for the ten-percent rate bracket from 2008 to 2003. Specifically, the proposal increases the taxable income level for the ten-percent regular income tax rate brackets for single individuals from $6,000 to $7,000 and for married individuals filing jointly from $12,000 to $14,000, respectively. The taxable income levels for the ten-percent regular income tax rate bracket will be adjusted annually for inflation for taxable years beginning after December 31, 2003.

Reduction of other regular income tax rates

The proposal accelerates the reductions in the regular income tax rates in excess of the 15-percent regular income tax rate that are scheduled for 2004 and 2006. Therefore, the regular income tax rates in excess of 15 percent under the proposal are 25 percent, 28 percent, 33 percent, and 35 percent for 2003 and thereafter.

Alternative minimum tax exemption amounts

The proposal increases the AMT exemption amount for married taxpayers filing a joint return and surviving spouses to $57,000, and for unmarried taxpayers to $39,750 for taxable years beginning in 2003, 2004, and 2005.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2002.

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[48] The description refers to the proposal in the President's Fiscal Year 2004 Revenue Proposals.

B. Accelerate Marriage Penalty Relief

1. Standard deduction marriage penalty relief

Present Law

Marriage penalty

A married couple generally is treated as one tax unit that must pay tax on the couple's total taxable income. Although married couples may elect to file separate returns, the rate schedules and other provisions are structured so that filing separate returns usually results in a higher tax than filing a joint return. Other rate schedules apply to single persons and to single heads of households.

A "marriage penalty" exists when the combined tax liability of a married couple filing a joint return is greater than the sum of the tax liabilities of each individual computed as if they were not married. A "marriage bonus" exists when the combined tax liability of a married couple filing a joint return is less than the sum of the tax liabilities of each individual computed as if they were not married.

Basic standard deduction

Taxpayers who do not itemize deductions may choose the basic standard deduction (and additional standard deductions, if applicable), [49] which is subtracted from adjusted gross income ("AGI") in arriving at taxable income. The size of the basic standard deduction varies according to filing status and is adjusted annually for inflation. For 2003, the basic standard deduction amount for single filers is 60 percent of the basic standard deduction amount for married couples filing joint returns (Alternatively, the basic standard deduction for married couples filing a joint return is 167 percent of the basic standard deduction for single filers). Thus, two unmarried individuals have standard deductions whose sum exceeds the standard deduction for a married couple filing a joint return.

EGTRRA increased the basic standard deduction for a married couple filing a joint return to twice the basic standard deduction for an unmarried individual filing a single return. The basic standard deduction for a married taxpayer filing separately will continue to equal one-half of the basic standard deduction for a married couple filing jointly; thus, the basic standard deduction for unmarried individuals filing a single return and for married couples filing separately will be the same.

An increase in the standard deduction is scheduled to be phased-in over five years beginning in 2005 and will be fully phased-in for 2009 and thereafter. Table 4, below, shows the standard deduction for married couples filing a joint return as a percentage of the standard deduction for single individuals during the phase-in period.

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[49] Additional standard deductions are allowed with respect to any individual who is elderly (age 65 or over) or blind.

Table 4.–Scheduled Phase-In of Increase of the Basic Standard Deduction for Married Couples Filing Joint Returns

Calendar Year	Standard Deduction for Joint Returns as Percentage of Standard Deduction for Single Returns
2005	174%
2006	184%
2007	187%
2008	190%
2009 and later	200%

Description of Proposal[50]

The proposal would accelerate the increase in the basic standard deduction amount for joint returns to twice the basic standard deduction amount for single returns effective for 2003.

Effective Date

The provision is effective for taxable years beginning after December 31, 2002.

2. Accelerate the expansion of the 15-percent rate bracket for married couples filing joint returns

Present Law

In general

Under the Federal individual income tax system, an individual who is a citizen or resident of the United States generally is subject to tax on worldwide taxable income. Taxable income is total gross income less certain exclusions, exemptions, and deductions. An individual may claim either a standard deduction or itemized deductions.

An individual's income tax liability is determined by computing his or her regular income tax liability and, if applicable, alternative minimum tax liability.

Regular income tax liability

Regular income tax liability is determined by applying the regular income tax rate schedules (or tax tables) to the individual's taxable income and then is reduced by any applicable tax credits. The regular income tax rate schedules are divided into several ranges of income, known as income brackets, and the marginal tax rate increases as the individual's income increases. The income bracket amounts are adjusted annually for inflation. Separate rate

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[50] The description refers to the proposal in the President's Fiscal Year 2004 Revenue Proposals.

schedules apply based on filing status: single individuals (other than heads of households and surviving spouses), heads of households, married individuals filing joint returns (including surviving spouses), married individuals filing separate returns, and estates and trusts. Lower rates may apply to capital gains.

In general, the bracket breakpoints for single individuals are approximately 60 percent of the rate bracket breakpoints for married couples filing joint returns.[51] The rate bracket breakpoints for married individuals filing separate returns are exactly one-half of the rate brackets for married individuals filing joint returns. A separate, compressed rate schedule applies to estates and trusts.

15-percent regular income tax rate bracket

EGTRRA increased the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return to twice the size of the corresponding rate bracket for a single individual filing a single return. The increase is phased-in over four years, beginning in 2005. Therefore, this provision is fully effective (i.e., the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return is twice the size of the 15-percent regular income tax rate bracket for an unmarried individual filing a single return) for taxable years beginning after December 31, 2007. Table 5, below, shows the increase in the size of the 15-percent bracket during the phase-in period.

Table 5.–Scheduled Increase in Size of the 15-Percent Rate Bracket for Married Couples Filing a Joint Return

Taxable year	End point of 15-percent rate bracket for married couple filing joint return as percentage of end point of 15-percent rate bracket for unmarried individuals
2005	180%
2006	187%
2007	193%
2008 and thereafter	200%

Description of Proposal

The proposal would accelerate the increase of the size of the 15-percent regular income tax rate bracket for joint returns to twice the width of the 15-percent regular income tax rate bracket for single returns effective for 2003.

Effective Date

The provision is effective for taxable years beginning after December 31, 2002.

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[51] The rate bracket breakpoint for the 38.6 percent marginal tax rate is the same for single individuals and married couples filing joint returns.

C. Accelerate the Increase in the Child Tax Credit

Present Law

In general

For 2003, an individual may claim a $600 tax credit for each qualifying child under the age of 17. In general, a qualifying child is an individual for whom the taxpayer can claim a dependency exemption and who is the taxpayer's son or daughter (or descendent of either), stepson or stepdaughter, or eligible foster child.

The child tax credit is scheduled to increase to $1,000, phased-in over several years.

Table 6, below, shows the scheduled increases of the child tax credit.

Table 6.–Scheduled Increase of the Child Tax Credit

Calendar Year	Credit Amount Per Child
2003-2004	$600
2005-2008	$700
2009	$800
2010 and later	$1,000

The child tax credit is phased-out for individuals with income over certain thresholds. Specifically, the otherwise allowable child tax credit is reduced by $50 for each $1,000 (or fraction thereof) of modified adjusted gross income over $75,000 for single individuals or heads of households, $110,000 for married individuals filing joint returns, and $55,000 for married individuals filing separate returns. Modified adjusted gross income is the taxpayer's total gross income plus certain amounts excluded from gross income (i.e., excluded income of U.S. citizens or residents living abroad (sec. 911); residents of Guam, American Samoa, and the Northern Mariana Islands (sec. 931); and residents of Puerto Rico (sec. 933)). The length of the phase-out range depends on the number of qualifying children. For example, the phase-out range for a single individual with one qualifying child is between $75,000 and $85,000 of modified adjusted gross income. The phase-out range for a single individual with two qualifying children is between $75,000 and $95,000.

The child tax credit is not adjusted annually for inflation.

Refundability

The child credit is refundable to the extent of 10 percent of the taxpayer's earned income in excess of $10,500 for calendar years 2003.[52] The percentage is increased to 15 percent for calendar years 2005 and thereafter. Families with three or more children are allowed a refundable credit for the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income credit (the present and prior-law rule), if that amount is greater than

[52] The $10,500 amount is indexed for inflation.

the refundable credit based on the taxpayer's earned income in excess of $10,500 for 2003. The refundable portion of the child credit does not constitute income and shall not be treated as resources for purposes of determining eligibility or the amount or nature of benefits or assistance under any Federal program or any State or local program financed with Federal funds.

Alternative minimum tax liability

The child credit is allowed against the individual's regular income tax and alternative minimum tax.

Description of Proposal[53]

The amount of the child credit is increased to $1,000 for 2003 and thereafter. For 2003, the increased amount of the child credit will be paid in advance beginning in July 2003 on the basis of information on each taxpayer's 2002 return filed in 2003. Advance payments will be made in a similar manner to the advance payment checks issued by the Treasury in 2001 to reflect the creation of the 10-percent regular income tax rate bracket.[54] The increase in refundability to 15 percent of the taxpayer's earned income scheduled for calendar years 2005 and thereafter is not accelerated by the proposal.

Effective Date

The provision is effective for taxable years beginning after December 31, 2002.

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[53] The description refers to the proposal in the President's Fiscal Year 2004 Revenue Proposals.

[54] A discussion of the advance payment check regime of 2001 is included in the rebates section of this pamphlet, below.

D. Tax Rebate Proposals

Present Law

In general

Under the Federal individual income tax system, an individual who is a citizen or a resident of the United States generally is subject to tax on worldwide taxable income. Taxable income is total gross income less certain exclusions, exemptions, and deductions. An individual may claim either a standard deduction or itemized deductions.

An individual's income tax liability is determined by computing his or her regular income tax liability and, if applicable, alternative minimum tax liability.

Rate reduction credit for 2001

EGTRRA established a new 10-percent income tax rate bracket for a portion of taxable income that had previously been taxed at 15 percent, effective for taxable years beginning after December 31, 2000. EGTRRA included a rate reduction credit for 2001 to more immediately achieve one of the purposes behind the new bottom rate bracket for 2001. The Congress chose to utilize this credit mechanism (and the issuance of checks described below) because it was believed to deliver economic stimulus to the economy more rapidly than would implementation of a new 10-percent rate bracket, even if that were accompanied by an immediate implementation of new wage withholding tables. Accordingly, this rate reduction credit operated in lieu of the new 10-percent income tax rate bracket for 2001.

This credit was computed in the following manner. Taxpayers were entitled to a credit in tax year 2001 of 5 percent (the difference between the 15-percent rate and the 10-percent rate) of the amount of income that would have been eligible for the new 10-percent rate. Taxpayers did not receive a credit in excess of their income tax liability (determined after nonrefundable credits).

Most taxpayers received this credit in the form of a check issued by the Department of the Treasury. The amount of the check was computed in the same manner as the credit, except that it was done on the basis of tax returns filed for 2000 (instead of 2001). In general, the Department of the Treasury issued all checks before October 1, 2001, to taxpayers who timely filed their 2000 tax returns. Taxpayers who filed late or pursuant to extensions received their checks later in that fall.

Taxpayers reconciled the amount of the credit with the check they receive in the following manner. They completed a worksheet calculating the amount of the credit based on their 2001 tax return. They then subtracted from the credit the amount of the check they received. For many taxpayers, these two amounts were the same. If, however, the result was a positive number (because, for example, the taxpayer paid no tax in 2000 but paid tax in 2001), the taxpayer claimed that amount as a credit against 2001 tax liability. If, however, the result was negative (because, for example, the taxpayer paid tax in 2000 but owed no tax for 2001), the taxpayer was not required to repay that amount to the Treasury. Otherwise, the checks had no effect on tax returns filed in 2001; the amount was not includible in gross income and it did not

otherwise reduce the amount of withholding. In no event could the Department of the Treasury issue checks after December 31, 2001. This was designed to prevent errors by taxpayers who might claim the full amount of the credit on their 2001 tax returns and file those returns early in 2002, at the same time the Treasury check might be mailed to them. Payment of the credit (or the check) was treated, for all purposes of the Code,[55] as a payment of tax. As such, the credit or the check was subject to the refund offset provisions, such as those applicable to past-due child support under section 6402 of the Code.

In general, taxpayers eligible for the credit (and the check) were individuals other than estates or trusts, nonresident aliens, or dependents. The determination of this status for the relevant year was made on the basis of the information filed on the tax return.

Revised wage withholding for 2001

Under present law, the Secretary of the Treasury is authorized to prescribe appropriate income tax withholding tables or computational procedures for the withholding of income taxes from wages paid by employers. In general, the Secretary issued revised income tax withholding tables annually, to be effective on January 1. The Secretary also issued revised wage withholding tables in June 2001 to reflect the rate reduction in EGTRRA. The revised tables were effective for wages paid after June 30, 2001.

Description of Proposals

Proposal by Sen. Baucus

The proposal provides individuals with a refundable income tax credit for 2003 equal to 10 percent of wages, capped at a maximum of $300 ($600 for married couples). For most taxpayers, the credit would be delivered through an immediate adjustment of the wage withholding tables. For taxpayers who did not have any income tax liability for 2001, the credit would be delivered through a rebate check, similar to the rebate check mechanism employed in 2001. The checks would be required to be issued as rapidly as is practicable. Taxpayers who receive the credit via a check would be required to reconcile the credit on their tax returns.

Effective date.–The proposal is effective for 2003.

Proposal by Sen. Daschle

The proposal[56] provides individuals with a refundable income tax credit for 2003 equal to 10 percent of adjusted gross income[57], capped at a maximum of $300 for individuals or $600 for

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[55] A special rule provided that no interest was paid with respect to the checks.

[56] This description of the proposal reflects staff discussions as to the current details of the proposal.

[57] The January 24, 2003, Press Release issued by the Office of the Senate Democratic Leader states: "This new tax cut, which provides $300 for each adult in a family and $300 for the

married couples. The maximum credit amount is increased by $300 for each qualifying child, up to a maximum of two children. The credit would be delivered through a rebate check, similar to the rebate check mechanism employed in 2001. The checks would be required to be issued as rapidly as is practicable. Taxpayers who receive the credit via a check would be required to reconcile the credit on their tax returns.

Effective date.–The proposal is effective for 2003.

Proposal by Sens. Landrieu and Corzine

The proposal[58] provides a refundable income tax credit for the employee's portion of the payroll taxes on the first $10,000 of a worker's salary. Thus, the maximum credit is $765. The credit is computed based on payroll taxes paid in 2001. The credit would be delivered through a rebate check, similar to the rebate check mechanism employed in 2001. The checks would be required to be issued as rapidly as is practicable. Taxpayers who receive the credit via a check would be required to reconcile the credit on their tax returns.

The proposal also provides a refundable income tax credit to the employer for the employer's portion of the payroll taxes on the first $10,000 of each of its worker's salaries. Thus, the maximum credit is $765 for each worker. The credit is computed based on payroll taxes actually paid in 2003.

Effective date.–The proposal is effective for 2003.

Proposal by Congresswoman Pelosi

The proposal provides workers with a refundable income tax credit for 2003 equal to $300 ($600 for married couples), regardless of the amount of income taxes or payroll taxes that the worker paid. The credit would be delivered through a rebate check, similar to the rebate check mechanism employed in 2001. The checks would be required to be issued as rapidly as is practicable.

Effective date.–The proposal is effective for 2003.

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first two children, will be available for all people who work, including those who have payroll tax but not income tax liability."

[58] This description of the proposal reflects staff discussions as to the current details of the proposal.

E. Health Insurance Tax Credit for Business

Present Law

Present law does not provide an employer tax credit for the purchase of health insurance.

Under present law, amounts paid or accrued by an employer within a taxable year for a sickness, accident, hospitalization, medical expense, or similar health plan for its employees are generally deductible as ordinary and necessary business expenses under section 162. The deduction is available provided the amounts are used to pay accident and health insurance premiums or to pay or reimburse benefits directly. Amounts paid for premiums are not deductible if the proceeds of the policy are payable to the employer rather than the employee. The timing of the deduction is based on the employer's method of accounting. Under the cash method, the expenses are deductible for the taxable year in which they are paid. Under the accrual method, the expenses are deductible for the taxable year in which all events have occurred to determine the fact and amount of the expenses.

Contributions by an employer to a welfare benefit fund are not deductible under the usual income tax rules, but if they otherwise would be deductible under the usual rules (e.g., if they are ordinary and necessary business expenses), the contributions are deductible within limits for the taxable year in which such contributions are made to the fund.[59] A welfare benefit fund is, in general, any fund that is part of a plan of an employer, and through which the employer provides welfare benefits (i.e., benefits other than pension benefits) to employees or their beneficiaries. A "fund" is defined as certain tax-exempt trusts or organizations (including voluntary employees' beneficiary associations ("VEBAs") exempt from tax under section 501(c)(9)), any trust, corporation or other organization not exempt from tax, and, to the extent provided in regulations, any account held for an employer by any person.[60]

The amount of the deduction otherwise available to an employer for a contribution to a welfare benefit fund for any taxable year may not exceed the qualified cost of the fund for the year. The qualified cost of a welfare benefit fund for a year is the sum of (1) the amount that would be deductible for benefits provided during the year if the employer paid them directly and was on the cash method of accounting, and (2) the addition (within limits) to a qualified asset account under the fund for the year, reduced by (3) the after-tax income of the fund.[61]

A qualified asset account under a welfare benefit fund is an account consisting of assets set aside to provide for the payment of disability benefits, medical benefits, supplemental unemployment compensation or severance pay benefits, or life insurance benefits. Under present law, an account limit is provided for the amount in a qualified asset account for any year.

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[59] Secs. 419 and 419A.

[60] Sec. 419(e)(3).

[61] This limit does not apply to collectively bargained plans, or plans maintained by 10 or more employers.

The account limit for any taxable year may include a reserve to provide certain post-retirement medical and life insurance benefits. This limit allows amounts reasonably necessary to accumulate reserves under a welfare benefit plan so that the liabilities for post-retirement medical and life insurance benefits with respect to a group of employees can be prefunded.

Each year's computation of contributions with respect to post-retirement medical benefits is to be made under the assumption that the medical benefits provided to future retirees will have the same costs as medical benefits currently provided to retirees. Because the reserve is computed on the basis of the current year's medical costs, neither future inflation nor future changes in the level of utilization may be taken into account until they occur.

In the case of an employee who is a "key employee" under the pension rules,[62] a separate account is required to be established and maintained on a per-participant basis, and benefits provided to such employee (and his or her spouse and dependents) are payable only from the separate account. Contributions to the separate account of a key employee are considered annual additions to a defined contribution plan for purposes of the limits on contributions and benefits applicable to retirement plans,[63] except that the 25-percent-of-compensation limit[64] does not apply.

Under present law, if an employer maintains a welfare benefit fund that provides a disqualified benefit during any taxable year, the employer is subject to an excise tax equal to 100 percent of the disqualified benefit. A disqualified benefit includes (1) a benefit provided to a key employee other than from a separate account required to be established for such an employee, (2) any post-retirement medical or life insurance benefit that is provided in a discriminatory manner, and (3) any portion of a welfare benefit fund reverting to the employer.

Description of Proposal

Senator Baucus's proposed economic stimulus package for 2003 provides an employer tax credit of up to 50 percent of the employer cost of health insurance premiums for small employers with up to 50 employees.[65] The credit is available only for taxable years beginning after December 31, 2002 and before January 1, 2003.

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[62] Sec. 416.

[63] Sec. 415.

[64] Sec. 415(c)(1)(B).

[65] Senators Clinton and Durbin have introduced a similar bill, S. 86, which provides a tax credit for health insurance expenses of employers with 50 or fewer employees, wherein the size of the credit is a declining function of the number of employees and the average salary of the employees. A separate bill, S. 53, also introduced by Senators Clinton and Durbin, provides employers of fewer than 25 employees a tax credit for health insurance expenses for such employer's employees who earn less than $25,000 (but more than $5,000) annually. The latter bill provides a larger credit the greater is the percentage of eligible qualified employees that are provided health insurance coverage.

The proposal provides a credit for the qualified employee health insurance expenses of (1) 50 percent in the case of qualified small employers with fewer than 26 employees, (2) 40 percent in the case of qualified small employers with fewer than 36 but more than 25 employees, and (3) 30 percent in the case of qualified small employers with fewer than 51 but more than 35 employees.

Qualified small employers with respect to any calendar year are employers that provide eligibility for health insurance coverage for all qualified employees and that have an average of not less than two and not more than 50 employees during either of the two preceding calendar years.

Qualified employee health insurance expenses are any amount paid by an employer for health insurance coverage (as defined in paragraph (1) of section 9832(b), disregarding the last sentence of paragraph (2) of such section) provided to any qualified employee. In general, qualified employees are any employees who are reasonably expected to receive at least $5,000 in compensation from the employer during the year and who are not provided health insurance coverage under (1) a health plan of the spouse of the employee, (2) title XVIII, XIX or XXI of the Social Security Act, (3) chapter 55 of title 10, USC, (4) chapter 89 of title 5, USC, (5) chapter 17 of title 38, USC, or (6) any other provision of law.

The amount of qualified employee health insurance expenses per employee that are eligible for the credit may not exceed the maximum employer contribution for self-only coverage or family coverage (as applicable) determined under section 8906(a) of title 5, United States Code.

No deduction or credit under any other provision of the Code is available with respect to qualified employee health insurance expenses taken into account in determining the credit.

Effective Date

The provision applies to amounts paid or incurred in taxable years beginning after December 31, 2002, and before January 1, 2003.

F. Proposals Relating to Capital Cost Recovery

1. Increase section 179 expensing

Present Law

Present law provides that, in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 (for taxable years beginning in 2003 and thereafter) of the cost of qualifying property placed in service for the taxable year (sec. 179).[66] In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. An election to expense these items may be revoked only with the consent of the Commissioner.[67] In general, taxpayers may not elect to expense off-the-shelf software.[68]

The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.

Description of Proposals

Proposals by Sen. Baucus and Sen. Daschle

The proposals provide that the maximum dollar amount that may be deducted under section 179 is increased to $75,000 for property placed in service in 2003. In addition, the $200,000 amount is increased to $325,000 for property placed in service in 2003.

Proposal by Congresswoman Pelosi

The proposal provides that the maximum dollar amount that may be deducted under section 179 is increased to $50,000 for property placed in service in 2003.[69]

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[66] Additional section 179 incentives are provided with respect to a qualified property used by a business in the New York Liberty Zone (sec. 1400(f)) or an empowerment zone (sec. 1397A).

[67] Section 179(c)(2).

[68] Section 179(d)(1) requires that property be tangible to be eligible for expensing; in general, software is intangible.

[69] The proposal does not discuss any increase in the $200,000 amount.

Proposal by the President

The proposal provides that the maximum dollar amount that may be deducted under section 179 is increased to $75,000 for property placed in service in 2003 and thereafter. In addition, the $200,000 amount is increased to $325,000 for property placed in service in 2003 and thereafter. Both of these dollar limitations are indexed for inflation. The proposal also includes off-the-shelf computer software as qualifying property. The proposal permits taxpayers to make or revoke expensing elections on amended returns; the consent of the Commissioner is not required under the proposal.

2. Bonus depreciation

Present Law

Depreciation deductions--in general

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS"). Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from 3 to 25 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

Expensing

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment generally may elect to deduct up to $25,000 (for taxable years beginning in 2003 and thereafter) of the cost of qualifying property placed in service for the taxable year (sec. 179). In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business.

Additional depreciation deduction

In general, present law[70] allows an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified property. The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service. The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, present law provides that there are no adjustments to the allowable amount of depreciation for purposes of computing a taxpayer's

[70] Section 101 of the Job Creation and Worker Assistance Act of 2002 (Pub. L. 107-147), March 9, 2002.

alternative minimum taxable income with respect to property to which the provision applies. A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.

In order for property to qualify for the additional first-year depreciation deduction it must meet all of the following requirements. First, the property must be property to which the general rules of MACRS apply with (1) an applicable recovery period of 20 years or less, (2) water utility property (as defined in section 168(e)(5)), (3) computer software other than computer software covered by section 197, or (4) qualified leasehold improvement property. Second, the original use of the property must commence with the taxpayer on or after September 11, 2001. Third, generally the taxpayer must purchase the property after September 11, 2001, and before September 11, 2004. Finally, the property must be placed in service before January 1, 2005. An extension of the placed in service date of one year (i.e., January 1, 2006) is provided for certain property with a recovery period of ten years or longer and certain transportation property.

Description of Proposals

Proposal by Sen. Baucus

The proposal allows an additional first-year depreciation deduction equal to 10 percent of the adjusted basis of qualified property. This is in addition to the additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified property that is allowed under present law (for a total additional first-year depreciation deduction equal to 40 percent of the adjusted basis of qualified property).

Effective date.–The proposal applies to property acquired after December 31, 2002 and before September 11, 2004.

Proposal by Sen. Daschle

The proposal allows an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified property. This replaces the additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified property that is allowed under present law; these present-law additional first-year depreciation rules would be repealed for investments after December 31, 2002.

Effective date.–The proposal allowing an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified property applies to property placed in service in calendar year 2003.

Proposal by Congresswoman Pelosi

The proposal allows an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified property acquired in 2003 and an additional first-year depreciation deduction equal to 10 percent of the adjusted basis of qualified property acquired in 2004. These percentages replace the additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified property that is allowed under present law.

Effective date.–The proposal allowing an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified property applies to property placed in service in calendar year 2003. The proposal allowing an additional first-year depreciation deduction equal to 10 percent of the adjusted basis of qualified property applies to property placed in service in calendar year 2004, prior to September 11, 2004.

G. President's Proposal to Eliminate the Double Taxation of Corporate Earnings

Present Law

Under present law, a corporation pays a tax on its taxable income, generally at the rate of 35 percent.[71] To the extent that a corporation distributes its after-tax earnings and profits as a dividend to an individual shareholder, the recipient includes the amount of the dividend in gross income and pays tax at the shareholder's individual tax rate. The earnings and profits of a corporation consist of amounts that have been taxed to the corporation and amounts that have not been subject to tax due to exclusions, accelerated deductions and credits. A tax is imposed at capital gain rates on the gain of a shareholder at the time the shareholder sells his or her stock.

Under present law, corporations receiving dividends from domestic corporations generally are allowed a deduction of 70 percent or more of the amount of the dividends received. Certain anti-abuse rules prevent corporations from receiving low-taxed dividends and creating a capital loss.[72] The dividends-received deduction on certain debt-financed portfolio stock is reduced.[73]

Description of Proposal

In general

Under the proposal, dividends received by shareholders are not included in gross income to the extent of the corporation's excludable dividend amount "(EDA") for the calendar year. The EDA, as discussed below, generally measures the corporation's previously taxed income reduced by taxes paid. In addition, shareholders may be allowed to increase the basis in their corporate stock to the extent the EDA exceeds the dividends paid by the corporation during the year. These rules apply to both individual and corporate shareholders. [74]

Excludable dividend amount

A corporation calculates an excludable dividend amount that measures the amount of the corporation's income that was previously taxed reduced by taxes paid. The EDA is calculated on January 1 of each calendar year. The amount in the EDA is increased by the amount of Federal income tax (both regular tax and alternative minimum tax) paid which is shown on a

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[71] Lower rates apply to the first $75,000 of taxable income. The benefits of the lower rates are phased-out.

[72] Secs. 246(c) and 1059.

[73] Sec. 246A.

[74] Certain taxable dividends received by a parent corporation from a subsidiary will continue to receive a 100-percent dividends received deduction.

corporation's income tax return filed during the prior calendar year divided by .35 (the highest applicable corporate tax rate). The amount of tax is computed after the allowance of all nonrefundable credits (other than the foreign tax credit). The EDA is decreased by the sum of the amount of income tax shown on the return plus any foreign tax credit claimed on the return. An assessment of a deficiency of tax is treated as an amount of tax shown on a return for the calendar year in which the tax is assessed.

The EDA also is increased by the amount of dividends received from another corporation in the prior calendar year that are excluded under this provision or amounts added to the basis of stock in the other corporation in the prior calendar year (as described below).

To the extent that the EDA exceeds the accumulated earnings and profits, the excess is added to the EDA for the following year. No other carryover of an amount in the EDA is allowed.

The portion of any dividend that may be excluded by a shareholder is a fraction (not more than one) the numerator of which is the amount in the corporation's EDA account for the calendar year in which the dividend is paid and the denominator of which is the amount of all dividends paid by the corporation in that calendar year.

Retained earnings basis adjustments

If the amount of the EDA (or, if less, the accumulated earnings and profits) exceeds the amount of dividends paid by a corporation for any calendar year, a shareholder is allowed to increase the basis in the corporation's stock by the portion of the excess allocated to the stock by the corporation. Basis increases are to be allocated by the corporation in the same manner as distributions are allocated, except that no amount may be allocated to stock that is preferred and limited as to dividends. The Secretary of the Treasury may prescribe regulations involving allocations where a corporation has multiple classes of stock. Earnings and profits are reduced by the amount of basis allocated.

Cumulative earnings basis adjustments account

Each corporation allocating basis adjustments is required to maintain a cumulative retained earnings basis adjustment account ("CREBA"). The amount in the CREBA is the cumulative amount of basis adjustments for prior calendar years.

To the extent of the amount in the CREBA, distributions made by a corporation in any calendar year in excess of the amount in the EDA are not treated as dividends and reduce the basis of the shareholder's stock (or result in gain to the extent the distributions exceed the shareholder's basis). These distributions reduce the amount in the CREBA. The portion of any distribution that is not treated as a dividend to a shareholder is a fraction (not in excess of one) the numerator of which is the amount in the CREBA account at the beginning of the calendar year and the denominator of which is the amount of all distributions paid by the corporation during the calendar year.

For example, assume that corporation X, a calendar year corporation, has a sole shareholder A. For its first taxable year, X has taxable income of $100, and files a return and

pays a tax of $35 in its second taxable year. For all other taxable years, assume that X has no income or loss. On January 1 of its third taxable year, X has an EDA of $65 ($35/.35 less $35). X pays no dividends in the third year but allocates $65 of basis to A, and A increases its basis in the X stock by $65. The value of the X stock declines, and A sells the stock to B for $50. X then distributes $65 to B in a subsequent year. B will treat the $65 as a $50 reduction of the basis in the X stock to zero and a $15 capital gain from the sale of the X stock.

Carrybacks

Except for the foreign tax credit, no deduction, loss, or credit may be carried back more than one year (or cause another item to be carried back for more than one year from the current year). To the extent that Federal income tax is reduced in the prior calendar year by reason of a carryback, the EDA is recalculated to reflect the reduced tax paid in the prior year. As under present law, a corporation may elect not to carryback a net operating loss.

Refunds and credits of tax

The overpayment of a corporate income tax is allowed as a refund to the extent of tax paid in the prior taxable year that increased the EDA for the current taxable year. The current year EDA is recomputed by reducing the amount of tax taken into account in the prior taxable year.

Overpayments also are allowed to the extent of any tax previously paid in the current taxable year that would otherwise be taken into account in computing the EDA for the next succeeding calendar year.

Any additional overpayments are allowed only as a credit against income tax due in the future.

These rules do not apply to the extent any overpayment is created by the carryback of a foreign tax credit.

Redemptions

The present law rules relating to the treatment of redemptions of stock (either directly by a corporation or through the use of a related corporation) as a dividend or as an exchange remain the same as under present law, except that the attribution rules might be modified. Redemptions treated as exchanges reduce the EDA and CREBA by the ratable share of the amount attributable to the shares redeemed.

Tax-free reorganizations and liquidations

In the case of a tax-free reorganization or liquidation, the current rules providing for the carryover of tax attributes will be amended to provide for the carryover of the acquired corporation's EDA and CREBA. In the case of a tax-free spin-off, the CREBA is divided between the distributing and controlled corporations based on the relative fair market value of the assets and to insure that any duplicate CREBA is eliminated.

Foreign corporations

The EDA of a foreign corporation takes into account only the tax attributable to income that is effectively connected with a U.S trade or business. The EDA is reduced by the amount of any branch profits tax imposed. Also, a foreign corporation's EDA is increased by (i) the excludable portion of any dividend received in excess of any U.S. withholding tax, and (ii) by the amount any distribution out of a CREBA in excess of any U.S. withholding tax. (For taxation of a foreign corporation as a shareholder, see the discussion below.)

Partnerships and S corporations

Excluded dividends received by a partnership and basis adjustments to stock held by a partnership pass through to the partners, and the adjusted basis in their partnership interests is adjusted to reflect these amounts. A similar rule applies to S corporations and their shareholders.

Except for purposes of determining a shareholder's basis in the stock of the S corporation, items that are taken into account in computing the taxes imposed on built-in gains (sec. 1374) and excess passive investment income (sec. 1375) are not taken into account by shareholders. The accumulated adjustment account continues to be increased by the amount of these items.

Regulated investment companies (RICs) and Real Estate Investment Trusts (REITs)

A RIC or REIT that receives excludable dividend income is allowed to pass through the exclusion to its shareholders. In addition, the retained earnings basis adjustments may be passed through to the shareholders of the RIC or REIT.

Generally a RIC or REIT treats the excludable portion of any dividend in a manner similar to tax-exempt interest in applying the RIC and REIT provisions.

Insurance companies

Under the proposal, all excludable dividends received by an insurance company are subject to proration. Thus, the excluded dividends are allocated on a pro rata basis between the insurance company's general earnings and those amounts set aside to pay benefits. The basis increase allocated to an insurance company will be adjusted to take into account the proration rules. In addition, all excludable dividends and basis increases attributable to assets held in a separate account funding variable life insurance and annuity contracts are allocated to the separate account.

Employee stock ownership plans (ESOPs)

The exclusion does not apply to any dividend for which a corporation is allowed a deduction with respect to dividends paid on shares held by an ESOP. The corporation's EDA is not reduced as a result of the dividend.

Basis may not be allocated to shares held by an ESOP and the treatment of otherwise deductible dividends is not affected by the existence of a CREBA.

Private foundations

Excludable dividends and distributions from a CREBA will not be included in the calculation of net investment income of a private foundation for purposes of the tax imposed by section 4940.

Rules to prevent creation of basis

Certain rules presently applicable to the corporate dividends-received deduction are extended to the dividends received by individuals. First, shareholders must hold stock for more than 45 days during the 90-day period beginning 45 days before the ex-dividend date in order to receive the dividend exclusion.[75] A similar rule applies to the basis adjustments. Second, the rules of section 1059 applicable to certain extraordinary dividends are made applicable to the excluded dividends and basis adjustments.[76] Third, if a shareholder of a RIC receives an excludable dividend or basis adjustment, any loss on the sale of the RIC stock held six months or less is disallowed to the extent of the exclusion or adjustment.

Shareholder indebtedness

The investment interest limitations of section 163(d) are applied by not taking into account any excluded dividend as investment income.

Foreign shareholders

Foreign shareholders, both individual and corporate, are taxed the same as under present law. Thus, withholding taxes continue to apply to all dividends and distributions from a CREBA and no basis adjustments are made to stock held by foreign persons.

Options, etc.

The Secretary of the Treasury may promulgate regulations treating the holder of a right to acquire stock as the holder of stock as necessary to prevent the creation of stock losses or the reduction of stock gains.

Alternative minimum tax

Excluded dividends and reduced gain (or increased loss) resulting from the allocated basis adjustments are not an item of tax preference or adjustment for purposes of determining alternative minimum taxable income (including the determination of adjusted current earnings for corporations).

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[75] In the case of preferred stock, the periods are doubled.

[76] For purposes of applying the rules in the case of inherited stock, the holding period would begin on the valuation date for estate tax purposes.

Accumulated earnings tax and personal holding company tax

The accumulated earnings tax and the personal holding company tax are repealed.

Compliance

Form 1099 will be revised to provide information to shareholders to indicate the amount of excludable dividends and basis adjustments.

A corporation will calculate the EDA and CREBA and report those amounts to the IRS annually on its income tax return.

Effective Date

In general

The proposal applies to distributions made after December 31, 2002, with respect to corporate earnings arising in taxable years ending after December 31, 2000. Thus, for example, a calendar year corporation that filed its 2001 federal income tax return and paid tax on September 15, 2002, may pay excluded dividends or allocate basis adjustments beginning January 1, 2003, based on the amount of tax paid with respect to its taxable income for 2001.

Payments, refunds, and credits of tax attributable to taxable years the return for which was filed before January 1, 2002, will not be taken into account in computing the EDA.

Loss carrybacks

The proposal does not apply to the carryback of losses to a taxable year the return for which was filed before January 1, 2003.

Dividends-received deduction

The present law dividends received deduction continues to apply to the distribution of earnings and profits accumulated in taxable years beginning before January 1, 2001, that are distributed before January 1, 2006, with respect to stock issued before February 3, 2003

H. Deduction for Dividends Received from Controlled Foreign Corporations

Present Law

Income earned by a foreign corporation from its foreign operations generally is subject to U.S. tax only when such income is distributed to any U.S. persons that hold stock in the corporation. Accordingly, a U.S. corporation that conducts foreign operations through a foreign corporation generally is subject to U.S. tax on the income from those operations only when the income is repatriated to the United States through a dividend distribution to the U.S. corporation. The income is reported on the U.S. corporation's tax return for the year the distribution is received, and the United States imposes tax on such income at that time. A foreign tax credit may reduce the U.S. tax imposed on such income.

A variety of complex anti-deferral regimes impose current U.S. tax on certain U.S. shareholders of foreign corporations with respect to certain categories of income earned by the foreign corporation. One of the main anti-deferral regimes set forth in the Code is the controlled foreign corporation regime of subpart F (secs. 951-964). A controlled foreign corporation generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only). Under the subpart F rules, the United States generally taxes the U.S. 10-percent shareholders of a controlled foreign corporation on their pro rata shares of certain income of the controlled foreign corporation (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders. Subpart F income typically is passive income or income that is readily movable from one taxing jurisdiction to another. In effect, the United States treats the U.S. 10-percent shareholders of a controlled foreign corporation as having received a current distribution out of the corporation's subpart F income. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are required to include currently in income for U.S. tax purposes their pro rata shares of the corporation's earnings invested in U.S. property. The U.S. tax on such amounts may be reduced through foreign tax credits.

Dividends paid to a U.S. corporation generally are eligible for a dividends-received deduction. The recipient corporation can generally claim a 100-percent dividends-received deduction if the recipient corporation owns 80 percent or more of the distributing corporation. If the recipient corporation owns less than 80 percent but at least 20 percent of the distributing corporation, the dividends-received deduction is 80 percent. If the recipient corporation owns less than 20 percent of the distributing corporation, the dividends-received deduction is 70 percent.

Dividends received by a U.S. corporation from a foreign corporation are eligible for the dividends-received deduction only in certain limited circumstances. In this regard, dividends received from certain 10-percent or greater-owned foreign corporations are eligible for the dividends-received deduction to the extent that the dividend is attributable to certain U.S.-source income. The percentages allowed as a deduction for the U.S.-source portion of the dividend equal those percentages described in the preceding paragraph.

Description of Proposal

The proposal would provide that dividends received by a U.S. corporation from a controlled foreign corporation would be eligible for an 85-percent dividends-received deduction. For purposes of the proposal, dividends would include both actual dividends and deemed dividends arising from investments in U.S. property under section 956 (but not any other subpart F deemed-dividend inclusions).

The proposal would disallow foreign tax credits (deemed-paid credits as well as direct withholding taxes) to the extent attributable to dividends that are eligible under the proposal for the dividends-received deduction. The proposal would also modify the ordering of distributions from a foreign corporation to treat dividends from foreign corporations as coming first out of untaxed earnings to the extent that the dividend is eligible for the dividends-received deduction, then out of previously taxed earnings (i.e., the sec. 959(c)(1) and (c)(2) pools), and then out of any remaining untaxed earnings (i.e., the sec. 959(c)(3) pool).

Effective Date

The proposal would apply to dividends received from a controlled foreign corporation during the period beginning January 1, 2003 and ending June 30, 2004.

I. Reduction in the Taxation of Capital Gains

Present Law

Individual Capital Gains

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income. Any net capital gain of an individual is taxed at maximum rates lower than the rates applicable to ordinary income. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, (5) certain U.S. publications, (6) certain commodity derivative financial instruments, (7) hedging transactions, and (8) business supplies. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances that would have been available under the straight-line method of depreciation.

The maximum rate of tax on the adjusted net capital gain of an individual is 20 percent. In addition, any adjusted net capital gain which otherwise would be taxed at a 10- or 15-percent rate is taxed at a 10-percent rate. These rates apply for purposes of both the regular tax and the alternative minimum tax.

The "adjusted net capital gain" of an individual is the net capital gain reduced (but not below zero) by the sum of the 28-percent rate gain and the unrecaptured section 1250 gain. The net capital gain is reduced by the amount of gain that the individual treats as investment income for purposes of determining the investment interest limitation under section 163(d).

The term "28-percent rate gain" means the amount of net gain attributable to long-term capital gains and losses from the sale or exchange of collectibles (as defined in section 408(m) without regard to paragraph (3) thereof), an amount of gain equal to the amount of gain excluded from gross income under section 1202 (relating to certain small business stock),[77] the net short-

[77] This results in a maximum effective regular tax rate on qualified gain from small business stock of 14 percent.

term capital loss for the taxable year, and any long-term capital loss carryover to the taxable year.

"Unrecaptured section 1250 gain" means any long-term capital gain from the sale or exchange of section 1250 property (i.e., depreciable real estate) held more than one year to the extent of the gain that would have been treated as ordinary income if section 1250 applied to all depreciation, reduced by the net loss (if any) attributable to the items taken into account in computing 28-percent rate gain. The amount of unrecaptured section 1250 gain (before the reduction for the net loss) attributable to the disposition of property to which section 1231 applies shall not exceed the net section 1231 gain for the year.

The unrecaptured section 1250 gain is taxed at a maximum rate of 25 percent, and the 28-percent rate gain is taxed at a maximum rate of 28 percent. Any amount of unrecaptured section 1250 gain or 28-percent rate gain otherwise taxed at a 15-percent rate is taxed at the 15-percent rate.

Any gain from the sale or exchange of property held more than five years that would otherwise be taxed at the 10-percent rate is taxed at an 8-percent rate. Any gain from the sale or exchange of property held more than five years and the holding period for which begins after December 31, 2000, which would otherwise be taxed at a 20-percent rate is taxed at an 18-percent rate. A taxpayer holding a capital asset or property used in the trade or business on January 1, 2001, may have elected to treat the asset as having been sold on that date for an amount equal to its fair market value, and having been reacquired for an amount equal to such value.

Present law also provides for a 50-percent exclusion for certain stock in small businesses; a 60-percent exclusion for certain stock in small businesses located in an enterprise zone; and a 100-percent exclusion for certain stock and other property relating to the District of Columbia Enterprise Zone and (with respect to acquisitions after 2001) relating to Renewal Communities. These exclusions apply to property held more than five years.

Table 7, below, shows a breakdown of individual capital gain rates under present law for each individual marginal rate bracket and alternative minimum tax rate bracket.

Table 7.–Tax Rates Applicable Under Present Law to Capital Gains

	Regular Tax Rate Bracket[1]						Minimum Tax Rate Bracket	
Category of gain	**10%**	**15%**	**27%**	**30%**	**35%**	**38.6%**	**26%**	**28%**
Short-term capital gain[2]	10	15	27	30	35	38.6	26	28
Long-term capital gain[3]	10	10	20	20	20	20	Same as regular tax	
Section 1250 gain[4]	10	15	25	25	25	25	25	25
Collectible gain	10	15	27	28	28	28	26	28
Small business stock[5]	5	7.5	13.5	14	14	14	18.46[6]	19.88[5]
Small business stock for empowerment zone business[7]	3.2	6	10.8	11.2	11.2	11.2	14.768	15.904
5-year gain if acquired before 2001	8	8	20	20	20	20	Same as regular tax	
5-year gain if acquired after 2000	8	8	18	18	18	18	Same as regular tax	
D.C. Enterprise Zone stock and Renewal Community stock	0	0	0	0	0	0	0	0

Notes:

[1] These are the tax rate brackets for 2003. In future years, reductions are scheduled to take effect for the rate brackets above 15%. Certain rates will be reduced accordingly.

[2] Gain from assets held not more than one year.

[3] Gain from assets held more than one year not included in another category.

[4] Capital gain attributable to depreciation on section 1250 property (i.e., depreciable real estate).

[5] Effective rates after application of 50-percent exclusion for small business stock held more than five years.

[6] Effective rate taking into account the minimum tax preference for the excluded gain. If the holding period for the stock begins after 2000, the rates are 16.64% and 17.92%, respectively.

[7] Effective rates after application of 60-percent exclusion for small business empowerment zone stock held more than

Corporate capital gains

Under present law, the net capital gain of a corporation is taxed at the same rates as ordinary income, and is subject to tax at graduated rates up to 35 percent.

Taxpayer's basis

Under present law, gain or loss from the disposition of any asset generally is the sales price of the asset reduced by the taxpayer's adjusted basis in that asset. The taxpayer's adjusted basis generally is the taxpayer's cost in the asset adjusted for depreciation, depletion, and certain other amounts. No adjustment is allowed for inflation.

1. H.R. 44, the "Investment Tax Incentive Act of 2003"

Description of Proposal

Overview

Congressman Dreier (for himself and others) introduced H.R. 44, the "Investment Tax Incentive Act of 2003." In general, the proposal reduces the rates of tax applicable to individual capital gains and corporate capital gains for assets acquired during a two-year period. In addition, the proposal provides for the indexing of an individual's basis for purposes of calculating gain on the disposition of certain assets.

Individual capital gains

The proposal reduces the rate on the adjusted net capital gain to 10 percent (5 percent for gain which otherwise would be taxed at a 8- or 10-percent rate) for assets the holding period for which begins during the two-year period beginning on the date of enactment of the proposal. The proposal reduces the rate on includible small business stock gain to 14 percent for assets the holding period begins during the two-year period. The reduced rates apply for both the regular tax and the alternative minimum tax.

Corporate capital gains

The proposal provides an alternative corporate capital gain tax rate of 20 percent for gain (of the type to which the lower individual rates provided under the proposal apply) on assets the holding period for which begins during the two-year period beginning on the date of enactment of the proposal.

Basis indexing

In general

The proposal generally provides for an inflation adjustment to (i.e., indexing of) the adjusted basis of certain assets (called "indexed assets") held more than three years for purposes of determining gain (but not loss) upon a sale or other disposition of such assets by a taxpayer other than a C corporation. Assets held by trusts, estates, S corporations, regulated investment companies ("RICs"), real estate investment trusts ("REITs"), and partnerships are eligible for indexing, to the extent gain on such assets is taken into account by taxpayers other than C corporations.

Indexed assets

Assets eligible for the inflation adjustment generally would include common (but not preferred) stock of C corporations and tangible property that are capital assets or property used in a trade or business. A personal residence would not qualify for indexing.

Computation of inflation adjustment

The inflation adjustment under the provision would be computed by multiplying the taxpayer's adjusted basis in the indexed asset by an inflation adjustment percentage. The inflation adjustment percentage would be the percentage by which the GDP deflator for the last calendar quarter ending before the disposition exceeds the GDP deflator for the last calendar quarter ending before the asset was acquired by the taxpayer (or, if later, the calendar quarter ending December 31, 2002). The inflation adjustment percentage would be rounded to the nearest one-tenth of a percent. No adjustment would be made if the inflation adjustment is one or less.

Special entities

RICs and REITs.–In the case of a RIC or a REIT, the indexing adjustments generally would apply in computing the taxable income and the earnings and profits of the RIC or REIT. The indexing adjustments, however, would not be applicable in determining whether a corporation qualifies as a RIC or REIT.

In the case of shares held in a RIC or REIT, partial indexing generally would be provided by the provision based on the ratio of the value of indexed assets held by the entity to the value of all its assets. The ratio of indexed assets to total assets would be determined quarterly (for RICs, the quarterly ratio would be based on a three-month average). If the ratio of indexed assets to total assets exceeds 80 percent in any quarter, full indexing of the shares would be allowed for that quarter. If less than 20 percent of the assets are indexed assets in any quarter, no indexing would be allowed for that quarter for the shares. Partnership interests held by a RIC or REIT would be subject to a look-through test for purposes of determining whether, and to what degree, the shares in the RIC or REIT are indexed.

A return of capital distribution by a RIC or REIT generally would be treated by a shareholder as allocable to stock acquired by the shareholder in the order in which the stock was acquired.

Partnership and S corporations, etc.–Under the proposal, stock in an S corporation or an interest in a partnership or common trust fund would not be an indexed asset. Under the provision, the individual owner would receive the benefit of the indexing adjustment when the S corporation, partnership, or common trust fund disposes of indexed assets. Under the provision, any inflation adjustments at the entity level would flow through to the holders and result in a corresponding increase in the basis of the holder's interest in the entity. Where a partnership has a section 754 election in effect, a partner transferring his interest in the partnership would be entitled to any indexing adjustment that has accrued at the partnership level with respect to the partner and the transferee partner is entitled to the benefits of indexing for inflation occurring after the transfer.

The indexing adjustment would be disregarded in determining any loss on the sale of an interest in a partnership, S corporation or common trust fund.

Foreign corporations

Common stock of a foreign corporation generally would be an indexed asset if the stock is regularly traded on an established securities market. Indexed assets, however, would not include stock in a foreign investment company, a passive foreign investment company (including a qualified electing fund), a foreign personal holding company, or, in the hands of a shareholder who meets the requirements of section 1248(a)(2) (generally pertaining to 10-percent shareholders of controlled foreign corporations), any other foreign corporation. An American Depository Receipt (ADR) for common stock in a foreign corporation would be treated as common stock in the foreign corporation and, therefore, the basis in an ADR for common stock generally would be indexed.

Other rules

Improvements and contributions to capital.–No indexing would be provided for improvements or contributions to capital if the aggregate amount of the improvements or contributions to capital during the taxable year with respect to the property or stock is less than $1,000. If the aggregate amount of such improvements or contributions to capital is $1,000 or more, each addition would be treated as a separate asset acquired at the close of the taxable year.

Suspension of holding period.–No indexing adjustment would be allowed during any period during which there is a substantial diminution of the taxpayer's risk of loss from holding the indexed asset by reason of any transaction entered into by the taxpayer, or a related party.

Short sales.–In the case of a short sale of an indexed asset with a short sale period in excess of one year, the proposal would require that the amount realized be indexed for inflation for the short sale period.

Related parties.–The proposal would not index the basis of property for sales or dispositions between related persons, except to the extent the adjusted basis of property in the hands of the transferee is a substituted basis (e.g., gifts).

Collapsible corporations.–Under the proposal, indexing would not reduce the amount of ordinary gain that would be recognized in cases where a corporation is treated as a collapsible corporation (under sec. 341) with respect to a distribution or sale of stock.

Effective Date

The proposals reducing the rates of tax on individual and corporate capital gains apply to assets the holding period for which begins on or after the date of enactment.

With respect to the indexing of basis, the proposal would apply to dispositions after December 31, 2002.

2. H.R. 1619 as reported by the House Committee on Ways and Means, October 10, 2002

Description of Proposal

The amount of capital losses of individuals that may offset ordinary income is increased to $8,250 (($4,125 in the case of a married individual filing a separate return).

These amounts are indexed for inflation beginning in 2003.

Effective Date

The proposal applies to taxable years beginning after December 31, 2001.

3. S. 106, the "Small Business Growth and Worker Assistance Act"

Description of Proposal

Senator Collins introduced the "Small Business Growth and Worker Assistance Act." The bill would increase the exclusion for qualified sec. 1202 stock from 50 percent to 75 percent. In the case of a qualified empowerment zone business that issues qualified sec. 1202 stock the exclusion would be increased from 60 percent to 85 percent. The bill would tax the includible portion of any gain at the same capital gain rates as other long-term capital gain. The bill would repeal the minimum tax preference for small business stock gain. The bill would increase the eligible gain from $10 million to $20 million in case of married taxpayers filing a joint return. To be eligible for the exclusion, the taxpayer must have held the qualifying stock for three years, rather than five years as required by present law. The 60-day period to make a rollover would be increased to 180 days.

In addition, the proposal would provide that certain working capital must be expended within five years (rather than two years) in order to be treated as used in the active conduct of a trade or business. No limit on the percent of the corporation's assets that are working capital would be imposed. The proposal would provide that if the corporation establishes a business purpose for a redemption of its stock, that redemption is disregarded in determining whether other newly issued stock could qualify as eligible stock.

Effective Date

The proposal would be effective for stock issued after the date of enactment.

4. S. 818, the "Capital Gains Relief and Simplification Act of 2001" (107th Congress)

Description of Proposal

Senator Hatch, for himself and others, introduced the Capital Gains Relief and Simplification Act of 2001, in the 107th Congress. The bill generally would provide a 100-percent deduction for the first $1,000 ($2,000 in the case of a joint return) of net capital gain of an individual and a 50-percent deduction on the remainder of the gain. The bill also would reduce the holding period for long-term capital gain to six months. Finally the bill would

increase the $3,000 limitation on the deductibility of capital losses to $10,000 and index that amount for inflation.

Effective Date

The bill generally would have applied after December 31, 2001 (December 31, 2000, in the case of capital losses).

J. Tax Credit Bonds for the Highway Trust Fund

Present Law

Highway Trust Fund

Established in 1956, the Highway Trust Fund provides a source of financing for the interstate highway system and provides Federal aid for certain other highway programs. Funds are provided annually to each State Department of Transportation (or equivalent) to construct and maintain a designated system of roads known as the Federal-aid highway system.[78]

Excise taxes funding the Highway Trust Fund

The Code imposes six separate excise taxes to finance the Highway Trust Fund program. Three of these taxes are imposed on highway motor fuels. The remaining three are a retail sales tax on heavy highway vehicles, a manufacturers' excise tax on heavy vehicle tires, and an annual use tax on heavy vehicles. A substantial majority of the revenues produced by the Highway Trust Fund excise taxes is derived from the taxes on motor fuels. These taxes are summarized below.

Fuels taxes.–The Highway Trust Fund motor fuels[79] tax rates are as follows:

Gasoline	18.3 cents per gallon
Diesel fuel and kerosene	24.3 cents per gallon
Special motor fuels	18.3 cents per gallon generally[80]

The Code exempts or partially exempts from tax a variety of fuel uses. Generally, these exemptions are for governments or for uses not involving the use of the highway system. Blends

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[78] *See generally*, Congressional Research Service, Report RL31665, *Highway and Transit Program Reauthorization* (December 11, 2002).

[79] These fuels are subject to an additional 0.1-cent-per-gallon excise tax to fund the Leaking Underground Storage Tank ("LUST") Trust Fund. *See*, secs. 4041(d) and 4081(a)(2)(B). That tax is imposed as an "add-on" to other existing taxes.

[80] The statutory rates for certain special motor fuels are determined on an energy equivalent basis, as follows: liquefied petroleum gas (propane), 13.6 cents per gallon; liquified natural gas, 11.9 cents per gallon; methanol derived from petroleum or natural gas, 9.15 cents per gallon; and compressed natural gas, 48.54 cents per MCF. *See* sec. 4041(a)(2) and (3) and 4041(m).

The compressed natural gas tax rate is equivalent only to 4.3 cents per gallon of the rate imposed on gasoline and other special motor fuels rather than the full 18.3-cents-per-gallon rate. The tax rate for the other special motor fuels is equivalent to the full 18.3 cents per gallon gasoline and special motor fuels tax rate.

of alcohol and gasoline meeting certain requirements are taxed at reduced rates.[81] For calendar year 2003, mixtures of 90 percent gasoline and 10 percent alcohol are taxed at 13.2 cents per gallon, an exemption of 5.1 cents. This exemption is coordinated with an income tax credit equal to 52 cents per gallon producing a net tax subsidy for these fuels.

Nonfuel taxes.–A 12-percent retail sales tax is imposed on the first retail sale of tractors, heavy trucks (over 33,000 pounds) and trailers (over 26,000 pounds). Tires designed for use on heavy highway vehicles are subject to a graduated tax, based on the weight of the tire (sec. 4071).

40 pounds or less	No tax
40-70 pounds	15 cents per pound 40 pounds
70-90 pounds	4.50 plus 30 cents per pound over 70 pounds
Over 90 pounds	$10.50 plus 50 cents per pound over 90 pounds

An annual use tax is imposed on heavy highway vehicles, at the rates below.[82]

Under 55,000 pounds	No tax
55,000-75,000 pounds	$100 plus $22 per 1,000 pounds over 55,000
Over 75,000 pounds	$550

Operative rules for the Highway Trust Fund

Section 9503 of the Code contains the operative rules for transfer of revenues to the Highway Trust Fund and for expenditure of monies from the Trust Fund.

In general, these rules provide for transfer of "gross receipts" from the Highway Trust Fund excise taxes to the Trust Fund (sec. 9503(b)). The transfers are net of refunds for tax overpayments. Additionally, 2.5 cents per gallon of the tax imposed on gasohol are retained in the General Fund. Also with respect to gasohol, Highway Trust Fund revenues are reduced by the amount of the tax subsidy claimed through the excise tax system, but not for amounts claimed as income tax credits.

Amounts deposited in the Highway Trust Fund are divided between a Mass Transit Account and a residual, or Highway, Account. The Mass Transit Account receives 2.86 cents per gallon of the Highway Trust Fund motor fuels excise taxes.[83] The balance of the motor fuels

[81] Reduced rates also apply to alcohol mixtures that contain diesel fuel and kerosene.

[82] Sec. 4081.

[83] This amount is adjusted to reflect the taxes imposed on certain special motor fuels that are subject to tax at special "Btu equivalent" rates. There is no reduction in the Mass Transit portion to reflect the reduced tax per gallon paid on gasohol.

tax receipts and all receipts from the three non-fuels excise taxes are deposited in the Highway Account.

The Code allows expenditure of Highway Trust Fund monies for the purposes authorized under each of the highway authorization Acts that have been enacted since creation of the Trust Fund in 1956, as those Acts were in effect on the date of enactment of the Transportation Equity Act for the 21st Century ("TEA 21") (sec. 9503(c)).[84] These expenditures are limited by an internal to the Trust Fund anti-deficit provision, the so-called "Harry Byrd Rule". This Byrd Rule requires the Treasury Department to determine, on a quarterly basis, the amount (if any) by which unfunded highway authorizations exceed projected net Highway Trust Fund tax receipts for the 24-month period beginning at the close of each Fiscal Year (sec. 9503(d)). If there is an excess, apportionments to the States under the Highway Trust Fund are reduced by that amount.

State and local tax-exempt and tax-credit bonds

Tax-exempt bonds may be issued by States or local governments to finance their governmental activities or to finance certain capital expenditures of private businesses or loans to individuals. Additionally, States or local governments may issue tax-credit bonds to finance the operation of "qualified zone academies." Qualified zone academy bonds presently are the only tax-credit bonds authorized by the Code.

Tax-exempt bonds

Interest on bonds issued by States or local governments to finance activities of those governmental units is excluded from tax (sec. 103). In addition, interest on certain bonds ("private activity bonds") issued by States or local governments acting as conduits to provide financing for private businesses or individuals is excluded from income if the purpose of the borrowing is specifically approved in the Internal Revenue Code (sec. 141). Examples of approved private activities for which States or local governments may provide tax-exempt financing include transportation facilities (airports, ports, mass commuting facilities, and certain high-speed intercity rail facilities); public works facilities such as water, sewer, and solid waste disposal; and certain other programs such as low-income rental housing, student loans, and mortgage loans to certain first-time homebuyers.

Issuance of most private activity bonds is subject to annual State volume limits of the greater of $75 per resident or $228,580,000 million in calendar year 2003. Investment earnings on all tax-exempt bonds, including earnings on invested sinking funds associated with such bonds are restricted by the Code to prevent the issuance of bonds earlier or in a greater amount than necessary for the purpose of the borrowing. In general, all profits on investment of such

[84] The Code further contains a special enforcement provision to prevent expenditure of Highway Trust Fund monies for purposes not authorized in section 9503 (i.e., not approved by the tax-writing committees of Congress) (sec. 9503(b)(5)). This provision provides that should such unapproved expenditures occur, no further excise tax receipts will be transferred to the Highway Trust Fund. Rather, the taxes will continue to be imposed with receipts being retained in the General Fund.

proceeds must be rebated to the Federal Government. Interest on bonds associated with invested sinking funds is taxable.

Tax-credit bonds for qualified zone academies

As an alternative to traditional tax-exempt bonds, certain States or local governments are given authority to issue "qualified zone academy bonds." $400 million of qualified zone academy bonds are authorized to be issued in each year of 1998 through 2003. The $400 million is allocated to States according to their respective populations of individuals below the poverty line.

Qualified zone academy bonds are taxable bonds with respect to which the investor receives an income tax credit equal to an assumed interest rate set by the Treasury Department to allow issuance of the bonds without discount and without interest cost to the issuer. The bonds may be used for renovating, providing equipment to, developing course materials for, or training teachers in eligible schools. Eligible schools are elementary and secondary schools with respect to which private entities make contributions equaling at least 10 percent of the bond proceeds.

Only financial institutions are eligible to claim the credits on qualified zone academy bonds. The amount of the credit also is taken into income. The credit may be claimed against both regular income tax and alternative minimum tax liability.

There are no arbitrage restrictions applicable to investment earnings on qualified zone academy bond proceeds.

Treasury securities

The full faith and credit of the United States guarantees the timely payment of principal and interest on Treasury securities. The Treasury sells marketable bills, fixed-principal notes and bonds, and inflation-indexed notes and bonds in regularly scheduled auctions. Bills, fixed-principal notes and bonds, and inflation-indexed notes and bonds are freely transferable. They are traded in global capital markets. The Treasury also sells nonmarketable securities to the public in the form of U.S. Savings Bonds, State and local government series securities, foreign-series securities, domestic-series securities and mortgage guaranty insurance company tax and loss bonds. These nonmarketable securities are not transferable.[85]

Generally, gross income includes interest on Treasury securities. However, interest earned on qualified U.S. Series EE and Series I savings bonds issued after 1989 are excludable from gross income if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year.[86]

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[85] *See*, Bureau of Public Debt, *Treasury Securities at a Glance* <http://www.publicdebt.treas.gov/com/comintro.htm> (February 2, 2003).

[86] Sec. 135. If the aggregate redemption amount (i.e., principal plus interest of all Series EE or Series I bonds redeemed by the taxpayer during the taxable year) exceeds the qualified

Description of Proposals

S. 3097 (107th Congress)

On October 10, 2002, Senator Baucus (for himself and Senator Crapo) introduced S. 3097, the "Maximum Economic Growth for America Through Innovative Finance Act or MEGA Innovate." Under the bill, the Secretary of the Treasury would sell tax credit bonds with the proceeds being placed in the Highway Account of the Highway Trust Fund. The Treasury would be responsible for the principal. In lieu of interest, the bondholder would receive a tax credit. For each calendar year, a total of $3 billion of qualified highway bonds could be issued in 2004, 2005, 2006, 2007, and 2008. For calendar year 2009, the applicable bond limitation is $1 billion.

Under the proposal, a bond would be treated as a qualified highway bond only if the following five requirements were satisfied: (1) at least 95 percent of the bond proceeds are transferred to the Highway Trust Fund for expenditure under the requirements of such Trust Fund, (2) the bond is issued by the Secretary, is in registered form, and meets certain bond limitation requirements discussed above, (3) the Secretary designates such bond as a qualified highway bond for purposes of this provision, (4) the term of each bond that is part of such an issue cannot exceed 20 years, and (5) the payment of principal with respect to such bond is the obligation of the United States Government.

Unlike present-law qualified zone academy tax-credit bonds, any taxpayer would be able to hold a qualified highway bond and thereby claim the tax credit. The "credit rate" for qualified highway bonds would be set daily by the Treasury Department so that the rate is equal to an average market yield (as of the day before the date of sale of the issue) on outstanding long-term corporate debt obligations (determined in such manner as the Secretary prescribes). Credits would accrue quarterly and would be includable in the gross income of the taxpayer. In the case of a bond issued during the three-month period between credit allowance dates, the amount of the credit would be prorated based on the portion of the three-month period during which such bond is outstanding. A similar rule would apply when the bond is redeemed. Unused credits could not be carried back, but could be carried forward.

Effective date.–The proposal would be effective for obligations issued after December 31, 2003.

Senator Baucus's Stimulus Package for 2003

In December 2002, Senator Baucus proposed that during 2003 the Secretary of the Treasury would sell $4 billion of tax credit bonds with the proceeds being placed in the Highway Account of the Highway Trust Fund. The Treasury would be responsible for the principal. In lieu of interest, the bondholder would receive a tax credit.

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higher education expenses incurred, then the excludable portion of the interest income is based on the ratio that the education expenses bears to the aggregate redemption amount.