

THE PRESIDENT'S FISCAL YEAR 1978 TAX EXPENDITURE PROPOSALS

As required by Public Law 93-344

Staff Working Paper

April 1977



Congress of the United States
Congressional Budget Office
Washington, D.C.

THE PRESIDENT'S FISCAL YEAR 1978
TAX EXPENDITURE PROPOSALS

A Report to the Senate and House
Committees on the Budget

(As Required by Public Law 93-344)

PREFACE

In February, CBO published Budget Options for Fiscal Year 1978, as one of the documents prepared pursuant to section 202(f) of the Budget Act of 1974. The Preface noted that a separate report on tax expenditures must take into account proposals by the President in the Budget of the U.S. Government. This year, there have been two sets of proposals. The first was transmitted by President Ford in the January budget. The second was contained in Budget revisions by President Carter.

This report summarizes the effect of both sets of proposals on the current levels of tax expenditures. It was prepared by John Roth of the Tax Analysis Division.

Alice M. Rivlin
Director

April 1977

TABLE OF CONTENTS

	<u>Page</u>
Preface	iii
Introduction	1
Levels of Tax Expenditures Under Existing Law	2
Changes Proposed in the January Budget	2
Changes in Budget Revisions	6

.

.

.

.

LIST OF TABLES

	<u>Page</u>
1. Levels Under Existing Law of Tax Expenditures	
Directly Affected by January Budget Proposals	3
2. Effect of Tax Proposals in the January Budget	
on the Level of Tax Expenditures	5
3. Effect of Tax Proposals in the Budget Revisions	
on the Level of Tax Expenditures	8

LEVELS OF TAX EXPENDITURES

INTRODUCTION

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

A tax expenditure provision may offer its tax relief in any of the following forms:

- o special exclusions, exemptions, and deductions, which reduce taxable income, and thus result in a lesser amount of tax (for example, tax-exempt municipal bond interest or the deduction of interest paid on consumer loans).
- o preferential rates, which reduce taxes by applying lower rates to part or all of a taxpayer's income (for example, the special 50 percent maximum tax rate on personal service income).
- o special credits, which are subtracted from the actual taxes due, rather than from the income on which the tax is figured (for example, the investment tax credit).
- o deferrals of tax, which generally result from allowing in the current year deductions that are properly attributable to a future year (for example, accelerated depreciation).

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

LEVELS OF TAX EXPENDITURES UNDER EXISTING LAW

There are 84 items in the tax expenditures budget for fiscal 1978. ^{1/} The level of tax expenditures for individuals in fiscal year 1978 is estimated to be \$95.8 billion and for corporations, \$28.9 billion. Several of these items would be directly affected by the budget proposals submitted in January by President Ford. Those items and their levels are set forth in Table 1.

CHANGES PROPOSED IN THE JANUARY BUDGET

The proposals in the January budget included major revisions of both the individual and corporate income tax. Among those were recommendations to lower rate structures. A lowering of rates would change the value of many tax expenditures. For example, a charitable contribution of \$100 by a corporation in the top rate produces \$48 of tax relief under current tax law, but would be worth only \$46 if the top corporate rate were lowered to 46 percent.

Major Proposals Affecting Individuals

The major changes proposed for individual taxpayers were to:

- o eliminate the current \$35 per exemption tax credit and the alternative credit of 2 percent of taxable income up to \$9,000, and increase the personal exemption from \$750 to \$1,000;
- o raise the low-income allowance from \$1,700 to \$1,800 for single persons and from \$2,100 to \$2,500 for married couples filing joint returns; and
- o eliminate the earned income credit now available to low-income families.

Table 2 shows the effect of each of these provisions on the current levels of tax expenditures.

^{1/} See Five-Year Budget Projections: Fiscal Years 1978-1982, A Supplemental Report, Congressional Budget Office, April 1977, for a report on tax expenditure projections for fiscal years 1978-1982.

TABLE 1. LEVELS UNDER EXISTING LAW OF TAX EXPENDITURES DIRECTLY AFFECTED BY JANUARY BUDGET PROPOSALS FOR FISCAL YEAR 1978, IN MILLIONS OF DOLLARS

Tax Expenditure	Individuals	Corporations
Major provisions affecting individuals:		
Earned income credit--		
Nonrefundable portion	205	
Refundable portion	1,145	
Excess of percentage standard deduction over low-income allowance	1,410	
Additional exemption for over 65	1,280	
Additional exemption for the blind	20	
Parental personal exemptions for students, age 19 and over	770	
Major provisions affecting corporations:		
Corporate surtax exemption		4,250
Exclusion of employee benefits: employee stock ownership plans (ESOPs) funded through investment tax credits		255
Miscellaneous provisions:		
Deductibility of charitable contributions--		
Education	565	240
Health	965	150
Other than education and health	4,510	295
Exclusion of interest on state and local pollution control bonds	100	220
Exclusion of interest on state and local industrial development bonds	110	235
Exclusion of interest on general purpose state and local debt	1,880	3,470

Source: Joint Committee on Taxation.

The excess of percentage standard deduction over the low-income allowance would be reduced by the combination of the larger low-income allowance and lower rates. The elimination of the earned income credit would increase revenues by \$1,350 million in fiscal year 1978.

Major Proposals Affecting Corporations

The January budget also contained a package of corporate income tax proposals that would significantly affect existing tax expenditures. The major proposed changes in business taxes were to:

- o reduce the maximum corporate tax rate from 48 percent to 46 percent;
- o make permanent the corporate surtax exemption provision that provides a lower tax rate on the first \$50,000 of corporate income;
- o make permanent the 10 percent investment tax credit that reverts to 7 percent at the end of 1980 under current law;
- o permit accelerated depreciation for new plant and equipment in areas with unemployment rates of 7 percent or higher;
- o integrate partially the individual and corporate income taxes by providing for a corporate deduction for a portion of dividends paid and an adjustment at the shareholder level for the remaining corporate tax on dividend distributions; and
- o repeal the current law provision that allows funding Employee Stock Ownership Plans (ESOPs) through supplemental investment tax credits.

The plan to integrate the individual and corporate income taxes would have a significant impact on the levels of all tax expenditures. Estimates of that effect have not been made pending further specification of details. Nor has a separate estimate of the effect of the lower maximum corporate tax rate on each tax expenditure been made. Table 2 shows the effects of the other proposed changes on corporate tax expenditures.

TABLE 2. EFFECT OF TAX PROPOSALS IN THE JANUARY BUDGET ON THE LEVEL OF TAX EXPENDITURES FOR FISCAL YEAR 1978, IN MILLIONS OF DOLLARS

Tax Expenditures	Individuals	Corporations
Major proposals affecting individuals:		
Earned income credit--		
Nonrefundable portion	- 205	
Refundable portion	-1,145	
Excess of percentage standard deduction over low-income allowance	- 605	
Additional exemption for over 65	425	
Additional exemption for the blind	5	
Parental personal exemptions for students, age 19 and over	255	
Major proposals affecting corporations:		
Corporate surtax exemption		1,045
Exclusion of employee benefits: employee stock ownership plans (ESOPs) funded through investment tax credits		- 255
Accelerated depreciation in high unemployment areas	30	175
Miscellaneous proposals:		
Deductibility of charitable contributions	55	
Exclusion of interest on state and local debt	- 5	
Credit for home insulation	195	
Expensing of geothermal research and development		a/

Source: Special Analysis of the Budget of the United States Government for Fiscal Year 1978, Special Analysis F, Table F-2; and Joint Committee on Taxation.

a/ Less than \$5 million.

Miscellaneous Proposals

President Ford also recommended several other changes in current tax law that would, if enacted, have significant impact on existing tax expenditures in some cases and create new tax expenditures in other cases. The miscellaneous proposals include:

- o excluding all charitable contributions from the base of the minimum tax on preference income;
- o giving state and local governments the option of issuing taxable securities in return for a federal subsidy equal to 30 percent of their net interest cost;
- o providing a 15 percent tax credit to homeowners for the cost of insulation and storm windows; and
- o allowing certain expenditures for the discovery of geothermal energy resources to be treated as current expenses as private research and development outlays are now treated under existing tax law.

Table 2 also shows the estimated impact of these miscellaneous proposals.

CHANGES IN BUDGET REVISIONS

President Carter has proposed to extend the following tax expenditure features of the Tax Reform Act of 1976 that are scheduled to expire at the end of calendar year 1977:

- o the earned income credit, generally available to low-income families with dependents; and
- o the corporate surtax exemption which provides lower tax rates on the first \$50,000 of corporate net income.

President Carter proposed only a one-year extension, through calendar year 1978, of these two provisions. The estimated impact of their extension is presented in Table 3.

Tax Expenditures in Economic Stimulus Package

Two features of President Carter's economic stimulus package would effect major changes in tax expenditures for fiscal year 1978. These changes are: (1) a permanent simplification of the standard deduction, consisting of replacement of the low-income allowance and the percentage standard deduction with a flat standard deduction, and (2) a permanent reduction of business taxes.

Standard Deduction. The minimum standard deduction now allowed for individuals is \$1,700 for single returns and \$2,100 for married couples filing jointly. The percentage standard deduction is equal to 16 percent of adjusted gross income up to a maximum of \$2,400 for single returns and \$2,800 for joint returns. President Carter proposed replacing these provisions with a flat standard deduction of \$2,200 for single persons and \$3,000 for married couples. This change would become effective May 1, 1977, and would be a permanent change in the law.

The present tax expenditure consisting of the excess of the percentage standard deduction over the low-income allowance would simply vanish. But individual tax burdens would not be raised by the \$1,410 million shown in Table 3 because the change is offset by the revenue loss (lowered tax burdens) of initiating the flat standard deduction. The fiscal year 1978 revenue loss associated with the flat standard deduction is estimated to be \$5.6 billion.

Business Tax Cuts. The other permanent tax change proposed by President Carter is a reduction in business taxes to be effected either through a 2 percentage point increase in the investment tax credit or a refundable credit against income taxes equal to 4 percent of an employer's social security tax liability. Businesses would be given the opportunity to choose whichever of the two provisions was more favorable for them but would not be permitted to change once their choice was made. This proposal would reduce receipts by \$2.3 billion in fiscal year 1978. The estimated impact of this change is listed in Table 3 (as business tax cuts). ^{2/}

^{2/} The President's fiscal stimulus package is currently being acted on by the Senate. The House-passed version (H.R. 3477) substituted a jobs tax credit based on employment for the business tax cuts, and increased the flat standard deduction to \$2,400 for single filers and \$3,000 for joint returns. The Senate Finance Committee included a 2 percent increase in the investment tax credit as an

TABLE 3. EFFECT OF TAX PROPOSALS IN THE BUDGET REVISIONS ON THE LEVEL OF TAX EXPENDITURES FOR FISCAL YEAR 1978 IN MILLIONS OF DOLLARS

Tax Expenditure	Individuals	Corporations
Fiscal stimulus proposals:		
Excess of percentage standard deduction over minimum standard deduction	-1,410	
Business tax cuts	500	1,800
Extension of temporary tax provisions:		
Earned income credit--		
Nonrefundable portion	205	
Refundable portion	1,145	
Corporate surtax exemption		1,045
Proposals retained from January budget:		
Exclusion of interest on state and local debt	- 5	

Source: Fiscal Year 1978 Budget Revisions and Joint Committee on Taxation.

Tax Expenditure Proposals Retained from January Budget

President Carter also recommended giving state and local governments the option of issuing taxable securities in return for a federal subsidy equal to 30 percent of net interest costs. This proposal was also contained in the January budget. Except for this option, the one-year extension of the earned income credit, and the simplification of the minimum standard deduction, all the other individual tax expenditure proposals in the January budget were omitted in the budget revisions. Similarly, except for the optional increase in the investment tax credit and the one-year extension of the lowered corporate surtax exemption, all the other business tax expenditure proposals in the January budget were omitted as well.

option to the jobs tax credit. It also changed the levels of the standard deduction to \$2,200 for singles and \$3,200 for joint returns and heads of households.