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# Reducing the Budget Deficit: Tax Policy Options

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# Summary

Tax reform and deficit reduction are two issues being considered by the 112th Congress. In recent months, a number of groups have published various plans for tackling the nation's growing deficits. On September 19, 2011, President Obama submitted recommendations to the Joint Select Committee for Deficit Reduction.

This report analyzes various revenue options for deficit reduction, highlighting proposals made by the President's Fiscal Commission, the Debt Reduction Task Force, and the President's proposal. Others, such as House Budget Committee Chairman Paul Ryan and the Obama Administration, have noted the importance of tax reform as part of deficit reduction plans. These plans, however, do not provide the same level of detail with respect to tax provisions as the Fiscal Commission, Debt Reduction Task Force, and President's proposal, and are therefore not reviewed in detail as part of this report.

Large budget deficits, rising national debt, and the growth of entitlement spending have raised questions regarding fiscal sustainability in the United States. The Congressional Budget Office (CBO) predicts a FY2011 budget deficit of nearly $1.5 trillion, or 9.8% of gross domestic product (GDP). Over the past three decades, budget deficits have averaged 3% of GDP. Large budget deficits have contributed to an increased level of federal debt, relative to the size of the economy. Increased debt levels are expected to lead to increased federal interest payments. If not addressed, the current fiscal situation could undermine economic growth.

Reducing federal deficits will likely require reductions in spending, increased federal revenues, or some combination of spending cuts and revenue increases. Federal revenues in 2009 and 2010, relative to the size of the economy, were low by historical standards. Reduced federal collections may be partially attributable to the weak economy and the fiscal policy response. Historically low individual income tax collections may also be partially explained by the 2001 and 2003 tax cuts. Spending through the tax code, via tax expenditures, also reduces federal revenues. The use of tax expenditures may undermine economic efficiency and equity in the tax code.

The primary sources of federal revenues are individual income taxes, payroll taxes, corporate income taxes, and excise taxes. Additional income tax revenues could be raised with a broader tax base, which could be achieved by eliminating various exemptions, credits, and deductions. A broader tax base could also allow for lower tax rates, without a loss in federal revenues. Broadening the tax base could enhance the economic efficiency of the tax system.

The Fiscal Commission, the Debt Reduction Task Force, and the President's proposal took different approaches in the tax reform components of their fiscal sustainability plans. The President's Fiscal Commission raised additional tax revenues primarily through comprehensive income tax reform. The Fiscal Commission chose to broaden the tax base, allowing for both lower tax rates and increased federal revenues. The Debt Reduction Task Force's proposal also recommended individual income tax reform. The individual income tax reforms recommended by the Debt Reduction Task Force were designed to enhance efficiency and increase progressivity in the income tax system. Additional revenues in the Debt Reduction Task Force's plan originate from the proposed 6.5% debt-reduction sales tax. The President's proposal does not propose comprehensive tax reform, but instead highlights various provisions that could be modified or eliminated to generate additional federal revenues.

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# Introduction

The 112th Congress is currently considering various options for tax reform and deficit reduction. In recent years, deficits have reached historically high levels relative to the size of the economy, leading to concerns over fiscal sustainability in the long run. A balanced approach to deficit reduction could involve changes to both federal spending and revenues. This report addresses revenue options, highlighting proposals made by the President's Fiscal Commission and the Debt Reduction Task Force. Both of these groups offered bipartisan proposals for deficit reduction that provide a potential starting point for what is likely to be a process that involves many difficult policy choices. In addition to changes in revenue policy geared toward deficit reduction, fundamental tax reform has been an issue of interest in the 112th Congress. It is possible for tax reform to complement deficit reduction goals.

This report begins by reviewing the current fiscal situation. As a percentage of gross domestic product (GDP), revenues remain at historically low levels while spending remains elevated, contributing to budget deficits. The budget deficit in FY2011 is projected to be nearly $1.5 trillion, or 9.8% of GDP. Further, in recent years, the share of the federal budget devoted to mandatory spending has increased, making it difficult, if not impossible, for fiscal sustainability to be achieved through cuts in discretionary spending alone. Large budget deficits continue to contribute to a growing national debt, which, if left unchecked, could undermine future economic growth.

After examining the current fiscal situation, this report analyzes current federal revenues. The United States currently raises most federal revenues through the individual income tax and payroll taxes. Reforms to both types of taxes could result in additional revenues. Further, the United States could generate additional revenue by reforming the corporate income tax, levying additional consumption taxes, or by increasing excise taxes on certain items (e.g., gasoline, alcohol), among other options.

In recent months, a number of groups and individuals have issued proposals for deficit reduction. This report provides a comparison of the tax reforms suggested in two of these proposals, the President's Fiscal Commission and the Debt Reduction Task Force. These two were chosen as each provided comparable specifics with respect to tax reform.

In addition to the Fiscal Commission and Debt Reduction Task Force plans, notable deficit reduction plans have been released by congressional leadership and the Administration. In April, 2011, Representative Paul Ryan, chairman of the House Committee on the Budget released *The Path to Prosperity: Restoring America's Promise*.[1] This document accompanies the House-passed FY2012 budget resolution, H.Con.Res. 34. Chairman Ryan's *Path to Prosperity* proposes to reduce budget deficits and stabilize national debt using a combined strategy, including spending cuts, entitlement reforms (specifically, Medicare), and tax reforms. The *Path to Prosperity* suggests simplifying the tax code by reducing rates and eliminating tax expenditures. Specifics regarding which tax expenditures would be eliminated were not provided.

The Administration has also outlined a broad framework for deficit reduction, in a fact sheet titled *The President's Framework for Shared Prosperity and Shared Fiscal Responsibility*.[2] The

[1] The Path to Prosperity is available on the House Committee on the Budget website, at http://budget.house.gov/fy2012budget/.

[2] The White House, "FACT SHEET: The President's Framework for Shared Prosperity and Shared Fiscal Responsibility," press release, April 13, 2011, http://www.whitehouse.gov/the-press-office/2011/04/13/fact-sheet-presidents-framework-shared-prosperity-and-shared-fiscal-resp.

President also supports eliminating tax expenditures. Eliminating tax expenditures might allow for reduced rates or deficit reduction. The Administration's proposal does not provide specifics regarding which tax expenditure provisions would be eliminated.[3] The Administration also notes that reforms to Social Security should be considered. This potentially could include changes to the payroll tax base, however, specifics were not provided.

The Budget Control Act of 2011 (P.L. 112-25) couples an increase in the debt ceiling with reduced spending, while also establishing a 12-member Joint Select Committee to identify additional policies to reduce the deficit.[4] Under the Budget Control Act of 2011, the debt ceiling is increased through multiple phases by $2.1 trillion to $2.4 trillion. The increase in the debt ceiling is matched with a decrease in projected federal deficits. Under the first phase, the debt ceiling is increased by $900 billion ($400 billion up front, with another $500 billion increase to occur in the absence of a joint resolution of disapproval). Under the second phase, the 12-member Joint Select Committee on Deficit Reduction identifies an additional $1.5 trillion in deficit reduction over the FY2012 - FY2021 budget window. If the Joint Select Committee fails to find at least $1.2 trillion in deficit reduction, $1.2 trillion in across-the-board spending cuts would be enacted. As the Joint Select Committee evaluates policy options for achieving the additional $1.2 trillion to $1.5 trillion in deficit reduction, revenue options may be considered.

On September 19, 2011, President Obama submitted recommendations for deficit reduction to the Joint Select Committee on Deficit Reduction.[5] The President's proposal, when combined with the discretionary spending caps enacted as part of the Budget Control Act, would result in nearly $4.9 trillion in deficit reduction through 2021.

# The Current Fiscal Situation

Several factors contribute to the current fiscal situation. First, there are historically large budget deficits. Bringing down budget deficits could involve reducing spending, increasing revenues, or both. Second, these large budget deficits are contributing to a growing national debt. If these deficits and the debt are not addressed, there may be macroeconomic consequences. The following sections address these factors in turn.

## The Budget Deficit

The U.S. federal budget deficit has increased relative to historical levels.[6] In recent decades, budget deficits have rarely exceeded 5% of GDP. The FY2010 budget deficit was $1.3 trillion, or 8.9% of GDP. The Congressional Budget Office (CBO) projects a FY2011 budget deficit of

[3] The Administration has outlined a number of tax expenditure provisions that could be eliminated in the FY2012 Budget Proposal.

[4] For background on the federal debt limit, see CRS Report RL31967, *The Debt Limit: History and Recent Increases*, by D. Andrew Austin and Mindy R. Levit.

[5] Office of Management and Budget, "Living Within Our Means and Investing in the Future: The President's Plan for Economic Growth and Deficit Reduction," September, 2011. Available at http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/jointcommitteereport.pdf.

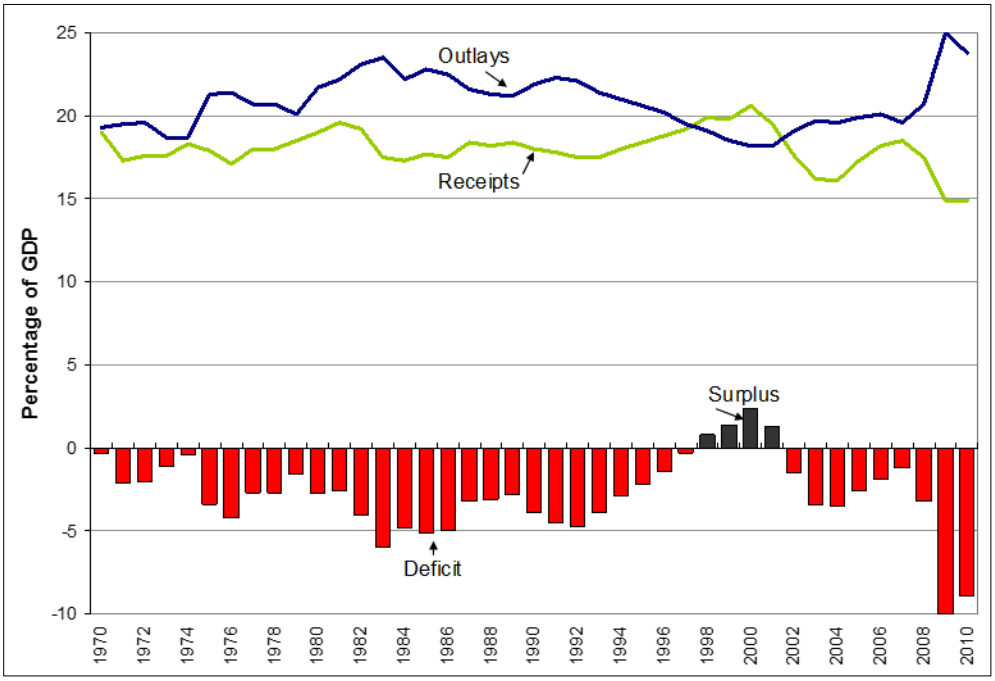
[6] The budget deficit (or surplus) is the difference between federal revenues (i.e., taxes and fees) collected and government outlays (i.e., spending).

nearly $1.5 trillion, or 9.8% of GDP.[7] The Office of Management and Budget (OMB) projects budget deficits rising to $1.6 trillion, or 10.9% of GDP. [8]

Over the past three decades (1980 through 2010), the average budget deficit was 3% of GDP.[9] **Figure 1** illustrates outlays, receipts, and deficits as a percentage of GDP. In years where outlays exceed revenues, the federal government runs a budget deficit. As can be seen in **Figure 1**, outlays have increased while revenues have decreased, relative to GDP, in recent years. The increase in federal outlays coupled with a decrease in federal receipts has led to a rising budget deficit.

**Figure 1. Federal Budget Deficits/Surplus Relative to GDP**

1970–2010




**Source:** CRS graphic using data from the President's FY2012 Budget, Historical Tables, Table 1.2.

Federal spending consists of mandatory spending, discretionary spending, and net interest payments. Generally, mandatory spending includes spending on entitlement programs and spending controlled by laws other than annual appropriations acts.[10] Discretionary spending is the

[7] The Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2011 to 2021*, Washington, DC, January 2011, http://www.cbo.gov/ftpdocs/120xx/doc12039/01-26_FY2011Outlook.pdf.

[8] The Office of Management and Budget, *The President's Budget for Fiscal Year 2012*, Washington , DC, February 14, 2011, http://www.whitehouse.gov/omb/budget [henceforth cited as the President's FY2012 Budget].

[9] This figure is the simple average of deficits or surpluses as reported in the President's FY2012 Budget, Historical Tables, Table 1.2.

[10] Mandatory spending is primarily spending on Social Security, Medicare, and Medicaid. Other mandatory spending programs include Temporary Assistance to Needy Families (TANF), Supplemental Security Income (SSI), unemployment insurance, veterans' benefits, federal employee retirement and disability, SNAP (formerly Food Stamps), and refundable tax credits, such as the Earned Income Tax Credit (EITC). See CRS Report RL33074, *Mandatory Spending Since 1962*, by D. Andrew Austin and Mindy R. Levit.

portion of spending controlled by annual appropriations legislation.[11] Net interest includes the government's interest payments on debt held by the public, offset by interest income the government receives through loans made and investments.

Over the past few decades, mandatory spending has grown to dominate federal outlays. In FY2010, mandatory spending was 55% of total outlays, or $1,913 billion.[12] In FY1980, mandatory spending was 44% of total outlays. Discretionary spending as a percentage of total outlays was 39% in FY2010, or $1,347 billion. Discretionary spending as a percentage of total outlays was 47% in FY1980. Discretionary spending can be further decomposed into defense-related and non-defense-related discretionary spending. In FY2010, non-defense discretionary spending was $658 billion, a sum equal to 49% of discretionary spending or 19% of total federal outlays. Non-defense discretionary spending was 24% of total outlays in 1980. Eliminating the FY2010 budget deficit using only cuts in discretionary spending would have required eliminating all discretionary spending, including defense-related discretionary spending.

An evaluation of the federal budget deficit and appropriate policy responses requires examining anticipated longer-term deficits. The FY2010 budget deficit is partially due to fiscal stimulus and other policies enacted in response to the financial crisis and Great Recession which began in late 2007. Automatic increases in spending during the recession also contributed to budget deficits. While the budget deficit was 9% to 10% of GDP in FY2010, the CBO baseline has budget deficits at 3.0% of GDP in 2015. The President's FY2012 Budget projects deficits of 3.2% of GDP by 2015. Various projections predict budget deficits to persist through FY2020 and beyond.

## The National Debt and Interest Payments

Budget deficits add to the national debt. In 2010, the national debt was $9 trillion.[13] By 2016, projections suggest that the national debt will reach $15 trillion.[14] **Figure 2** illustrates debt as a percentage of GDP from 1970 through 2016. Between 1970 and the mid-1990s, debt as a percentage of GDP increased from less than 30% to nearly 50% of GDP. In the late 1990s, during a phase of federal budget surpluses and strong economic growth, the debt decreased to less than 33% of GDP in 2001. By 2009, debt relative to GDP had increased to 62%. By 2016, it is expected that debt relative to GDP will reach 76%.[15]

[11] See CRS Report RL34424, *Trends in Discretionary Spending*, by D. Andrew Austin and Mindy R. Levit.

[12] This figure includes undistributed offsetting receipts of $82 billion.

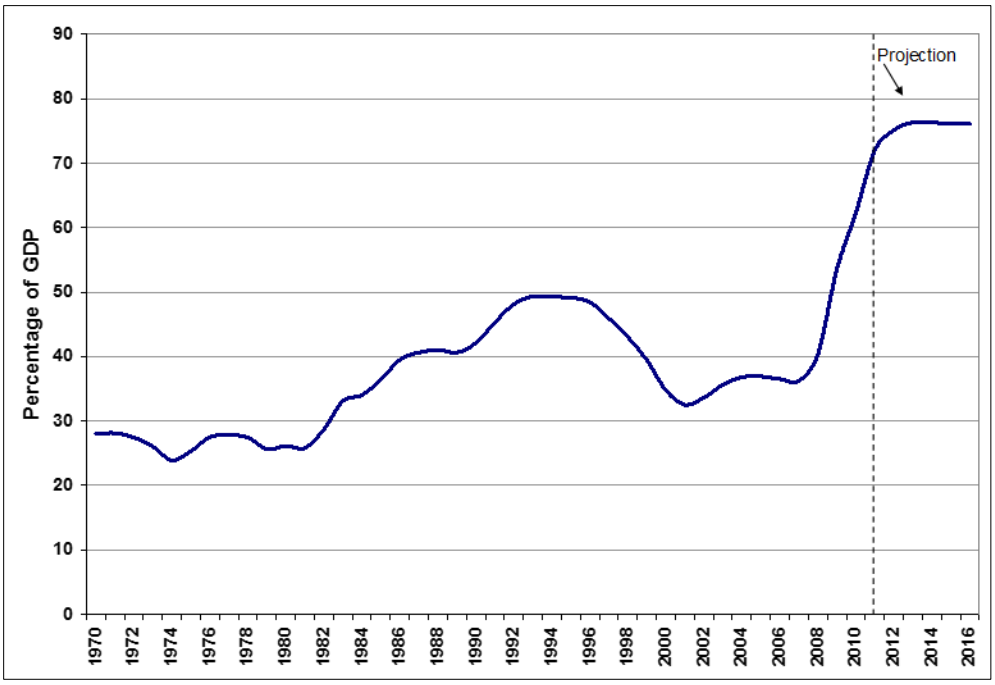
[13] This figure is debt held by the public, as reported in the President's FY2012 Budget, Historical Tables, Table 7.1. Available at http://www.whitehouse.gov/omb/budget/Historicals.

[14] Ibid.

[15] For additional background, see CRS Report RL30520, *The National Debt: Who Bears Its Burden?* by Marc Labonte.

**Figure 2. Federal Debt as a Percentage of GDP**

1970–2016




**Source:** CRS graphic using data from the President's FY2012 Budget, Historical Tables, Table 7.1.

**Notes:** Debt depicted is debt held by the public (e.g., debt held by federal government accounts is excluded). Data from 2011 through 2016 are projections. Projections assume that the President's budget is enacted.

Increasing debt can mean increased interest payments to service the debt. **Figure 3** illustrates net interest payments as a percentage of GDP from 1970 through 2016.[16] Net interest payments as a percentage of GDP more than doubled between 1970 and the mid-1980s. After reaching 3.3% in the early 1990s, net interest payments as a percentage of GDP fell to 1.3% (1970 levels) by 2009. Net interest payments are predicted to increase to nearly 3% of GDP by 2015.

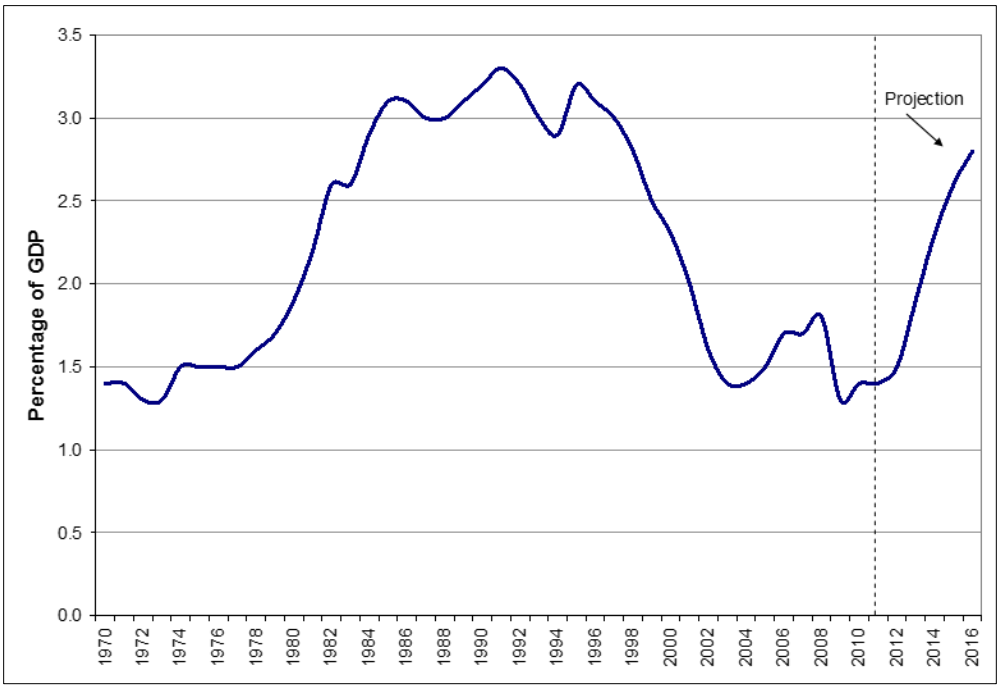
While increasing national debt is generally associated with rising interest payments, interest rates are also a determining factor. Rising net interest payments in the early 1980s were largely driven by increasing interest rates. When interest rates fell towards the end of the 1980s, net interest payments remained around 3% of GDP as the national debt was increasing. In recent years, net interest payments have remained low, relative to historical levels, despite rising debt levels. Low interest rates in recent years have prevented interest payments as a percentage of GDP from increasing to date. If interest rates rise in the future, all else equal, then interest payments relative to GDP are projected to increase as well.[17] If the national debt increases, as projected, and interest rates increase, then interest payments as a percent of GDP will rise at a faster rate.

[16] Net interest payments are interest payments that involve a transfer of funds out of the government. Interest payments made to other government accounts, such as those made to the Social Security trust fund, are excluded.

[17] For additional background and analysis, see CRS Report RS22354, *Interest Payments on the Federal Debt: A Primer*, by Thomas L. Hungerford.

**Figure 3. Net Interest as a Percentage of GDP**

1970–2016




**Source:** CRS graphic using data from the President's FY2012 Budget, Historical Tables, Table 8.4.

**Notes:** Net interest excludes interest paid to federal government holdings of debt.

## Macroeconomic Considerations[18]

The current fiscal situation is unlikely to be sustainable. Deficit levels are considered unsustainable when deficits cause the national debt to grow faster than GDP (output) over a sustained period of time. As the national debt grows faster than output, an increasing share of national income must be devoted to servicing the debt (making interest payments). With an increasing share of government spending going toward debt service, investors holding the debt may begin to lose faith in the government's ability to continue making interest payments. When investors lose confidence in the government's ability to service debt, and become unwilling to hold the debt at normal interest rates, the government is left with two options. First, the government can default on its debt and fail to pay investors. Second, the government can monetize the debt, or finance debt repayment through money creation. The second option will result in rapid price inflation that will reduce the real value of the debt held by investors.

The continued ability of the Treasury to issue debt at historically low interest rates suggests that investors do not view the current U.S. fiscal circumstance as irreversible. Increasing federal deficits in 2009 and 2010 are largely attributable to the economic recession and subsequent policy responses. The policy response includes actions taken in response to the financial crisis, including fiscal stimulus and the Troubled Asset Relief Program (TARP).[19] Fiscal policy responses have included increased spending and tax reductions, enacted to stimulate a weak economy. If,

[18] For additional background and analysis, see CRS Report R40770, *The Sustainability of the Federal Budget Deficit: Market Confidence and Economic Effects*, by Marc Labonte.

[19] For background on TARP, see CRS Report R41427, *Troubled Asset Relief Program (TARP): Implementation and Status*, by Baird Webel.

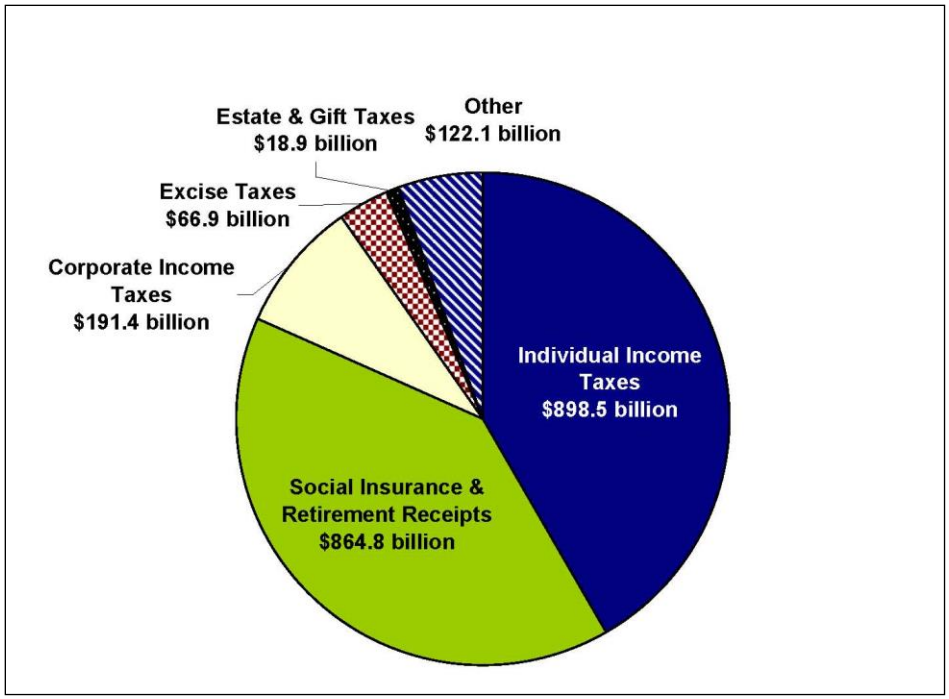
however, the deficit does not return to sustainable levels, and the debt continues to grow after the economy has recovered, the risk that the deficit and accompanying debt will stunt economic growth and potentially decrease standards of living increases.

# Federal Revenues

In FY2010, federal revenues were $2.2 trillion. The sources for these revenues are illustrated in **Figure 4**. Nearly 41.5% of total receipts ($899 billion) was collected through individual income taxes. Another 40.0% ($865 billion) was collected through social insurance and retirement (i.e., payroll) taxes. The corporate tax accounted for 8.9% ($191 billion) in total tax collections.[20] Excise taxes accounted for 3.1% of total collections ($67 billion). The estate and gift taxes were responsible for 0.8% ($18 billion) in revenue, and the remaining 5.6% ($122 billion) in receipts came from other sources.[21]

**Figure 4. Federal Receipts by Source**

FY2010




**Source:** CRS graphic using data from the President's FY2012 Budget, Historical Tables, Table 2.1 and Table 2.5.

**Figure 5** illustrates the trends in federal receipts as a percentage of GDP, by receipts source, over the past four decades. As can be seen in **Figure 5**, both individual and corporate tax receipts relative to GDP reached a 40-year low in 2009. Corporate receipts recovered modestly in 2010.

The low levels of individual and corporate income tax collections can be partially explained by the recession. Another factor contributing to reduced income tax collections is the increased availability of income tax credits, exemptions, and deductions. Individual income tax collections

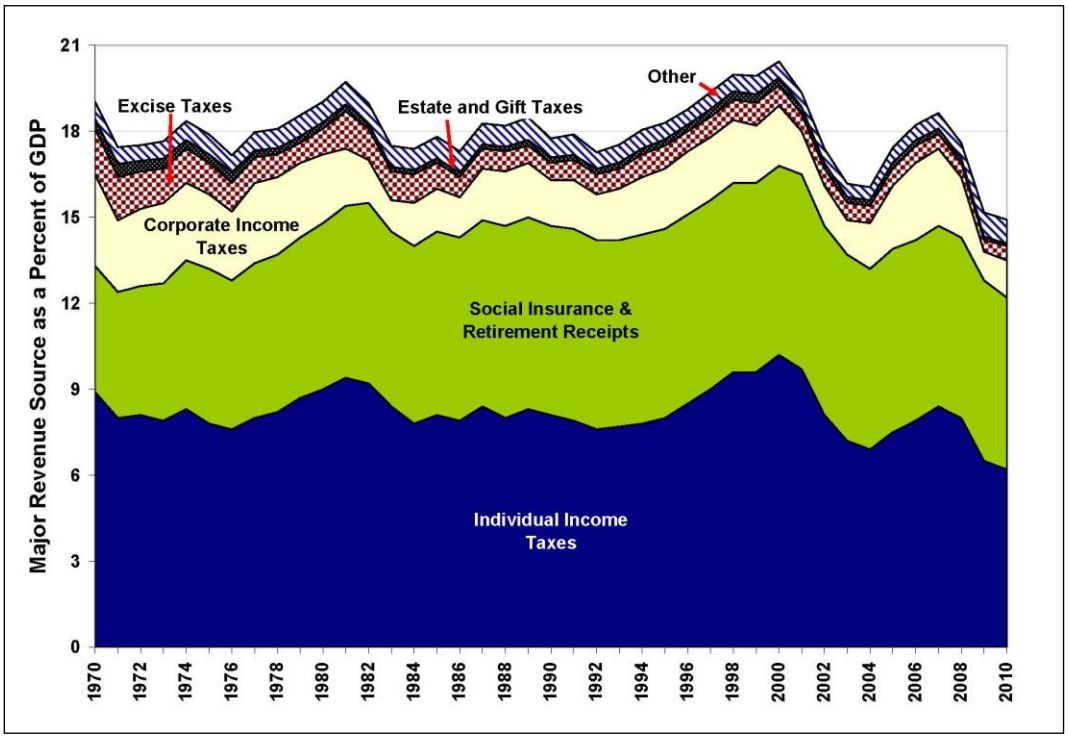
[20] In 2007, prior to the financial crisis, corporate tax revenues were 14.4% of total receipts, or $370 billion.

[21] Other receipts include customs duties and fees as well as miscellaneous receipts.

have tended to be below historical averages, since the 2001 tax cuts. Social insurance tax collections were slightly above the historical average.

**Figure 5. Federal Revenue as a Percentage of GDP**

1970–2010




**Source:** CRS graphic using data from the President's FY2012 Budget, Historical Tables, Table 2.1, Table 2.5, and Table 10.1.

As a benchmark, it is helpful to consider the magnitude of the increase in revenues that would be needed, should deficits be eliminated through only tax increases.[22] **Table 1** provides some guidance on the percentage increase in revenues that would be necessary to achieve a balanced budget under the CBO current policy baseline and the Administration's FY2012 budget proposal (OMB), based on FY2011 and FY2015 projections.[23]

Both CBO and OMB projections suggest that the federal budget deficit will remain around $1.5 trillion in FY2011. Closing this budget deficit using only increased income tax revenue would require income tax receipts to increase by 145%, using CBO's projections, or 141%, using OMB's projections. Increases in income tax receipts could be achieved through higher rates or by reducing various tax expenditures (this issue is discussed further below). Balancing the FY2011 budget through increases in both income and social insurance taxes would require an increase in receipts of 78%, using CBO's projections, or 72%, using OMB's projections. Increasing social

[22] For a comparison of the magnitude of various spending decreases and tax increases necessary to balance the budget, see CRS Report RS21939, *The Magnitude of Changes That Would Be Required to Balance the FY2011 Budget*, by Marc Labonte.

[23] For a full comparison of the different budget estimates and projections, see CRS Report R41147, *FY2011 Budget Proposals and Projections*, by D. Andrew Austin.

insurance receipts could be achieved either through rate increases or by applying the tax to income above the social security cap.[24]

**Table 1. Achieving a Balanced Budget Through Tax Increases**

| | 2011 | | 2015 | |
|---|---|---|---|---|
| | CBO Baseline | President's Budget (OMB) | CBO Baseline | President's Budget (OMB) |
| Increase Individual Income Taxes Only | 145% | 141% | 30% | 37% |
| Increase Income and Social Insurance Taxes | 78% | 72% | 18% | 21% |
| Increase All Taxes | 65% | 59% | 15% | 17% |

**Source:** CRS calculations based on data from CBO's Budget and Economic Outlook: Fiscal Years 2011 through 2021, January 2011, and the President's FY2012 Budget (OMB).

Balancing the budget through tax increases in FY2015 would require less in terms of increased revenues. Both CBO and OMB project increasing tax revenues and falling deficits over time as the economy continues to recover from the recent recession.[25] Note that CBO's baseline is current law, meaning that the 2001 and 2003 tax cuts, and the AMT patch, among other policies, are allowed to expire as scheduled in 2012. If tax cuts that are scheduled to expire are extended further, the tax increases required to eliminate the deficit would be even larger.

Using these projections, increasing income tax revenues by 30% (using CBO's baseline) or 37% (using OMB's projections) would achieve a balanced budget in FY2015. If both income and social insurance taxes were increased, revenue increases of 18% (using CBO's baseline) or 21% (using OMB's projections) would be necessary to achieve a balanced budget. If all taxes were increased, including corporate taxes, estate and gift taxes, and excise taxes, revenues would have to increase by 15% (using CBO's baseline) or 17% (using the OMB's projections) to achieve a balanced budget.

# An Economic Framework for Evaluating Tax Reform Options

Economists oftentimes evaluate the relative merits of tax policies using the concepts of economic efficiency and equity. Generally, there is a trade-off between economic efficiency and equity.[26] Tax systems that maximize economic efficiency oftentimes do not have desirable distributional

[24] In 2011, only the first $106,800 in income is subject to the Social Security payroll tax. For additional background, see CRS Report RL33943, *Increasing the Social Security Payroll Tax Base: Options and Effects on Tax Burdens*, by Thomas L. Hungerford.

[25] For FY2011, CBO projects a deficit of $1,480 billion with total revenues of $2,228 billion. OMB's FY2011 projections predict a deficit of $1,645 billion with total revenues of $2,174 billion. For FY2015, CBO projects a deficit of $551 billion with total revenues of $3,651 billion. OMB's FY2015 projection predicts a deficit of $607 billion with total revenue of $3,487 billion.

[26] Economic efficiency means that society's resources are being used in a way that maximizes the production of goods and services, or economic output. Equity is concerned with how fairly society's resources are distributed.

consequences. Thus, policymakers may strive to balance these two objectives when implementing changes to the tax code.

Another challenge for policymakers is that tax reforms may create winners and losers. Eliminating targeted tax incentives may increase tax liability for some, even as rates across the board are reduced. While eliminating certain tax incentives targeted for low-income individuals may broaden the tax base, eliminating such tax preferences may raise equity concerns. Alternatively, eliminating tax preferences that tend to benefit higher-income taxpayers may enhance tax-code equity at the expense of economic efficiency, if the tax preferences were designed to address a market failure.[27] For example, higher-income households are more able and more likely to benefit from education-related tax incentives.[28] Thus, eliminating various education tax benefits could enhance tax code equity. Eliminating education tax incentives, however, could reduce economic efficiency. Tax subsidies for education can enhance economic efficiency if they are successful in increasing investment in education.

## Economic Efficiency and Tax Reform

Generally, in the absence of market failures, economists believe that market outcomes maximize economic efficiency.[29] Taxes may lead to inefficiencies when they result in changes in behavior. These behavioral responses, generally, occur when taxes change the price of goods or activities. For example, if an individual responds to an increase in income taxes by working less, the tax is said to generate an inefficiency. Not all taxes, however, are associated with market inefficiencies. For example, taxes on the production and consumption of goods associated with negative externalities can enhance economic efficiency.[30] Take, for example, the federal excise tax on gasoline. The consumption of gasoline in motor vehicles may generate negative externalities, in the form of pollution and roadway congestion. Since consumers fail to take these negative external costs into account when making consumption decisions, markets may lead to overconsumption of gasoline relative to economically efficient levels. The federal excise tax on gasoline reduces consumption of gasoline, leading the market to more efficient levels of gasoline consumption.

Taxes generally lead to greater inefficiencies when market participants are highly responsive to tax-imposed changes in price.[31] If market participants are responsive to price changes, this means they change their behavior in response to taxes, driving the level of economic activity away from the socially optimal level. In other words, market participants increase participation in low-tax activities while engaging in fewer high-tax activities. This logic is consistent with the economic theory of optimal commodity taxation, which suggests that taxes are more efficient when levied on goods with low demand elasticities (i.e., demand is not responsive to changes in price).[32] While taxing goods with low demand elasticities may be economically efficient tax policy, such a policy may raise equity concerns. Demand elasticities—or the responsiveness of demand for a

[27] Problems that cause market economies to fail to deliver goods and services efficiently are referred to as market failures.

[28] For a more detailed discussion, see CRS Report RL32554, *An Overview of Tax Benefits for Higher Education Expenses*, by Mark P. Keightley.

[29] Markets may fail to maximize economic efficiency in the presence of externalities, in the case of public goods, or if there are informational asymmetries.

[30] An externality is a spillover from a transaction to a third party, one not directly involved in the transaction itself. Negative externalities result from transactions that impose a cost on the third party not paid by those directly involved in the transaction.

[31] The inefficiency of a tax increases as the elasticity of demand or supply for the good increases.

[32] This principle is known as the Ramsey Rule.

product to changes in price—for necessities, such as basic food, clothing, healthcare, and shelter, tend to be relatively low. Conversely, luxury goods tend to have relatively elastic demand. Thus, a tax system designed to minimize economic distortions and maximize economic efficiency would tend to tax necessities, even though necessities represent a larger share of household consumption among those with low income. However, placing higher tax rates on necessities relative to luxury goods may violate equity principles, which are discussed below.

Economic theory informs that the inefficiency of a tax is an increasing function of the tax rate. In other words, the inefficiency of a tax is not a linear function of tax rates. Instead, the economic inefficiency associated with higher tax rates is disproportionately large. Thus, to minimize distortions and economic inefficiencies from taxation, taxes should be levied at low rates. Broadening the tax base, while lowering tax rates, can yield the same amount of revenue with fewer inefficiencies. Broadening the tax base, to allow for reduced rates, was one of the major policy objectives of the last major overhaul of the U.S. tax code in 1986.

### Equity and Tax Reform

Fairness in the tax code can be evaluated using the concept of equity. There are two different measures of equity: horizontal equity and vertical equity. The tax system may be used as a tool for redistribution, which some may view as enhancing equity in society. How much the tax system should be used for redistribution is a policy choice, and beyond the scope of this report.

The principle of vertical equity suggests that groups with more resources, or a greater ability to pay, should pay more in taxes. Progressive tax structures, such as the current federal income tax system, are vertically equitable, as those with higher incomes pay higher rates. Consumption taxes, which tend to be regressive, are not vertically equitable.

The principle of horizontal equity suggests that individuals who are similar should be treated similarly by the tax code. As an example, consider many homeowners are given tax incentives for housing, while renters are not. Two families, with similar incomes living in similar houses, may have different income tax liabilities if one family owns their house while the other rents. Thus, tax preferences designed to encourage certain behavior may create circumstances where similar individuals have different tax liabilities. This may be viewed as violating the principle of horizontal equity.

## Options for Tax Reform[33]

The following sections provide a broad overview of various tax reform options, categorized according to the various sources of federal revenues discussed above.[34] Providing a detailed analysis of the many reform options available is beyond the scope of this report. Instead, broad options for reform within each revenue source are reviewed. This overview provides a foundation for the discussion of specific deficit reduction proposals that follows.

[33] The Congressional Budget Office (CBO) periodically provides a report to the House and Senate Committees on the Budget presenting options for altering federal spending and revenues. The CBO Budget Options, Volume 2, published in August 2009, contains 66 revenue options (not all revenue options, however, generate additional revenues). Details on these various revenue options can be found at http://www.cbo.gov/ftpdocs/102xx/doc10294/08-06-BudgetOptions.pdf.

[34] For a general overview of deficit reduction policy options, see CRS Report R41778, *Reducing the Budget Deficit: Policy Issues*, by Marc Labonte.

## Individual Income Tax Reform

There are two broad options for generating additional revenues using the individual income tax. First, tax revenues can be enhanced by increasing tax rates. Second, additional tax revenues can be generated by eliminating various exemptions, deductions, and credits available under the current tax code (i.e., broaden the tax base). Eliminating enough exemptions, deductions, and credits may allow policymakers to reduce tax rates and increase revenues generated through the income tax system simultaneously. Since marginal tax rates generally influence economic behavior, eliminating targeted preferences, allowing for reduced tax rates, could enhance economic efficiency. Further, if existing tax preferences tend to benefit higher income taxpayers, eliminating such preferences may enhance equity within the tax code.

**Table 2** lists the largest individual income tax expenditures, ranked according to federal revenue losses. Taken together, these 10 items account for $651 billion in foregone revenue annually, or approximately 70% of total individual tax expenditures.[35] As noted above (**Figure 4**), FY2010 individual income tax collections were $898.5 billion. Given that tax expenditures have grown to nearly $1 trillion annually, eliminating or scaling back existing tax expenditure provisions could be a part of any deficit reduction proposal.[36]

**Table 2. Largest Individual Income Tax Expenditures: 2010**

(billions of dollars)

| Tax Expenditure | Amount |
|---|---|
| Exclusion of employer provided healthcare | 105.7 |
| Mortgage interest deduction | 90.8 |
| Exclusion of contributions and earnings to retirement plans | 83.8 |
| Reduced tax rates on dividends and long-term capital gains | 77.7 |
| Making Work Pay credit | 59.7 |
| Earned Income Tax credit | 56.2 |
| Child tax credit | 55.1 |
| Exclusion for Medicare benefits | 54.6 |
| Deduction for charitable contributions | 36.8 |
| Deduction of state and local taxes | 30.7 |

**Source:** Joint Committee on Taxation, JCS-3-10 and 2010 CRS Tax Expenditure Compendium.

**Notes:** Tax expenditure items as compiled by CRS may include multiple items as listed by JCT. See the 2010 CRS Tax Expenditure Compendium for details.

A closer look at the specific provisions listed in **Table 2** highlights the various types of tax expenditure provisions as well as possible equity issues associated with using tax expenditures to deliver federal assistance. The first, third, and eighth provisions listed are exclusions from income. Under current law, employer provided healthcare, contributions to retirement accounts,

[35] U.S. Congress, Senate Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, committee print, prepared by Congressional Research Service, 111th Cong., 2nd sess., December 2010, S. Prt. 111-58 [Henceforth referenced as "2010 CRS Tax Expenditure Compendium"].

[36] For more information on tax expenditures and the federal budget, see CRS Report RL34622, *Tax Expenditures and the Federal Budget*, by Thomas L. Hungerford.

and Medicare benefits are not included in taxable income.[37] Excluding contributions to retirement accounts and employer provided healthcare from income reduces the cost of this form of compensation, encouraging employers to provide these benefits to employees. Delivering such benefits through the tax code, however, may raise equity concerns. Both the retirement contribution and healthcare exclusions are examples of "upside-down" subsidies, where higher income taxpayers receive a greater benefit.[38] Generally, as a consequence of the progressive income tax structure, exclusions and deductions result in an upside-down subsidy.

The mortgage interest deduction and reduced rates for dividends and long-term capital gains also raise equity concerns. The mortgage interest deduction is another example of an upside-down subsidy.[39] Eliminating the mortgage interest deduction would reduce after-tax income by an estimated 0.01% for individuals in the lowest income quintile.[40] For individuals in the 90th to 95th income percentile, eliminating the deduction would reduce after tax income by an estimated 1.7%. Proponents of the mortgage interest deduction, however, cite benefits associated with homeownership as a possible rationale for retaining this tax preference.[41] The reduced rates for dividends and long-term capital gains tend to disproportionally benefit higher-income households, as such households derive a larger proportion of income from these sources.[42] One possible justification for reduced tax rates on dividends and long-term capital gains may be a reduction in double taxation of corporate income.[43] With respect to capital gains rates, the revenue raising potential of a tax increase is less than the tax expenditure, due to behavioral responses.[44]

In contrast, the earned income tax credit (EITC) and the child tax credit both provide greater benefit to lower-income taxpayers.[45] Both credits are at least partially refundable, allowing benefits to flow to those with limited tax liability. Eliminating these tax benefits would raise additional revenue, but decrease the progressivity of the current individual income tax system.

A full analysis of tax expenditures in the current tax code is beyond the scope of this report.[46] The examples above serve to highlight the complexities associated with a deficit reduction plan that looks to reduced tax expenditures as a source of additional revenues. Many of the tax code's

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[37] The U.S. income tax treats all forms of employee compensation as taxable income, unless the tax code provides a specific exclusion. Thus, exclusions for retirement contributions and healthcare are considered tax expenditures.

[38] For more on the policy option of eliminating or reducing the exclusion for employer provided healthcare, see CRS Report R40648, *Tax Options for Financing Health Care Reform*, by Jane G. Gravelle.

[39] See CRS Report R41596, *The Mortgage Interest and Property Tax Deductions: Analysis and Options*, by Mark P. Keightley.

[40] For more background on the estimated effects of eliminating the mortgage interest deduction, and analysis of other mortgage interest deduction policy options, see Eric Toder, Margery Austin Turner, and Katherine Lim, et al., *Reforming the Mortgage Interest Deduction*, Urban Institute and Tax Policy Center, April 2010, http://www.taxpolicycenter.org/uploadedpdf/412099-mortgage-deduction-reform.pdf.

[41] See CRS Report R41596, *The Mortgage Interest and Property Tax Deductions: Analysis and Options*, by Mark P. Keightley.

[42] For additional background, see CRS Report R41394, *Tax Treatment of Long-Term Capital Gains and Dividends and Related Provisions in the President's FY2011 Budget Proposal*, by Mark P. Keightley.

[43] For additional background, see CRS Report RL33171, *Federal Business Taxation: The Current System, Its Effects, and Options for Reform*, by Donald J. Marples.

[44] For further discussion, see CRS Report R41364, *Capital Gains Tax Options: Behavioral Responses and Revenues*, by Jane G. Gravelle.

[45] For additional background, see CRS Report RL31768, *The Earned Income Tax Credit (EITC): An Overview*, by Christine Scott and CRS Report RL34715, *The Child Tax Credit*, by Maxim Shvedov.

[46] 2010 CRS Tax Expenditure Compendium.

current tax expenditure provisions were adopted to encourage targeted behavior and enhance economic efficiency by addressing externalities or to promote equity and fairness in the tax code. Eliminating or scaling back various tax expenditure provisions will require analysis of the revenue gains that can be achieved through various reforms, as well as the distributional and economic consequences of various tax expenditure reforms.

## Social Insurance Tax Reform

Mandatory spending associated with entitlement programs such as Social Security, Medicare, and Medicaid has grown in recent decades. In the early 1960s, mandatory spending accounted for approximately 30% of all federal spending. By 2010, mandatory spending had grown to account for approximately 55% of all federal spending.[47] Social Security, Medicare, and Medicaid accounted for nearly 63% of total mandatory spending in 2009.[48] The number of Social Security and Medicare recipients is expected to increase in coming years with the aging of the baby boom generation. As the population ages, and if healthcare costs continue to rise, financial pressures on these entitlement programs will continue to contribute to long-run fiscal challenges.

Social Security and some Medicare spending is managed through federal trust funds.[49] Revenues are collected through payroll taxes and deposited into these trust funds. Benefits are also paid out from these trust funds. While both trust funds have historically run surpluses, it is expected that the Social Security and Medicare trust funds will be exhausted within the next 30 years. Restoring these trust funds essentially involves choosing between two alternatives: reduce outlays (benefits) or increase revenues (taxes). As this report focuses on tax policy options for increasing revenues, policy options to reduce outlays through eligibility and benefit modifications are not discussed.

One way to potentially increase revenues for entitlement program trust funds is through tax rate increases. Generally, the Social Security payroll tax is 12.4% (6.2% is collected from the employer and employee each).[50] For 2011, the employee's share of the payroll tax has been reduced by two percentage points, to 4.2%.[51] Payroll taxes are also used to fund Medicare's Hospital Insurance (HI) trust fund.[52] The Medicare payroll tax is generally 2.9%, with employers and employee each contributing 1.45%. Under the Patient Protection and Affordable Care Act (PPACA; P.L. 111-148), an additional payroll tax of 0.9% on high-income taxpayers (income above $200,000 for single filers and $250,000 for married filers) is scheduled to take effect in 2013.[53]

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[47] For additional background, see CRS Report RL33074, *Mandatory Spending Since 1962*, by D. Andrew Austin and Mindy R. Levit.

[48] *Ibid.*, p. 8.

[49] For additional background, see CRS Report R41328, *Federal Trust Funds and the Budget*, by Thomas L. Hungerford and CRS Report R41436, *Medicare Financing*, by Patricia A. Davis. Medicare Part B is financed mostly through general revenues. Medicare Part D is also partially financed through general revenues.

[50] For additional background, see CRS Report RL33028, *Social Security: The Trust Fund*, by Dawn Nuschler and Gary Sidor.

[51] The Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (P.L. 111-312). The law states that this temporary tax reduction will not affect the balances in the Social Security trust fund, as lost revenues are to be transferred from the general fund. Nonetheless, this provision contributes to budget deficits.

[52] For additional background, see CRS Report R41436, *Medicare Financing*, by Patricia A. Davis.

[53] The additional revenues will be transferred to the Medicare Hospital Insurance Trust Fund (Part A). See CRS Report R41128, *Health-Related Revenue Provisions in the Patient Protection and Affordable Care Act (PPACA)*, by Janemarie Mulvey.

Another option for increasing Social Security trust fund revenues is to increase the cap on taxable earnings.[54] In 2011, only the first $106,800 in income is subject to Social Security payroll taxes (all income is subject to Medicare payroll taxes). One option is to increase the share of earnings subject to the Social Security payroll tax.[55] In 1982, approximately 90% of covered earnings were subject to the payroll tax.[56] By the late 2000s, the proportion of covered earnings subject to the payroll tax was closer to 83%. CBO estimates that increasing the share of covered earnings subject to Social Security payroll taxes to 90% would generate approximately $503 billion over 10 years.[57] Increasing the share of covered earnings to 92% would generate approximately $669 billion over 10 years.[58] Increasing the share of covered earnings to 90% or 92% is unlikely to generate enough additional revenues to achieve Social Security solvency in the long run.[59]

## Corporate Tax Reform

Congress has begun evaluating various options for corporate tax reform.[60] As with individual tax reform, much of the discussion has centered on broadening the base by eliminating various deductions, exemptions, and credits, and reducing statutory rates.[61] Deficit reduction may or may not be a policy objective of corporate tax reform. In his 2011 State of the Union address, President Obama called for corporate tax reform that does not add to the deficit.[62]

Corporate tax reform proposals may also address U.S. taxation of income earned abroad. The current U.S. tax system is a hybrid of a residence-based and territorial tax system.[63] Reforms that move toward a territorial tax system, where income is taxed where it is earned, may enhance economic efficiency. A switch to a territorial tax system, however, would likely result in federal revenue losses. Overall, corporate tax reform could be structured to be revenue neutral, or structured to raise additional revenues to reduce deficits. As was illustrated in **Figure 5**, revenues collected from the corporate tax relative to GDP are currently low relative to historical standards.

**Table 3** lists the 10 largest corporate tax expenditures for 2010. These 10 corporate tax expenditures together resulted in roughly $96.6 billion in revenue losses during 2010, and account for about 80% of total tax expenditure dollars directed to corporations. For comparison,

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[54] An additional revenue option, not addressed here, would be to include state and local government employees that do not currently participate in the federal Social Security program.

[55] For additional analysis of this policy option, see CRS Report RL33943, *Increasing the Social Security Payroll Tax Base: Options and Effects on Tax Burdens*, by Thomas L. Hungerford.

[56] Covered earnings are earnings from employment covered by the Social Security and Medicare programs.

[57] Congressional Budget Office, *Budget Options: Volume 2*, Washington, DC, August 2009, pp. 234-235, http://www.cbo.gov/ftpdocs/102xx/doc10294/08-06-BudgetOptions.pdf.

[58] *Ibid.*

[59] A 2005 report found that increasing the share of covered earnings to 90% would eliminate 43% of the long-run shortfall in Social Security. See CRS Report RL33840, *Options to Address Social Security Solvency and Their Impact on Beneficiaries: Results from the Dynasim Microsimulation Model*, by Dawn Nuschler et al. Since 2005, conditions in the Social Security trust fund have deteriorated further.

[60] The House Ways & Means Committee has had the first in a series of hearings on tax reform. Much of the focus on the first hearing was on corporate reforms. See U.S. Congress, House Committee on Ways and Means, *First in a Series of Hearings on Fundamental Tax Reform*, 112th Cong., 2nd sess., January 20, 2011.

[61] For a detailed analysis of corporate tax reform issues, see CRS Report RL34229, *Corporate Tax Reform: Issues for Congress*, by Jane G. Gravelle and Thomas L. Hungerford.

[62] The White House, The State of the Union, 2010, speech available at http://www.whitehouse.gov/state-of-the-union-2011.

[63] See CRS Report RL34115, *Reform of U.S. International Taxation: Alternatives*, by Jane G. Gravelle.

FY2010 corporate tax collections were $191.4 billion (see **Figure 4**). Scaling back corporate tax expenditures is one option for generating additional revenues through the corporate tax system.

The largest corporate tax expenditure is the allowance of accelerated depreciation. Accelerated depreciation allows firms to recover capital costs over a shorter period of time through larger depreciation deductions. By allowing firms to recover costs quickly, the tax code subsidizes capital investment. Depreciation allowances have been enhanced in recent years due to policies enacted during the economic recession designed to stimulate investment.[64] The Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) expanded and extended temporary bonus depreciation provisions, with an estimated revenue loss of $55 billion in 2011. The cost of the temporary extension is $20.1 billion over the 2011 to 2020 budget window, as some of the bonus depreciation costs are diminished through reduced depreciation deductions over time in the out years.

**Table 3. Largest Corporate Income Tax Expenditures: 2010**

(billions of dollars)

| Tax Expenditure | Amount |
|---|---|
| Depreciation of equipment in excess of the alternative depreciation system | 24.1 |
| Inclusion of income arising from business indebtedness discharged by the reacquisition of a bad debt instrument | 21.1[a] |
| Deferral of active income of controlled foreign corporations | 12.5 |
| Exclusion of interest on public purpose state and local government bonds | 7.5 |
| Inventory property sales source rule | 7.2 |
| Production activity deduction | 7.0 |
| Credit for low-income housing | 4.9 |
| Expensing of research and experimentation expenditures | 4.3 |
| Inventory methods and valuation | 4.0 |
| Credit for increasing research activities | 4.0 |

**Source:** Joint Committee on Taxation, JCS-3-10 and 2010 CRS Tax Expenditure Compendium.

**Notes:** Tax expenditure items as compiled by CRS may include multiple items as listed by JCT. See the 2010 CRS Tax Expenditure Compendium for details.

a. This provision was enacted temporarily to assist financially troubled companies during the financial crisis.

The second-largest corporate tax expenditure in 2010 was the result of a provision added to the tax code under the Recovery Act (ARRA; P.L. 111-5).[65] Generally, discharges of indebtedness are included in taxable income. Under this provision, taxpayers can defer taxable cancellations of indebtedness income that occurred in 2009 or 2010. This temporary provision was enacted to assist financially troubled companies following the financial crises.

The third-largest corporate tax expenditure relates to the U.S. treatment of income earned abroad. Deferral of active income of U.S. subsidiaries operating abroad allows firms to delay the payment

[64] For more information, see CRS Report RL31134, *Using Business Tax Cuts to Stimulate the Economy*, by Jane G. Gravelle and CRS Report R41034, *Business Investment and Employment Tax Incentives to Stimulate the Economy*, by Thomas L. Hungerford and Jane G. Gravelle.

[65] Internal Revenue Code (IRC) § 109(i).

of U.S. taxes by not repatriating income. In addition to generating revenue losses, deferral provides an incentive for U.S. firms to invest in active business operations in low-tax foreign countries. One possible benefit to deferral is that it may help make U.S. firms more competitive when operating abroad.

Allowing state and local governments to issue tax-exempt bonds is the fourth-largest corporate tax expenditure.[66] Corporate purchasers, and other purchasers, of tax-exempt debt are not required to pay taxes on interest earned from holding such bonds, thereby reducing their federal income tax liability.[67] This allows issuers to borrow at reduced interest costs. In recent years, Congress has allowed for various other forms of federally subsidized debt (e.g., tax-credit bonds).[68] Tax-exempt bonds provide a larger subsidy to high-income holders, and thus have been criticized for being inequitable. Tax-credit bonds provide a more equitable benefit to bond holders, as their value is not dependent on a taxpayer's marginal tax rate. The broader question is to what extent tax-subsidized debt is being used to provide public goods or address other potential market failures.

The fifth and ninth tax expenditures listed in **Table 3** also relate to the tax treatment of inventories. Current tax rules governing the source of inventory sales interact with foreign tax credit provisions in a way that can effectively exempt a portion of a firm's export income from U.S. taxation (the fifth item in **Table 3**). Last-in, first-out (LIFO) inventory accounting methods result in a tax subsidy when prices are rising, by allowing for a higher measure for cost of goods sold, which reduces taxable income (the ninth item in **Table 3**). International Financial Reporting Standards (IFRS) do not permit LIFO inventory accounting methods. As U.S. accounting standards merge with IRFS, LIFO inventory accounting methods will no longer be an option.[69]

The production activity deduction, the sixth-largest corporate tax expenditure in 2010 reduces the effective tax rate for domestic manufacturers. The provision was adopted in 2004, and is designed to encourage investment in manufacturing. The domestic production deduction is available for oil and gas extraction, at a reduced rate. President Obama's FY2012 budget proposes to eliminate this deduction for fossil fuels (oil and gas and coal), raising an estimated $18.7 billion over the 2012 through 2021 budget window.[70]

The remaining corporate tax expenditures are designed to provide support for low-income housing investments and encourage spending on research and development. The low-income housing tax credit (LIHTC) was introduced in 1986 to encourage development of affordable housing.[71] The tax code also contains provisions designed to reduce the cost associated with research and experimentation expenses, such as the ability to expense certain research-related capital expenditures and tax credits for qualified research-related costs.[72] These activities are viewed by many as generating positive externalities, and thus being underprovided by the market.

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[66] On the individual side, the exclusion of interest on public purpose state and local government debt is a $19.3 billion tax expenditure for 2010.

[67] For additional background, see CRS Report RL31457, *Private Activity Bonds: An Introduction*, by Steven Maguire.

[68] For additional background, see CRS Report R40523, *Tax Credit Bonds: Overview and Analysis*, by Steven Maguire.

[69] For additional background, see Janet E. Mosebach and Michael Mosebach, "Does Repealing LIFO Really Matter?" *Tax Notes*, May 24, 2010, pp. 901-906.

[70] The FY2012 Treasury Green Book, p. 147.

[71] For additional information, see CRS Report RS22389, *An Introduction to the Design of the Low-Income Housing Tax Credit*, by Mark P. Keightley.

[72] For additional background, see CRS Report RL31181, *Research and Experimentation Tax Credit: Current Status and Selected Issues for Congress*, by Gary Guenther.

These tax subsidies aim to correct these perceived market failures by encouraging additional investment in low-income housing and research and development.

Switching to a territorial tax system could help address complexities in the corporate tax code associated with foreign-source. One option would be to allow a "dividend exemption," allowing all repatriated dividends to be exempt permanently from U.S. taxation. If deductions allocable to tax-exempt foreign-source income are also disallowed, such a policy could result in additional revenues.[73]

## Estate Tax Reform

Historically, estate and gift taxes have represented a small share of federal revenues (on average, approximately 1.3% of federal revenues were generated through the estate tax over the past 40 years). In 2010, estate and gift taxes generated $18.9 billion in revenues. Taxable estates in 2009 were taxed at a maximum rate of 45%, subject to an exemption of $3.5 million (2009 rates and exemption levels are most relevant for 2010 revenues).[74] Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRAA; P.L. 107-16), the estate tax was fully phased-out in 2010. The Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (P.L. 111-5) set the maximum rate for the estate tax at 35% with an exemption of $5 million beginning in 2011. The legislation also included a provision allowing a spouse to inherit any unused exemption. Reducing the exemption amount or increasing the maximum rate is one option for raising revenue. Relative to other revenue options, the potential for revenue generation is small, as the base of the estate tax is small relative to the income and payroll tax bases.

## Other Tax Options

### Consumption Taxes[75]

Other industrialized nations tend to place a greater reliance than the United States on consumption taxes to finance government spending (see **Table 4**). In the United States, consumption tax collections are equivalent to approximately 4.7% of GDP. Most U.S. consumption taxes are collected at the state and local level through sales taxes. There is no broad-based consumption tax at the federal level. Across all OECD countries, consumption taxes average 10.9% of GDP, including revenues from federal, state, and local governments. Consumption taxes also tend to constitute a larger portion of overall tax revenues in other industrialized countries. In the United States, 7.8% of all tax revenues are generated through consumption taxes. The OECD average is 18.9%.

There are various forms of consumption taxes that could be imposed at the federal level. One option is a value-added tax (VAT). A value-added tax is a tax, levied at each stage of production, on each firm's value added. Another option is a national sales tax. This sales tax could be levied only on retail sales.[76] Consumption taxes are oftentimes regressive, and adoption of a broad-based consumption tax may raise equity concerns. A third option is a consumed-income tax. The tax

[73] See CRS Report RL34115, *Reform of U.S. International Taxation: Alternatives*, by Jane G. Gravelle.

[74] For additional background, see CRS Report R40615, *Estate and Gift Tax Revenues: Past and Projected in 2009*, by Nonna A. Noto.

[75] For a more detailed analysis, see CRS Report R41602, *Should the United States Levy a Value-Added Tax for Deficit Reduction?* by James M. Bickley.

[76] For a detailed comparison of a VAT and a national sales tax, see CRS Report RL33438, *A Value-Added Tax Contrasted With a National Sales Tax*, by James M. Bickley.

base would be determined by an individual's consumption (effectively, income less savings). This option would more easily allow for a progressive tax system.

**Table 4. Taxing Consumption: International Comparison**

(2007)

| Country | Tax Revenues as a % of GDP | General Consumption Taxes as a % of GDP | General Consumption Taxes as a % of Tax Revenues (2006) |
|---|---|---|---|
| United States | 28.3 | 4.7 | 7.8 |
| Japan | 28.3 | 5.1 | 9.2 |
| Canada | 33.3 | 7.9 | 14.0 |
| United Kingdom | 36.1 | 10.5 | 18.1 |
| Germany | 36.2 | 10.6 | 17.8 |
| France | 43.5 | 10.7 | 16.9 |
| OECD Average | 35.8 | 10.9 | 18.9 |

**Source:** CRS table based on data from the OECD Tax Database, Tables O.1 and O.5. Available at http://www.oecd.org/ctp/taxdatabase and OECD, *Consumption Tax Trends 2008: VAT/GST and Excise Rates, Trends, and Administration Issues*, OECD Publishing, November 2008.

**Notes:** Consumption taxes include value-added taxes (VAT), sales taxes, excise taxes, customs and import duties, and taxes on exports and investment goods. The OECD average is an unweighted average. The United States does not levy a broad-based consumption tax at the federal level. Consumption tax revenues in the United States are raised by state and local governments.

The potential for revenue from a consumption tax depends on the size of the taxable base. CRS estimates suggest that a broad-based value-added tax (VAT) could be levied on a taxable base of $8.8 trillion.[77] Exempting food, healthcare, housing, higher education, and social services from the taxable base leaves an estimated tax base of $5.1 trillion.[78] For low VAT rates, revenues generated from the VAT can be estimated by multiplying the proposed tax rate by the taxable base.[79] Higher VAT rates may lead to behavioral changes, as individuals reduce consumption or engage in tax evasion, further complicating VAT revenue estimates.

## Carbon Tax

Market-based mechanisms to discourage greenhouse gas emissions (GHG) also represent a possible federal revenue source.[80] As an example, the Congressional Budget Office (CBO) provides revenue estimates associated with pricing carbon to reduce emissions by 25% of projected levels in 2022, increasing to a 36% reduction from projected levels by 2026. Such a plan could raise an estimated $100 billion annually, beginning in 2014.[81]

[77] CRS Report RS22720, *Taxable Base of the Value-Added Tax*, by James M. Bickley.

[78] *Ibid.*

[79] For example, using this method, a VAT of 3% would yield $153 billion in estimated revenues when the VAT is levied on the smaller base. This estimate, however, does not include potential behavioral responses or potential administrative costs. For additional discussion, see CRS Report RS22720, *Taxable Base of the Value-Added Tax*, by James M. Bickley.

[80] For more, see CRS Report R40242, *Carbon Tax and Greenhouse Gas Control: Options and Considerations for Congress*, by Jonathan L. Ramseur and Larry Parker.

[81] Congressional Budget Office, *Budget Options, Volume 2*, Washington, DC, August 2009, pp. 254-255,

The Debt Reduction Task Force proposal, discussed in detail below, considered but ultimately did not recommend a tax on carbon dioxide ($CO_2$) emissions. A tax of $23 per ton of $CO_2$ emissions starting in 2018, increasing 5.8% annually, would raise approximately $1.1 trillion in cumulative revenues through 2025.[82] The Debt Reduction Task Force noted that such a tax might be attractive as it might enhance economic efficiency and promote investment in clean energy. However, a tax on carbon would also raise energy prices, and would likely be regressive. The revenue raising capacity of a carbon tax would be diminished to the extent tax collections were used to compensate low-income persons affected by the carbon tax.[83]

## Motor Fuel Excise Tax

Currently, the United States collects a $0.184 per-gallon federal excise tax on motor fuel. Generally, this revenue is earmarked for the Highway Trust Fund (HTF).[84] The motor fuel excise tax rate has remained the same since the mid-1990s. Thus, the real value of the tax rate has eroded over time. In FY2009, the motor fuel excise tax resulted in revenues of $25 billion.[85]

During the 1990s, the motor fuel excise tax was increased for the purposes of deficit reduction.[86] By 1997, however, motor fuel excise tax receipts that were flowing into the general fund were returned to the highway trust fund. In recent years, funds have been transferred from the general fund to the HTF, as spending from the fund has exceeded fund revenues and reserves.[87]

Relative to other potential revenue sources discussed above, the revenue potential of the motor fuel excise tax is small. A $0.01 increase in the motor fuel excise tax would generate an estimated $1.6 billion to $1.8 billion in annual revenues.[88] CBO estimates a $0.25 increase would generate $305 billion in revenues over 10 years.[89] Economists' estimates of an optimal gas tax, one that addresses the negative externalities associated with gasoline, suggest that the excise tax on motor fuel should be closer to $1 per gallon.[90] Assuming no additional behavioral responses, increasing the gas tax to $1 per gallon could raise as much as $1 trillion over 10 years.

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http://www.cbo.gov/ftpdocs/102xx/doc10294/08-06-BudgetOptions.pdf.

[82] Debt Reduction Task Force Plan, p. 43.

[83] For a discussion of this issue in the context of a cap-and-trade proposal, see CRS Report R40841, *Assisting Households with the Costs of a Cap-and-Trade Program: Options and Considerations for Congress*, by Jonathan L. Ramseur and Libby Perl.

[84] $0.183 per gallon is earmarked for the HTF. The remaining $0.001 per gallon is used to fund the Leaking Underground Storage Tank (LUST) trust fund. For additional background, see CRS Report R40808, *The Role of Federal Gasoline Excise Taxes in Public Policy*, by Robert Pirog.

[85] Internal Revenue Service (IRS), Statistics of Income (SOI), Historical Table 20. Available at http://www.irs.gov/taxstats/article/0,,id=175900,00.html.

[86] For background, see CRS Report RL30304, *The Federal Excise Tax on Gasoline and the Highway Trust Fund: A Short History*, by James M. Bickley.

[87] For additional background, see CRS Report R41490, *Surface Transportation Funding and Finance*, by Robert S. Kirk and William J. Mallett.

[88] CRS Report R41490, *Surface Transportation Funding and Finance*, by Robert S. Kirk and William J. Mallett.

[89] Congressional Budget Office, *Budget Options: Volume 2*, Washington, DC, August 2009, pp. 246-247, http://www.cbo.gov/ftpdocs/102xx/doc10294/08-06-BudgetOptions.pdf.

[90] Ian W. H. Perry and Kenneth Small, "Does Britain or the United States Have the Right Gasoline Tax," *The American Economic Review*, vol. 95, no. 4 (September 2005), pp. 1276-1289.

# Deficit Reduction Proposals

In February 2010, by executive order, President Obama created the National Commission on Fiscal Responsibility and Reform (Fiscal Commission). The 18-member commission was charged with "identifying policies to improve the fiscal situation in the medium term and achieve fiscal sustainability over the long run."[91] The Fiscal Commission released a final report in December 2010.[92]

A number of other groups have released alternative plans for achieving deficit reduction and fiscal sustainability.[93] A full comparison of the tax policies of these plans is beyond the scope of this report. Details of the Fiscal Commission's tax proposals are compared to the tax proposals put forth by The Debt Reduction Task Force in *Restoring America's Future: Reviving the Economy, Cutting Spending and Debt, and Creating a Simple, Pro-Growth Tax System*.[94] The Debt Reduction Task Force was co-chaired by former Senator Pete Domenici and Alice Rivlin, former director of the Congressional Budget Office (CBO) and Office of Management and Budget (OMB).[95] The details from this report are included for a number of reasons. First, like the Fiscal Commission, the Debt Reduction Task Force is a group comprised of a number of budget experts. Second, the Debt Reduction Task Force's plan contained specifics that could be compared to those put forth by the Fiscal Commission. Third, the Urban-Brookings Tax Policy Center provides distributional analysis of both reports' tax proposals, allowing for additional comparison.

**Table 5** provides a side-by-side comparison of the Fiscal Commission's tax proposals, the Debt Reduction Task Force's proposals, and tax provisions under current law. There are a number of similarities between the two proposals. For example, each plan seeks to broaden the tax base by eliminating various exemptions, deductions, and credits, allowing for lower tax rates. The following sections highlight similarities, as well as differences, through providing an overview of the two proposals.

As noted above, the Budget Control Act of 2011 established a Joint Select Committee for Deficit Reduction. As this bi-partisan committee evaluates various policy options, the findings of the Fiscal Commission and the Debt Reduction Task Force may serve as a useful starting point.

## The Fiscal Commission's Proposal

The Fiscal Commission's recommendation for deficit reduction and fiscal sustainability included a comprehensive tax reform proposal. The overall goal of the proposed reform is to broaden the base by reducing tax expenditures, allowing for lower tax rates, while still raising revenues for

[91] The White House, "Executive Order—National Commission on Fiscal Responsibility and Reform," press release, February 18, 2010, http://www.whitehouse.gov/the-press-office/executive-order-national-commission-fiscal-responsibility-and-reform.

[92] The National Fiscal Commission on Fiscal Responsibility and Reform, *The Moment of Truth*, The White House, December 2010, http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf.

[93] For more information on various deficit and debt reduction proposals, see CRS Report R41784, *Reducing the Budget Deficit: The President's Fiscal Commission and Other Initiatives* , by Mindy R. Levit.

[94] The Debt Reduction Task Force, *Restoring America's Future: Reviving the Economy, Cutting Spending and Debt, and Creating a Simple, Pro-Growth Tax System*, Bipartisan Policy Center, November 17, 2010, http://bipartisanpolicy.org/sites/default/files/FINAL%20DRTF%20REPORT%2011.16.10.pdf.

[95] Alice Rivlin was also a member of the President's Fiscal Commission.

deficit reduction. Another stated goal of the proposal is to maintain or increase the progressivity of the tax code.

The Fiscal Commission's plan seeks to reduce the deficit by $3.9 trillion through 2020, which is projected to stabilize the debt at 60% of GDP by 2025. Approximately 27% of this reduction would be realized through additional revenues, as described in the following paragraphs. The remainder would come through reductions in spending.

**Table 5** provides details on the "Illustrative Plan" proposed by the Fiscal Commission. The Commission's income tax proposals focus on eliminating most tax expenditures, allowing for lower tax rates. The proposal also seeks to reduce the number of income tax brackets from six to three. The Commission's proposal would retain, while also simplifying, certain provisions designed "to promote work, homes, health, charity, and savings."[96] The Fiscal Commission's Illustrative Plan keeps the EITC, the child tax credit, the standard deduction, and personal exemptions. Other existing tax expenditures are also retained, but are modified (e.g., the mortgage interest deduction, incentives for employer provided healthcare, retirement savings incentives, and charitable giving incentives).

The Fiscal Commission's proposal would also generate additional revenues through the payroll tax, corporate tax, and excise taxes. Additional revenues would be generated through the payroll tax by increasing the taxable base to include 90% of covered income. A $0.15 increase in the motor fuel excise tax would also generate additional revenues, eliminating the need to transfer general revenues to the Highway Trust Fund (HTF).[97]

The Fiscal Commission's corporate tax reforms are similar to those proposed on the individual side. The Commission's Illustrative Plan suggests eliminating most corporate tax expenditures, allowing corporate tax rates to be reduced to 28%. One major difference between the Fiscal Commission's proposal and that of the Deficit Reduction Task Force is the treatment of foreign-source income.

[96] The Moment of Truth: Report of the National Commission on Fiscal Responsibility and Reform, p. 30.

[97] The Fiscal Commission's report recommends complementing additional revenues to the Transportation Trust Fund with budget reforms and spending limits.

## Table 5. Comparing Selected Deficit-Reduction Tax Proposals to Current Law

| | Current Law | Fiscal Commission Plan | Debt Reduction Task Force Plan |
|---|---|---|---|
| **Individual Income Tax** | | | |
| Tax Rates | Rates of 10%, 15%, 25%, 28%, 33%, and 35% | Rates of 12%, 22%, and 28% | Rates of 15% and 27% |
| AMT, PEP, and Pease | AMT subject to annual patches | Eliminate AMT, PEP, and Pease | Eliminate AMT |
| EITC | Refundable EITC available. Credit varies based on number of children and filing status. | Maintain current law or an equivalent alternative | Earnings credit of 31.3% for first $20,300 in earnings |
| Child Tax Benefits | Partially refundable child tax credit of $1,000 per child | Maintain current law or an equivalent alternative | $1,600 per-child credit |
| Standard Deduction and Exemptions | Standard deduction of $5,700 for non-itemizers. Personal and dependent exemption of $3,650. | Maintain current law. All individuals take the standard deduction (itemized deductions eliminated).[a] | Eliminate standard deduction and personal exemption |
| Mortgage Interest | Deductible for itemizers on up to $1 million in principal. Allowed for second residence, with an additional $100,000 for home equity. | 12% non-refundable tax credit on up to $500,000 mortgage. No credit for second residence or home equity. | 15% refundable tax credit, capped at $25,000 |
| Employer Provided Health Insurance | Excluded from income. Beginning in 2018, 40% excise tax on high-cost plans. | Cap exclusion at 75th percentile of premium levels in 2014, with nominal cap frozen through 2018. | Eliminate employer health exclusion |
| Charitable Giving | Deductible for itemizers | 12% non-refundable tax credit | 15% refundable tax credit |
| Retirement | Various tax-preferred account options. Saver's credit of up to $1,000. | Cap tax-preferred contributions to the lower of $20,000 or 20% of income, consolidate retirement accounts, and expand the saver's credit | Cap tax-preferred contributions to the lower of $20,000 or 20% of income, expand saver's credit |
| Other Tax Expenditures | Over 150 individual tax expenditures | Eliminate most tax expenditures | Eliminate most tax expenditures |
| Capital Gains and Dividends | Top rate of 15% for capital gains and dividends | All capital gains and dividends taxed at ordinary rates. | $1,000 exclusion for capital gains (or losses). All other capital gains and dividends taxed at ordinary rates. |
| State and Municipal Bonds | Interest tax exempt | Interest taxable on newly issued bonds | Interest tax exempt for public purpose debt |
| **Payroll Tax** | | | |
| Payroll Tax Cap | Payroll tax cap at $106,800 | Increase payroll tax cap to cover 90% of wages | Increase payroll tax cap to cover 90% of wages |

| | Current Law | Fiscal Commission Plan | Debt Reduction Task Force Plan |
|---|---|---|---|
| Payroll Tax Holiday | Employees given a 2 percentage point reduction in payroll tax for 2011. | None included, but consideration of a temporary payroll tax holiday recommended. | One-year payroll tax holiday for employers and employees |
| **Corporate Income Tax** | | | |
| Tax Rates | Rate of 35% for most corporations | Rate of 28% | Rate of 27% |
| International Income | Taxed when repatriated (deferral) | Adopt a territorial tax system | Retains deferral |
| Passive Foreign-Source Income | Taxed under Subpart F | Maintain current law | Not explicitly discussed |
| Corporate Tax Expenditures | Over 75 corporate tax expenditures | Eliminate corporate tax expenditures, including the domestic production deduction, last-in first-out (LIFO) account method, and general business credits. | Eliminate most corporate tax expenditures |
| **Excise Tax** | | | |
| Motor Fuel Excise Tax | $0.184 per gallon excise tax on gasoline. | Increase by $0.15 per gallon | No change |
| Excise Tax on Alcoholic Beverages | Distilled spirits taxed at $13.50 per proof gallon. Reduced rates for wine and beer. | Maintain current law | Adjust excise tax on alcoholic beverages to $0.25 per ounce |
| **Estate Tax** | | | |
| Estate Tax Rate and Exemption | 35% tax rate with exemption of $5 million ($10 million for couples) | Not explicitly discussed, although extension at 2009 levels (45% rate with $3.5 million exemption) assumed. | Extend at 2009 levels (45% rate with $3.5 million exemption) |
| **Other Tax Reforms** | | | |
| National Sales Tax | None | None | 6.5% debt reduction sales tax |
| Sweetened Beverage Tax | None | None | New tax on sweetened beverages |

**Source:** CRS, The Fiscal Commission, and the Deficit Reduction Task Force.

**Notes:** The standard deduction and personal exemption amounts listed are for the 2010 tax year. The payroll tax cap listed is also for 2010. Current tax rates are scheduled to return to pre-2001 rates at the end of 2012. The estate tax rate and exemption reflect the changes made in P.L. 111-312. Appendix B of the Deficit Reduction Task Force's proposal contains a list of tax expenditures that are retained in their plan. PEP stands for the personal exemption phaseout. Pease refers to the limitation on itemized deduction.

a. The standard deduction in the plan voted on by the Fiscal Commission was larger than what was released in the December 1, 2010, illustrative plan. Increasing the standard deduction results in a slightly more progressive distribution that the one reported below.

The Fiscal Commission's proposal would have the United States tax foreign-source income under a territorial system.[98] With a territorial system, income earned abroad by U.S. multinationals is taxed where it is earned. The current U.S. tax system taxes U.S. based multinationals' worldwide income, allowing foreign tax credits to reduce domestic tax liability for tax payments to foreign governments. Foreign-chartered subsidiaries of U.S. multinationals can also defer U.S. tax payments until income is repatriated. To address concerns that passive foreign-source income could be easily shifted, deferral is restricted for some foreign-source income, which is taxed under Subpart F. The Fiscal Commission's proposal would not change the tax treatment of passive foreign-source income.

The Fiscal Commission proposal would also have raised additional revenues by applying a chained-CPI throughout the government. Portions of the tax code that are indexed for inflation would be adjusted using the chained-CPI rather than the currently used standard CPI. The Fiscal Commission notes that a chained-CPI is designed to more closely approximate cost-of-living changes. Applying a chained-CPI to the tax code would slow the increase in bracket thresholds, and overall lead to increased federal revenues.

The Fiscal Commission's proposal also suggests reforms that would limit the government's ability to raise revenues, while also ensuring that tax reforms are taken should Congress and the Administration fail to take action. Under the proposal, tax revenues would be limited to 21% of GDP. Historically, federal receipts have never exceeded 21% of GDP (see **Figure 5**). Over the 20-year period 1990 through 2009, total federal receipts as a percentage of GDP averaged 18.1%.[99] The Commission's recommendation also includes what they term a "failsafe," which would trigger automatic reductions in tax expenditures, should Congress and the Administration fail to enact comprehensive tax reform.

**Table 6** provides information on the estimated revenues if the provisions in the Fiscal Commission's Illustrative Plan were adopted. Over the 2012 through 2020 budget window, it is estimated these reforms would generate over $1.1 trillion in additional revenues. Of this, an estimated $785 billion in revenues would result from comprehensive tax reform. An additional $96 billion would be generated by applying chained-CPI to the tax code. The report does not distinguish between revenues raised through individual reforms as opposed to corporate reforms. Revenues are greater in the later years as many of the tax reforms are phased in over time. Over the 2012 through 2020 time period, the Fiscal Commission's proposal would reduce the budget deficits by an estimated $4.1 trillion.[100] Thus, approximately 27% of the deficit reduction can be attributed to revenues generated by the tax provisions noted in **Table 6**.

The Joint Select Committee on Deficit Reduction established by the Budget Control Act of 2011 may choose to consider both spending and revenue options. Overall, the Committee has been tasked with finding $1.2 trillion to $1.5 trillion in deficit reduction over the FY2012 – FY2021 budget window. Should the Committee decide to use a ratio of spending cuts to revenues that is similar to that of the Fiscal Commission, roughly $300 billion to $400 billion in deficit reduction would come from additional revenues. If the Committee chooses to use a ratio of spending cuts to revenues similar to that of the Fiscal Commission, and considers the fact that $900 billion in deficit reduction has already been enacted in the form of spending cuts under the Budget Control Act of 2011, revenues may be used to generate roughly $550 billion to $650 billion in deficit reduction. As discussed below, the President's deficit reduction proposal, as submitted to the Joint

[98] For additional background on international tax issues, as well as discussion and analysis of possible reforms, see CRS Report RL34115, *Reform of U.S. International Taxation: Alternatives*, by Jane G. Gravelle.

[99] Calculated using data available in the President's Fiscal Year 2011 Budget Proposal, Historical Tables, Table 1.2.

[100] This figure is based on the Fiscal Commission's plausible baseline.

Select Committee on Deficit Reduction, would generate, on net, $1.3 trillion in additional revenues over the FY2012 – FY2021 budget window.

**Table 6. Revenues Generated Through Tax Provisions: The Fiscal Commission's Illustrative Proposal**

(billions of dollars)

| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2012-2020 |
|---|---|---|---|---|---|---|---|---|---|---|
| Comprehensive Tax Reform | 0 | 20 | 40 | 80 | 90 | 105 | 120 | 150 | 180 | 785 |
| Raise Gas Tax by $0.15 | 0 | 2 | 7 | 12 | 17 | 19 | 19 | 19 | 19 | 114 |
| Apply Chained-CPI Throughout the Government | 1 | 3 | 4 | 6 | 10 | 13 | 17 | 20 | 23 | 96 |
| Raise Taxable Base of Social Security to Include 90% of Income | 3 | 5 | 8 | 12 | 14 | 18 | 22 | 26 | 30 | 138 |
| **Total** | **4** | **30** | **59** | **110** | **131** | **155** | **178** | **215** | **252** | **1,133** |
| **Deficit Commission's Plausible Baseline** | -1,004 | -819 | -722 | -798 | -889 | -913 | -931 | -1,045 | -1,136 | -8,257 |

**Source:** The Moment of Truth: Report of the National Commission on Fiscal Responsibility and Reform, Figure 17.

**Notes:** The plausible baseline does not include extensions of the 2001 and 2003 tax cuts for those with income above $250,000. The baseline also assumes that the estate tax was extended at 2009 levels and does not include the temporary 2 percentage point payroll tax deduction.

## The Debt Reduction Task Force's Proposal

Like the Fiscal Commission's proposal, the Debt Reduction Task Force's Proposal included comprehensive tax reform as part of a broader strategy for deficit reduction. The objectives of the Debt Reduction Task Force's proposal were similar to those of the Fiscal Commission: broaden the tax base and reduce tax rates. Enhancing progressivity in the tax code was another objective.

The Debt Reduction Task Force's proposal sought to stabilize the federal debt below 60% of GDP. Of the estimated $5.9 trillion in total debt reduction that would be achieved over the 2012-2020 period should the proposal be fully implemented, approximately 39% would be achieved through tax reforms.[101]

**Table 5** above summarizes the key provisions of the Debt Reduction Task Force's proposed tax reform. With respect to the individual income tax, the Debt Reduction Task Force's plan would eliminate most tax expenditures, eliminate the standard deduction and personal exemption, eliminate the AMT, and move from six tax brackets to two. Limited tax benefits would be retained for children, mortgage interest, charitable giving, and retirement. Unlike the Fiscal

[101] The Debt Reduction Task Force's payroll tax holiday proposal reduces revenue generated through tax reform. A larger proportion of the deficit reduction could be attributed to tax reform if the payroll tax holiday is not fully implemented.

Commission's proposal, the Debt Reduction Task Force's plan would eliminate the exclusion for employer provided health insurance.

Like the Fiscal Commission's proposal, the Debt Reduction Task Force's plan would raise additional revenues through the payroll tax, corporate tax, and excise taxes. The estate tax proposal in the Debt Reduction Task Force's proposal would also generate additional revenues relative to current law.[102]

Both the Fiscal Commission and Debt Reduction Task Force proposals would increase the payroll tax cap to cover 90% of wages. In addition to increasing the payroll tax cap, the Debt Reduction Task Force proposed a payroll tax holiday as an economic stimulus measure. The proposal called for a one-year suspension of the payroll taxes for both individuals and businesses. This proposal would have resulted in $641 billion in federal revenue losses. The proposal was, in part, effected by the Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (P.L. 111-312). P.L. 111-312 enacted a one-year 2 percentage point reduction (from 6.2% to 4.2%) in the payroll tax rate paid by individuals.

The Debt Reduction Task Force's proposed corporate tax reform is similar to that of the Fiscal Commission in that both would reduce corporate tax rates and eliminate most corporate tax expenditures.[103] Unlike the Fiscal Commission, the Debt Reduction Task Force's plan would not move toward a territorial tax system.

The Debt Reduction Task Force's plan proposed two excise tax modifications. First, the plan would increase excise taxes on alcoholic beverages by $0.25 per ounce. Second, the plan would impose a new tax on sweetened beverages.[104]

The Debt Reduction Task Force's proposal would also introduce a national sales tax. This sales tax would be levied at 6.5%, and would generate the majority of new revenues raised through tax reforms in the proposal.

**Table 7** presents data on the revenues generated through various tax provisions proposed by the Debt Reduction Task Force. The proposed reforms to the individual and corporate income taxes would lead to estimated revenue losses of $415 billion over the 2012-2020 budget window. While eliminating most tax expenditures results in added revenues ($3.5 trillion over the 2012-2020 window), the increased tax relief for low-income families and families with children, along with the reduced rates, means that these reforms, overall, are not revenue raisers. In other words, the Debt Reduction Task Force's proposed individual and corporate income tax reforms increase the deficit, on net.

[102] Revenues associated with modifying the estate tax are not shown in **Table 7**. The Debt Reduction Task Force assumed that the estate tax would be extended at 2009 levels. The estate tax was modified in the Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (P.L. 111-312).

[103] Appendix B of the Debt Reduction Task Force's plan contains a list of tax expenditures that would be retained. Corporate tax expenditures that are recommended for retention include accelerated depreciation, deferral of income from controlled foreign corporations, expensing for small investments, and expensing of research and development (R&D) expenditures.

[104] For analysis of taxes on sweetened beverages, see Kelly D. Brownell, Thomas Farley, and Walter C. Willett, et al., "The Public Health and Economic Benefits of Taxing Sugar-Sweetened Beverages," *The New England Journal of Medicine*, vol. 361, no. 16 (October 15, 2009), pp. 1599-1605.

**Table 7. Revenues Generated Through Tax Provisions: The Debt Reduction Task Force's Proposal**

(billions of dollars)

| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2012-2020 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Tax Expenditure Cuts and Reforms** | | | | | | | | | | |
| Restructure Itemized Deductions and Eliminate Tax Expenditures | 230 | 338 | 369 | 397 | 421 | 444 | 428 | 447 | 470 | 3,544 |
| Tax Capital Gains above $1,000 Exclusion | -1 | 2 | 5 | 29 | 38 | 40 | 42 | 44 | 46 | 243 |
| Restructure Tax Benefits for Low-Income Families, Families with Children, and Eliminate the Standard Deduction and Personal Exemption | -155 | -209 | -221 | -213 | -216 | -221 | -226 | -230 | -234 | -1,914 |
| **Rate Cuts and New Revenues** | | | | | | | | | | |
| Reduce Individual Income Tax Rates | -70 | -109 | -123 | -136 | -149 | -161 | -173 | -183 | -194 | -1,298 |
| Reduce Corporate Tax Rate | -71 | -79 | -90 | -84 | -89 | -90 | -92 | -93 | -96 | -785 |
| Repeal the AMT | -23 | -31 | -34 | -36 | -38 | -40 | -42 | -45 | -48 | -338 |
| Re-Index the Tax System | 2 | 6 | 8 | 11 | 13 | 17 | 21 | 24 | 29 | 133 |
| *Tax System Reform Subtotal* | *-88* | *-82* | *-86* | *-32* | *-20* | *-11* | *-42* | *-36* | *-27* | *-415* |
| Increase the Excise Tax on Alcoholic Beverages | 4 | 6 | 6 | 6 | 6 | 6 | 6 | 6 | 7 | 53 |
| Tax on Sweetened Beverages | 12 | 17 | 17 | 17 | 18 | 18 | 19 | 19 | 19 | 156 |
| Introduce a 6.5% Debt-Reduction Sales Tax | 105 | 268 | 326 | 345 | 364 | 382 | 400 | 419 | 439 | 3,048 |
| Increase the Taxable Base to 90% of Income | 1 | 4 | 6 | 9 | 11 | 14 | 17 | 21 | 24 | 107 |
| **Total** | **34** | **213** | **269** | **345** | **379** | **409** | **400** | **429** | **462** | **2,949** |

**Source:** The Debt Reduction Task Force Proposal.

**Notes:** The Debt Reduction Task Force's Proposal also included a one-year sales tax holiday that would have reduced revenues by $641 billion over the 2012-2020 period. Thus, total revenues generated with the sales tax holiday included were projected at $2,308 billion.

Nearly all of the revenues raised in the Debt Reduction Task Force's proposal would be through the 6.5% national sales tax.[105] The 6.5% tax would raise an estimated $3 trillion over the 2012-

[105] The national sales tax proposed by the Debt Reduction Task Force would fall on a broad base. Overall, roughly 75% of personal consumption expenditures would be subject to the tax. Certain goods and services are exempt from the tax, such as government services, services provided by charitable organizations, educational activities, the imputed value of financial services, government subsidies to healthcare, and rental housing. Other consumer goods, such as privately funded healthcare, food, and clothing would be subject to the tax.

2020 period. As noted in the Debt Reduction Task Force's report, a sales tax may be attractive since it does not tax the return to savings and investment, which may promote long-run economic growth. Sales taxes, broadly, tend to be regressive. Changes in the income tax system noted above were designed to address this concern. Another potential concern regarding a national sales tax may be the interaction with existing state-level sales taxes.[106]

Overall, the Debt Reduction Task Force's proposal would generate more in terms of additional tax revenues than would be generated under the Fiscal Commission's proposal. Over the 2012-2020 period, the Fiscal Commission's tax reforms would result in roughly $1 trillion in added revenues. In contrast, the Debt Reduction Task Force's reforms (not including the payroll tax holiday) would generate nearly three times as much additional tax revenue. Since the payroll tax holiday has already been partially enacted, one option would be to take the revenues that would have been used to finance the holiday and allow for a lower sales tax rate. With the payroll tax holiday option included, the Deficit Reduction Task Force's revenue proposals would have generated $2.3 trillion in additional revenues over the 2012-2020 period, or more than twice as much as the revenue proposals put forth by the Fiscal Commission.

## The President's Proposal

On September 19, 2011, President Obama submitted to Congress a deficit reduction plan to accompany his proposed American Jobs Act of 2011.[107] The American Jobs Act and the President's deficit reduction plan both contain a number of tax provisions (see **Table 8**). Unlike the Fiscal Commission and the Debt Reduction Task Force plans, the President's proposal does not propose comprehensive tax reform. Instead, the proposal outlines a number of tax policy changes that would have revenue implications.

[106] For further discussion, see CRS Report R41602, *Should the United States Levy a Value-Added Tax for Deficit Reduction?* by James M. Bickley.

[107] Office of Management and Budget, "Living Within Our Means and Investing in the Future: The President's Plan for Economic Growth and Deficit Reduction," September, 2011. Available at http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/jointcommitteereport.pdf.

**Table 8. Revenues Generated in the President's Proposal**

(billions of dollars)

| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2012-2021 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| ***Individual*** | | | | | | | | | | | |
| Allow 2001/2003 High-Income Tax Cuts and Estate Tax Cuts to Expire | 12.8 | 46.6 | 63.4 | 76.9 | 90.6 | 100.7 | 107.6 | 114.6 | 122.2 | 130.4 | 866.0 |
| Limit Itemized Deductions to 28% | | 21.7 | 36.0 | 39.6 | 43.0 | 46.8 | 50.4 | 54.0 | 57.5 | 61.1 | 410.1 |
| Tax Carried Interests as Ordinary Income | | 1.9 | 2.1 | 2.0 | 1.7 | 1.4 | 1.1 | 0.9 | 0.7 | 0.5 | 12.5 |
| ***Business*** | | | | | | | | | | | |
| Modify Depreciation Rules for Corporate Aircraft | | 0.1 | 0.4 | 0.6 | 0.7 | 0.8 | 0.8 | 0.6 | 0.3 | 0.3 | 4.7 |
| Eliminate Oil and Gas Tax Preferences | | 3.2 | 5.5 | 5 | 4.8 | 4.9 | 4.7 | 4.5 | 4.4 | 4.4 | 41.5 |
| Modify Tax Rules for Dual Capacity Taxpayers | | 0.6 | 1.0 | 1.0 | 1.1 | 1.1 | 1.2 | 1.2 | 1.3 | 1.4 | 9.9 |
| Eliminate Coal Tax Preferences | | 0.1 | 0.2 | 0.2 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 2.3 |
| Repeal LIFO and LCM Inventory Accounting Methods | | 2.8 | 7.1 | 8.8 | 7.9 | 7.7 | 6.5 | 6.5 | 6.4 | 6.3 | 60.0 |
| Reform Tax Treatment of Insurance Companies and Products | | 0.4 | 0.7 | 0.8 | 1.0 | 1.2 | 1.5 | 1.7 | 2.1 | 2.6 | 12.0 |
| Reform of U.S. International Tax System | | 8.3 | 14.1 | 14.5 | 15 | 15.5 | 12.5 | 10.5 | 10.8 | 11.3 | 112.7 |
| ***Other*** | | | | | | | | | | | |
| Reinstate Superfund Taxes | | 1.5 | 2.0 | 2.1 | 2.1 | 2.1 | 2.2 | 2.2 | 2.2 | 2.3 | 18.7 |
| Make 0.2% Unemployment Surtax Permanent | 1.3 | 1.4 | 1.4 | 1.4 | 1.5 | 1.5 | 1.5 | 1.5 | 1.5 | 1.5 | 14.6 |
| Worker Classification Enforcement | | 0.2 | 0.6 | 0.7 | 0.8 | 0.9 | 1.0 | 1.1 | 1.2 | 1.3 | 7.7 |
| **Total Tax Reform Revenues** | 14.2 | 88.9 | 134.5 | 153.8 | 170.6 | 184.8 | 191.3 | 199.8 | 211.1 | 223.6 | 1,572.6 |
| ***American Jobs Act Tax Incentives*** | | | | | | | | | | | |
| Employer Temporary Payroll Tax Reduction and Additional Payroll Tax Cut for New Jobs/Wages | -60.7 | -15.0 | 4.4 | 1.7 | 0.6 | 0.2 | (ii) | | | | -68.7 |

| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2012-2021 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Extend 100% Expensing Allowance | -50.7 | -17.9 | 21.3 | 13.7 | 9.7 | 7.2 | 4.7 | 3.0 | 1.8 | 1.4 | -5.8 |
| Extend Exemption for AMT for Certain Tax-Exempt Bonds | (i) | (i) | (i) | (i) | (i) | (i) | (i) | (i) | (i) | (i) | -0.2 |
| Veterans Hiring Tax Credit | (i) | (i) | (i) | (i) | (i) | (i) | (i) | | | | -0.1 |
| Long-Term Unemployed Hiring Tax Credit | -3.2 | -3.3 | -1.2 | -0.9 | -0.6 | -0.5 | -0.3 | -0.3 | -0.2 | -0.1 | -10.6 |
| Individual Temporary Payroll Tax Reduction | -129.2 | -49.7 | | | | | | | | | -178.8 |
| **Total Jobs Act Incentives** | -243.8 | -85.9 | 24.4 | 14.6 | 9.7 | 6.9 | 4.3 | 2.7 | 1.6 | 1.3 | -264.3 |
| **Tax Reform Revenues Less Jobs Act Tax Cuts** | -229.6 | 3.0 | 158.9 | 168.3 | 180.2 | 191.7 | 195.7 | 202.5 | 212.7 | 224.9 | 1,308.3 |

**Source:** CRS calculations using data from the Office of Management and Budget, "Living Within Our Means and Investing in the Future: The President's Plan for Economic Growth and Deficit Reduction," September, 2011. Available at http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/jointcommitteereport.pdf.

**Notes:** An (i) indicates a revenue loss of less than $50 million. An (ii) indicates a revenue gain of less than $50 million.

The tax provisions in the President's proposal would raise, on net, $1.3 trillion over the 2012 through 2021 budget window. The majority of the additional revenues would be generated by allowing the 2001 and 2003 tax cuts to expire for high-income earners and from limiting the value of itemized deductions to 28% (see **Table 8**).[108] Additional revenues would be generated by eliminating tax incentives that promote the use of fossil fuels, taxing carried interests as ordinary income, modifying certain inventory accounting rules, changing the tax treatment of insurance companies and products, modifying certain provisions related to the U.S. international tax system (including tax rules for dual capacity taxpayers), and by changing the depreciation rules for corporate jets. Additional revenues would also be raised by reinstating Superfund taxes, making the 0.2% unemployment insurance surtax permanent, and modifying worker classification treatment. While the President's proposal contains $1.6 trillion in new revenues over the 2012 through 2021 budget window, the $0.3 trillion in tax cuts proposed as part of the American Jobs Act reduces total net tax revenues to $1.3 trillion over the 2012 through 2021 budget window.

President Obama's American Jobs Act proposal would enact a number of measures providing tax relief in the short run. Specifically, the proposal would reduce employer and employee payroll taxes in 2012. The jobs proposal would also extend the 100% bonus depreciation allowance through 2012, and provide tax credits for hiring veterans and long-term unemployed.[109]

## Distributional Impacts

Both the Fiscal Commission's proposal and the Debt Reduction Task Force's plan sought to maintain or enhance progressivity in the tax code. The Tax Policy Center has conducted a distributional analysis of the two proposals using their microsimulation model.[110] **Table 9** and **Table 10** summarize the results of their analysis.[111]

The Fiscal Commission's proposal would make moderate changes to the distribution of the federal tax burden (see **Table 9**).[112] Average tax rates are estimated to increase for all income groups. The highest income quintile would see their share of the federal tax burden increase by approximately one percentage point, from 65.7% to 66.9%. The share of federal taxes paid by middle-income groups would decrease under the proposal. Increasing the share of taxes paid by high-income groups, while reducing or maintaining the share paid by lower- and middle-income groups, may appeal to the notions of vertical equity discussed above.

[108] For additional background, see CRS Report R41111, *Expiration and Extension of the Individual Income Tax Cuts First Enacted in 2001 and 2003: Background and Analysis*, by James M. Bickley.

[109] For additional background, see CRS Report RL31134, *Using Business Tax Cuts to Stimulate the Economy*, by Jane G. Gravelle.

[110] Details on the Tax Policy Center's microsimulation model can be found at http://www.taxpolicycenter.org/numbers/related.cfm.

[111] Earlier versions of this report contained an earlier distributional analysis prepared by the Tax Policy Center, available at http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=2855&DocTypeID=2. The current version of this report contains an updated distributional analysis of the illustrative proposal. This updated version has a reduced threshold for the 22% bracket and an increased standard deduction. This is the version of the illustrative proposal that was voted on by the Fiscal Commission.

[112] Additional distributional estimates related to the Fiscal Commission's proposal, and other deficit reduction proposals, are available at http://www.taxpolicycenter.org/taxtopics/Deficit-Reduction-Proposals.cfm.

**Table 9. Distributional Impacts of the Fiscal Commission Proposal**

(2020 law at 2015 income levels)

| | | | Current Law | | Fiscal Commission Proposal | |
|---|---|---|---|---|---|---|
| **Income Group** | **Average Pre-Tax Income ($)** | **Average After-Tax Income ($)** | **Average Federal Tax Rate (%)** | **Share of Federal Taxes Paid (%)** | **Average Federal Tax Rate (%)** | **Share of Federal Taxes Paid (%)** |
| 1st Quintile | 12,380 | 11,780 | 4.9 | 0.8 | 4.8 | 0.7 |
| 2nd Quintile | 31,685 | 28,249 | 10.8 | 4.1 | 11.7 | 4.1 |
| 3rd Quintile | 57,597 | 47,583 | 17.4 | 10.8 | 18.3 | 10.4 |
| 4th Quintile | 99,859 | 79,341 | 20.5 | 18.5 | 21.7 | 17.8 |
| 5th Quintile | 317,385 | 233,984 | 26.3 | 65.7 | 29.3 | 66.9 |
| Top 1% | 2,076,558 | 1,451,901 | 30.1 | 24.9 | 35.6 | 26.9 |

**Source:** Tax Policy Center. Full analysis available at http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=2857&DocTypeID=2.

**Notes:** The baseline is current policy, assuming an AMT patch and 2009 estate tax rates. The Fiscal Commission proposal is the illustrative proposal with individual tax rates of 12%, 22%, and 28% and the enhanced standard deduction. The distributional impacts reported are those expected in 2020 evaluated at 2015 income levels.

The Debt Reduction Task Force's plan appears to increase moderately progressivity in the tax code (see **Table 10**). Under the Debt Reduction Task Force's plan, average federal tax rates increase for all but the lowest income quintile. Under the plan, the highest income is responsible for a larger share of federal taxes (66.4% as opposed to 65.5%). Increasing the share of taxes paid by higher income groups is consistent with vertical equity principles. For all lower-income groups, the share of the federal tax burden is estimated to fall or remain the same.

The methodology used to generate the distributional analysis of the Debt Reduction Task Force's plan may understate the plan's regressivity. The Tax Policy Center's analysis allocated the burden of the consumption tax across individuals by treating the consumption tax as a tax on income from labor and a tax on profits plus a reallocation of tax burdens based on consumption patterns.[113] This is the so-called "income sources" method for allocating the distribution of consumption taxes. Another option is to allocate the distribution of the tax burden of a consumption tax using the ratio of current consumption to current income. This is the so-called "consumption ratio" method for allocating a consumption tax. A consumption ratio method of allocation leads to a more regressive distribution of consumption taxes.[114] There is disagreement amongst economists regarding which method best represents the distributional impact of uniform consumption taxes. Thus, it is possible that the income-sources method used in **Table 10** might overstate tax-system progressivity under the Debt Reduction Task Force's plan.

[113] For additional details, see Eric Toder and Joseph Rosenberg, *Effects of Imposing a Value-Added Tax to Replace Payroll Taxes or Corporate Taxes*, Tax Policy Center, Washington, DC, March 18, 2010, http://taxpolicycenter.org/UploadedPDF/412062_VAT.pdf.

[114] For additional background, see Jane G. Gravelle, "The Distributional Case Against a VAT," in *The VAT Reader: What a Federal Consumption Tax Would Mean for America*, ed. Tax Analysts (Tax Analysts, 2011), pp. 102-111.

**Table 10. Distributional Impacts of the Debt Reduction Task Force's Plan**

(2022 law at 2018 income levels)

| | | | Current Law | | Debt Reduction Task Force Plan | |
|---|---|---|---|---|---|---|
| **Income Group** | **Average Pre-Tax Income ($)** | **Average After-Tax Income ($)** | **Average Federal Tax Rate (%)** | **Share of Federal Taxes Paid (%)** | **Average Federal Tax Rate (%)** | **Share of Federal Taxes Paid (%)** |
| 1st Quintile | 13,751 | 13,069 | 5.0 | 0.8 | 5.0 | 0.7 |
| 2nd Quintile | 35,042 | 31,313 | 10.6 | 4.0 | 12.5 | 4.0 |
| 3rd Quintile | 63,944 | 52,761 | 17.5 | 10.8 | 19.8 | 10.3 |
| 4th Quintile | 112,508 | 93,727 | 20.8 | 18.8 | 24.2 | 18.5 |
| 5th Quintile | 355,513 | 261,786 | 26.4 | 65.5 | 31.6 | 66.4 |
| Top 1% | 2,262,666 | 1,586,676 | 29.9 | 24.0 | 35.8 | 24.4 |

**Source:** Tax Policy Center. Full analysis available at http://www.taxpolicycenter.org/taxtopics/Bipartisan-Policy-Center-Proposal-Tables.cfm.

**Notes:** The baseline is current policy, assuming an AMT patch and 2009 estate tax rates. Federal income taxes include individual and corporate income taxes, payroll taxes, and estate taxes. The proposal also includes a broad-based sales tax of 6.5%.

# Concluding Remarks

Persistent budget deficits and the accompanying increase in national debt is at the forefront of congressional debate. Achieving fiscal sustainability, reducing the budget deficit, and bringing the national debt to sustainable levels, will likely involve some combination of spending and revenue measures. This report provided a broad overview of some of the potential revenue options available to Congress.

The majority of federal revenues are collected through the individual income tax system and through payroll taxes. Revenues can be enhanced by eliminating various deductions, exemptions, and credits, generally broadening the tax base. A broader tax base could allow for lower tax rates, which may enhance economic efficiency. There are, however, additional revenue options outside of the existing tax code.

Both the President's Fiscal Commission and the Debt Reduction Task Force laid out plans for achieving fiscal sustainability. Tax reform was a substantial component of both proposals. Each proposed to modify the existing individual and corporate tax systems by eliminating tax expenditures allowing for lower tax rates. Each plan also suggested increasing the payroll tax base by increasing the share of covered wages. The plans differed, however, with respect to how much revenue would be generated through these tax reforms. Under the Fiscal Commission's proposal, comprehensive tax reform and payroll tax changes would generate the majority of revenues, with additional revenues coming from an additional excise tax on motor fuels. The Debt Reduction Task Force's comprehensive tax reform would not generate added revenues through 2020. Instead, the Debt Reduction Task Force proposed raising revenues through a consumption tax, in the form of a broad-based national sales tax.

The President's September 19, 2011, deficit reduction proposal also provides a specific framework for achieving long-run deficit reduction and enhancing fiscal sustainability. Additional

revenues in the President's proposal are raised primarily by allowing the reduced tax rates on high-income taxpayers to expire and by limiting the value of itemized deductions for high-income taxpayers, thereby broadening the tax base.

The Fiscal Commission, Debt Reduction Task Force, and President's proposal have provided possible roadmaps for achieving fiscal sustainability. In all three plans, tax reform is an important component. Understanding that tax reform could play an important role in any successful deficit reduction and debt control strategy, Congress may want to consider tax policies that will be economically efficient, equitable, and provide a stable foundation for future economic growth. It is also important to note, however, that enhancing equity and efficiency in the tax code may not necessarily lead to deficit reduction.

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