tax notes

TAX ANALYSTS®

Volume 81, Number 2 • Monday, October 12, 1998

SeidmanL@be.udel.edu 302-831-1917

DEPARTMENTS

Clinton Presidential Records
Digital Records Marker

This is not a presidential record. This is used as an administrative marker by the William J. Clinton Presidential Library Staff.

This marker identifies the place of a publication.

Publications have not been scanned in their entirety for the purpose of digitization. To see the full publication please search online or visit the Clinton Presidential Library's Research Room.

Taxes

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

December 2, 1998

CLOSE HOLD

MEMORANDUM FOR GENE SPERLING
DIRECTOR, NATIONAL ECONOMIC COUNCIL

FROM: **ROBERT E. RUBIN**

SUBJECT: **Meeting on Tax Cut Options**

An NEC process in coordination with Treasury staff has developed possible new tax cut options for the President's budget. NEC-DPC sub-groups (Treasury, OMB, CEQ, OVP, and various agencies) have been working on priority areas, including health, education and training, children and families, empowerment, R & D, and pensions.

This meeting will focus on these new possible proposals and the context for their consideration. Treasury has a number of concerns about many of these proposals, including questions about administrability, marginal effect and social policy judgments. Moreover, as a more general matter, we face serious budgetary and analytic resource constraints. Given what the Administration is almost certainly committed to, there is little room for new proposals, especially if we decide to support a fix to the marriage penalty.

In that context, we need to decide which, if any, of the new proposals to work on, bearing in mind that such effort comes at the cost of work on other high priority issues, development of possible raisers, revision of the tax baseline and issuance of regulatory guidance (which is always heavily weighted toward year-end).

More generally, there is as always the broader question regarding the extent to which we should focus on simplifying the tax code versus the extent to which we should pursue other social and economic objectives at the expense of making the tax code more complex.

In light of the above considerations, we believe that the NEC Principals need to focus on the following questions:

- Should the budget include marriage penalty relief?
- Should a share of tobacco receipts, if any, go to offset tax cuts?

- Will all revenue raisers continue to be dedicated solely to tax cuts?
- Should all of our tax cuts from last year's budget be re-proposed?
- Which of the new tax cut options should be given priority consideration, if any?
- Which tax cut options should not be considered further, because they are bad policy, conflict with other objectives, or have no realistic prospect of being enacted?

Below is a discussion and background relevant to the above questions as well as brief descriptions, pros and cons, and rough cost estimates of the possible new tax cut proposals.

Marriage Penalty Relief

Treasury estimates that, in 1999, 48 percent of all couples will have a marriage penalty and 41 percent will have a marriage bonus. Aggregate penalties will be $28 billion in 1999, and aggregate bonuses will be $27 billion. Despite this rough parity, marriage penalty relief has broad support in Congress. Various legislative proposals have been introduced to address the marriage penalty, some of which the Administration has supported. The question now is whether marriage penalty relief should be included in the budget. Marriage penalty relief would cost more than $10 billion over five years.

Pros

- It would increase the appeal of our package to Democrats (as well as Republicans) and increase the likelihood that they would embrace our proposal overall and help ensure that it would serve as the Democratic proposal in any tax debate. Recall that this past year the Senate Democrats dropped some of our key tax cuts to make room for marriage penalty relief.
- It would put the President on the record more clearly on an issue that we have voiced support for in the past, that is likely to pass one day in some form and that we would never openly oppose. Including a specific proposal might increase our chances of influencing the ultimate design of any marriage penalty relief.

Cons

- Proposed solutions are very costly. Even limited relief would absorb $10 billion or more in raisers that could be used for other priorities.
- There is little evidence that marriage penalties and bonuses in the income tax affect decisions to marry, divorce or work.

- Most marriage penalty relief proposals benefit higher income couples disproportionately. Steps can be taken to minimize this. For example, relief can be designed to help people who face marriage penalties due to the phase-out of the EITC.

If the group decides to move ahead on serious consideration of marriage penalty relief, two very general design options should be considered:

1) Increase the Standard Deduction for Married Couples -- Both Archer ($27 billion over five years) and Gramm-Domenici (about $15 billion) used this design, although their specific proposals were flawed and are not expressly suggested.

2) A Second Earner Deduction -- Daschle (about $10 billion) took this approach, although his specific proposal was overly complicated and is not expressly suggested. Couples would be allowed to deduct a portion of the earnings of the spouse with lower earnings.

There is a tradeoff between the two approaches. Raising the standard deduction is simpler, but the second earner deduction is better targeted to couples that actually face marriage penalties.

Tobacco

The details about how to approach tobacco need to be resolved. The first decision, of course, is whether tobacco should be on the list of revenue raisers. If so, one possibility would be to impose a $0.50 per pack excise tax on cigarettes (and a proportionate increase in the excise tax on other tobacco products). (Alternatively, the excise tax could be set equal to the difference between the $1.10 per pack increase projected to have arisen from last year's aborted tobacco settlement and the price increase due to the just-enacted settlement with state attorney generals.) A $0.50 excise tax would raise roughly $30 billion over five years.

Pros

- It would reduce smoking by roughly 2.5 billion packs per-year (a 10% reduction), thereby promoting the health of the U.S. population. Youth smoking would fall by roughly 16%.

- Many people want to quit, but can't. Preventing people from starting to smoke can make them much better off over the long run, even if they are hurt by the tax in the short run.

- The excise tax is much simpler than some alternative proposals and will have a more certain effect on cigarette prices.

Cons

- The tax increase may not be warranted on economic grounds. Some evidence suggests that current state and local cigarette taxes already may exceed the costs to society from premature death and illness, even before the $0.45 per-pack state settlement costs are considered.

- Smokers may react to higher taxes by switching to brands with higher tar and nicotine, or to less heavily taxed forms of tobacco, therefore reducing the health gains.

- Cigarette excise taxes are regressive.

- A high tax burden on cigarettes encourages smuggling. Smuggling can be addressed by stepped-up enforcement, but that is costly.

Revenue Raisers

About $22 billion over five years of our revenue raisers remain from last year's budget. This is several billion less than the cost of our existing tax cut package. Treasury staff is currently conducting an intensive effort to develop additional revenue raising provisions. It is too early to know the magnitude of these additional raisers. Many of our existing raisers remain controversial.

Under the existing tax package, the revenue raising provisions are dedicated solely to tax cuts. The group needs to discuss whether the new budget should be similarly constructed or whether any of the revenue raisers should go to offset spending priorities. The obvious downside of using the revenue raisers for spending priorities is that it will invite the criticism that the President's budget does not include a tax cut but a tax increase. The upside would be that the resources would provide some flexibility in an extremely tight budget year.

Existing Tax Cut Package

In addition to focusing on possible new proposals, the group needs to focus on whether to include each of the proposals from last year and whether any should be modified. The table below provides an overview of our existing tax cut package:

Existing Proposals	Five Year Cost -- Billions (Scoring from last year's budget)
Child Care:	
Dependent Care Tax Credit (DCTC)	5.1
Tax Credit for Employers	0.5
Subtotal	5.6
School Construction	5.0
Employer Provided Education (Sec. 127)	1.0
Low Income Housing Tax Credit	1.6
Climate Change	3.6
Pensions	0.9
Extenders (R&E, WOTC, WTW, etc.)	3.3
International and Puerto Rico	1.4
$2,000 Severance Pay Exemption	0.8
TOTAL	**$24 billion**

We have discussed possible modifications to some of our existing proposals, including:

School Construction -- a staff group has been discussing technical modifications to improve the targeting and efficiency of the school construction proposals.

Child Care -- in addition to considering additions to the current DCTC proposal, the child and family sub-group has been exploring how to include a stay-at-home-mom component within the existing proposal, in the event that no additional offsets are available (see below).

Climate Change -- Todd Stern's working group has been exploring possible modifications to the existing package within the same revenue constraint.

Possible New Tax Cut Proposals

Health

Long-term Care Tax Credit

Lack of insurance against the costs of long-term care expenses is a major problem for the elderly and their families. This proposal would give people who are limited in three or more activities of daily living (ADLs- eating, toileting, transferring, bathing, dressing, and continence) or their caregivers a tax credit of $1,000 to help pay for formal or informal long-term care. The credit would also cover people with severe cognitive impairments. The cost is **$6.5 billion** over 5 years.

Pros

- Long-term care costs account for nearly half of all out-of-pocket health expenditures for Medicare beneficiaries.
- The credit provides immediate relief for people needing long-term care and their families.
- Preliminary conversations with aging advocates suggest that this tax credit would be well received.

Cons

- Many people who need the most help will not benefit because they are not taxable and the credit is not refundable for most recipients. (Making the credit refundable would double its cost.)
- The IRS would find it difficult to enforce compliance without actually engaging in expensive and possibly intrusive audits of taxpayers. The Social Security Administration or other government agency may be better able than the IRS to verify the existence of a disability before any payment is made to the taxpayer.
- It is exceedingly difficult to define a qualifying standard for children under 6 years of age. Obviously, all small children are limited in their ADLs. Treasury is working with DPC and HHS to try to work out an enforceable and equitable standard.

Tax credit for disabled workers

Almost 75 percent of people with severe disabilities are unemployed. For many, the high cost of support services and devices, as well as the potential to lose Medicaid or Medicare coverage, prevent them from seeking and keeping jobs. This proposal would give a tax credit of $1,000 to people with disabilities who work in recognition of their formal and informal costs associated with employment. The credit would be available for people who are limited in two or more ADLs (excluding continence management) or three or more instrumental ADLs (IADLs -- meal preparation, shopping, money management, telephoning, and housework). The proposal will cost about **$700 million** over five years. About 240,000 taxpayers will benefit in CY 2000.

Pros

- Many disabled individuals incur additional costs in order to work and earn taxable income, and thus do not have the same ability to pay as taxpayers who do not incur such expenses. A tax credit would provide some adjustment for these differences in ability to pay.

- This credit is more attractive than a credit against employment related expenses because it compensates disabled people for formal and informal expenses both at home and at work.

Cons

- The proposed $1,000 credit would not induce many disabled people to enter the workforce.

- Many people who need the most help will not benefit because they are not taxable.

- Allowing taxpayers with difficulties with three or more IADLs may open the credit to abuse. A taxpayer, who had difficulty with cleaning the house, cooking meals, and shopping, could qualify for the credit even though he or she experienced no difficulty at work. Monitoring IADLs would be extremely difficult for the IRS to administer. (Treasury is exploring alternative options to provide coverage to disabled workers without using an IADL test.)

Small business health purchasing cooperatives

Over a quarter of private-sector workers in firms with 50 or fewer employees lack health insurance -- significantly higher than the national average of 17 percent uninsured. This results in part because administrative costs are higher and small businesses pay more for benefits than larger employers. This initiative encourages the development of small business health purchasing cooperatives, in some ways modeled on FEHBP. There are two tax proposals regarding these cooperatives. The first proposal would make them tax-exempt. (We are examining more limited alternatives to tax-exempt status that would also promote the making of grants by private foundations to a qualified cooperative.) The second part of the proposal would create a new tax credit for employers with fifty or fewer employees, who purchase health insurance through the cooperative, and who had not previously provided health insurance. The credit would be available for the first two years of coverage and would equal ten percent of employer contributions up to a cap. Rough estimate: **less than $0.1 billion** over five years for the credit; estimate not available for tax-exemption.

<u>Provide Tax Exemption to Cooperatives</u>

Treasury has serious tax policy concerns about granting permanent tax exemption to entities that are functionally identical to for-profit businesses to help cover start-up expenses.

Pro

- Private foundations would be more likely to make start-up grants to the cooperatives.

Cons

- The cooperatives would be indistinguishable from (and would compete on a tax-advantaged basis with) taxable, for-profit insurance brokers.

- Without special rules, granting tax-exempt status to these cooperatives creates the opportunity for small employers to shelter investment income from tax.

- It is unclear that the purported economies of scale to be gleaned by the cooperatives would ever materialize, especially since those employers that can purchase health insurance at favorable rates are less likely to join. Also, there is no guarantee that the benefits of tax exemption would flow through from the cooperative to small employers.

- The purpose of the tax exemption would be to enable private foundations to make grants for start-up expenses -- a short term problem -- but tax exemptions would be permanent.

Employer Tax Credit

Pros

- An employer tax credit may help to jump-start the cooperative.

- The proposed tax credit has been designed to minimize both inequities and undesirable behavioral responses to a credit. Tax credits are targeted to new health insurance coverage, reducing the chance that credits merely provide windfalls to employers for continuing to do what they already do.

Cons

- Many may view this credit as unfair. Employers who currently provide health insurance will view the credit as an unfair benefit to their competitors. Employers who insure outside the cooperative and large employers would not be eligible for the credit. Employees who purchase insurance outside of work typically pay higher premiums than do employers and receive no tax benefit at all–neither exclusion from income nor a tax credit–and may feel especially disadvantaged.

- The proposed credit is unlikely to substantially increase health insurance coverage.

Children and Families

Tax Relief for Stay-at-Home Parents

Our existing package includes an expansion of the child and dependent care tax credit (DCTC) to make it easier for families to afford child-care. The DCTC is equal to a percentage of the taxpayer's employment-related expenditures for child or dependent care, with the amount of the credit depending on the taxpayer's income. Our existing proposal, which costs about $4.5 billion over five years (not including the cost of proposed simplification to the household maintenance test), would increase the maximum credit from its current rate of 30% to 50% for those with incomes under $30,000, and gradually phase it down to 20% at $59,000 of income.

Our proposed increase in the DCTC did not receive strong bipartisan support, in part because conservatives objected to the exclusion of benefits for stay-at-home-parents. To increase support for our existing child care tax proposal, it could be expanded to include tax assistance to stay-at-home parents. This would be accomplished by assuming these families incur a certain amount of child-care expenses and therefore could be eligible for the DCTC. To control the cost, the stay-at-home-parent options would focus on families with very young children.

Treasury has serious tax policy concerns about compounding the tax code's heavy bias in favor of stay-at-home parents and exacerbating disincentives to work.

Options include:

A. Include stay-at-home family feature within existing revenue cost. This option would reduce our original proposal so that families with income of $30,000 or less could take a credit for 40% of their expenses (rather than our proposed 50%), and the rate would more gradually phase down to 20% at $58,500. The proposal would add an allowance for $600 worth of child care expenses per year for those families with children under age one regardless of actual child care costs or earnings. The maximum credit for a family with an infant and a stay-at-home parent is $240. Under this option, the maximum allowable child care expenses would remain $2,400 for one child and $4,800 for two or more children.

B. Add stay-at-home parent feature on top of existing proposal. Add one of the following to the existing proposal:

   I) Allow all families with a child under the age of one to have assumed expenses of $600 per year per child. Under this proposal, the maximum allowable expenses would increase from $2,400 to $3,000 for one child under age one and from $4,800 to $6,000 for two or more children under age one. This proposal adds **$1.6 billion** to the cost of the existing $4.5 billion proposal over five years.

ii) Same as I), but assume $1,200 per year in expenses and raise cost maximum to $3,600 for one child under age one and $7,200 for two or more children under age one. This would add about **$2.9 billion** to the cost of the existing $4.5 billion proposal over five years.

iii) Same as I), but increase the age limit so that families with children under 4 benefit. This would add **$6.1 billion** to the cost of the existing $4.5 billion proposal over five years.

Pros

- A variation of this proposal has been adopted by a number of Republicans in the Senate, led by Senator Chafee, and a few in the House, including Bob Franks (R-NJ).

- By having one tax proposal that supports child care as well as stay-at-home parents, it builds support for the initiative from two different constituencies.

- Some research suggests that infants benefit from having a stay-at home parent; thus, the disincentive to work may be desirable in this case.

Cons

- The income tax code and Social Security heavily favor families with stay-at-home parents.

- It is a paradox to be arguing for tax relief for stay-at-home parents and marriage penalty relief. Most stay-at-home parents receive marriage bonuses; proposals to aid one-earner couples will increase those bonuses.

- The CDCTC is one of the few major work incentives in the tax code for second earners with children. Providing the credit for one-earner couples partially negates that incentive.

Education and Training

Tax Credits for Work-Site Schools

A 25 percent tax credit would be provided to employers who enter into a cooperative agreement with local public schools to provide space, utilities and maintenance for satellite elementary schools located on their work site. The base for the annual credit would include the cost of tangible personal property or real property donated to the school plus the fair market rental value of real property dedicated for school use. Teacher salaries are ineligible for the credit. The credit would be limited to $150,000 per year, per facility. Credits could be claimed for up to 10 years. To be eligible for the credit, the taxpayer must enter into an agreement with a local public school agency that is approved by the Department of Education. The Department may approve no more than X agreements per year. (No estimate available.)

Treasury is concerned that this provision subsidizes quasi-private education by providing a tax credit to private employers who contract with public schools for their employees. This is inconsistent with the Administration's strong opposition to the Coverdell bill, which would have directly subsidized private education.

Pros

- Work-site schools can benefit employers by reducing turnover and absenteeism, and school districts, because work-site schools are an inexpensive way to relieve overcrowding.

- About 30 work-site schools have been established over the past 10 years.

Cons

- Tax credits will not provide an incentive for government and non-profit employers, nor for small firms or those without tax liabilities. Several of the existing work-site schools were established by tax-exempt employers.

- It is not clear that a credit would stimulate the creation of many additional work-site schools, since other factors appear to dominate the decision to establish such schools for both employers and school districts.

- If work-site schools convey extra benefits to employers, they, not the federal government, should share the costs with the local school district.

Tax Credit for Workplace Literacy Programs

An alarming number of adults in the U.S. -- 44 million according to the National Adult Literacy Survey -- struggle with a job application or cannot read to their children. Many have a learning disability and never knew it. Others are immigrants who face long waiting lists in many cities where they seek English-as-a-Second Language (ESL) courses.

Under the proposal, employers who provide certain workplace literacy, ESL, and basic education programs for their employees would be allowed a 10 percent income tax credit against expenses, with a maximum credit of $525 per participating employee. Eligible education would generally be limited to instruction at or below the level of a high school degree given to employees with less than a high school diploma or its equivalent, and to ESL for employees with limited English proficiency. Eligible expenses would include payments to third parties and payments made directly to cover instructional costs, including salaries of instructors, curriculum development, textbooks, etc. Unless the employer works with an eligible provider under the Adult Education Act, the curriculum must be approved by a state or local adult education authority. The education must be provided under a section 127 educational assistance plan. The employer could claim a credit for employees with high school degrees but with low functional education if the employer works with a provider under the

Adult Education Act to test the employees and provide the instructional program. The approximate cost is **less than $0.2 billion** over five years.

Treasury believes that the substantive goals of this proposal could be much more effectively met through a grant program.

Pros

- Two common problems with adult basic education programs are attrition and lack of relevancy. The three primary reasons for attrition are: 1) lack of child care, 2) lack of transportation to classes, and 3) difficulty making classes fit with job responsibilities. This proposal avoids these problems because employees would not need to find additional child care, transportation, and time outside of that required for work. In addition, because these courses are tailored to each employer, adults are better able to understand the relevancy of the basic skills concepts as they apply them to their current work situation.

- A tax credit available to all non-profit private-sector employers, because of its potentially wide availability, would mesh well with the President's commitment to reduce illiteracy. A grant program would reach far fewer employers.

Cons

- Approximately two-thirds of employers (30-40% employees) do not pay taxes and therefore could not benefit from a tax credit. Nearly 60% of C corporations that employ workers either pay no taxes or are limited in their use of tax credits. Governments and nonprofit entities such as universities, nonprofit hospitals, etc. would not benefit from a tax credit.

- Much of the benefits of the credit would simply be windfalls for employers who are already providing literacy education.

- It is unclear whether this credit would significantly affect employers' willingness to establish literacy programs.

- The credit will impose significant administrative burdens on both the IRS and on participating employers in order to limit their ability to recharacterize job-specific training that would not qualify for the credit as basic education that would qualify. Also, to prevent abuse, employers who want to serve workers with a high school degree but poor education would be forced to use outside providers and testers, which might not be the most efficient arrangements.

- The cost of subsidizing employers is less controllable with tax credits, which are essentially entitlements, than with grants.

Liberalize the Lifetime Learning Credit

The proposal presents two options to enhance the Lifetime Learning Credit. The primary advantage is that this builds upon an existing provision without creating significantly more complexity. The primary drawback is the cost.

Option 1

Accelerate from 2003 to 2000 the increase in the base of the lifetime learning credit from $5,000 to $10,000. The approximate cost is **$2.8 billion** over five years.

Pros

- Consistent with the President's original proposal.
- The incentive effect of the higher limit would come into play sooner.

Option 2

Increase the expense limit starting in 2000 as in Option 1.

Increase the expense limit starting in 2000 as in Option 1.

Increase the lifetime learning credit rate from 20 percent to 30 percent of the first $5,000 and reduce it to 10 percent on the second $5,000 of qualified expenses. The maximum credit per taxpayer would remain equal to $2,000. The rough cost is **$7.1 billion** over 5 years.

Pros

- This option provides a proportionately larger incentive for lifetime learning for those taking a single course or attending a less expensive institution.
- This targeting diminishes the incentive for students to attend more expensive educational institutions, and makes it less likely that the credit will simply be captured as higher tuition.

Con

- Benefits only those with sufficient tax liabilities to use additional credits.

Lifetime learning savings accounts

Two proposals are being considered. The first would make Education Individual Retirement Accounts available to everyone (adults as well as children) by removing the current-law age 30 distribution requirement and the age 18 contribution limit. The second would add education expenses to the list of distributions from a Roth IRA that can be taken tax free. Unlike other distributions on the list, however, tax-free withdrawals for education expenses could be taken at any time, without being subject to a five-year holding period. (No estimate available.)

Treasury has serious concerns regarding these proposals because they are unlikely to stimulate education among those most in need, but provide windfalls to the rich for saving they would have done anyway.

Pros

- Well-educated workers are essential to an economy experiencing technological change and facing global competition. The proposals are intended to encourage the retraining of the workforce to reflect changing needs and new technologies.

- Either proposal may make it easier for adults to finance their own education.

Cons

- The proposal will be very ineffective at increasing educational opportunities for families whose adult members have little or no post-secondary education. These families are much more likely to have low incomes. Low-income families do not have the financial resources to make significant contributions to an account for adult education and often do not have tax liability. Other tax-favored savings vehicles already compete for their limited savings, including deductible IRAs, Roth IRAs, 401(k) plans and Medical Savings Accounts.

- The proposal would primarily benefit people with high incomes, providing a windfall for saving they are already likely doing. It is unlikely to increase their saving.

- Current law already contains many subsidies for adult education which are better targeted to aid low- and middle-income families. These provisions include: the Lifetime Learning tax credit, the exclusion for employer-provided educational assistance, guaranteed student loans, subsidized loans, and student loan interest deductions.

Exclude Americorp Education Awards from Taxable Income

Americorp members are eligible for post-service educational awards of up to $9,450. The awards can be used either to pay higher education expenses or to repay student loans. Americorp also pays the interest on existing student loans while the borrower is a member of Americorp. The educational awards and interest payments are treated as taxable income. The proposal would exclude from taxable income Americorp educational awards. (Estimate not available, but this might actually raise a very small amount.)

Treasury believes that this proposal will benefit few recipients of Americorp education assistance and could make many worse off.

Pros

- Americorp officials strongly support the proposal because recent Americorp alumni have complained that they have been subject to unexpected tax liabilities at a time when they have no cash to pay.

- Similar tax subsidies exist under the GI Bill (with respect to educational expenses) and Peace Corp (with respect to loan repayments and interest forbearance).

Cons

- Many recipients will pay more in taxes if education grants are tax-free, since the grants can reduce educational expenses eligible for the Hope or Lifetime Learning credits. For taxpayers in the 15-percent tax bracket, the tax credits are more generous.

- Excluding amounts used for living expenses would run counter to the tax treatment of scholarships generally.

- Excluding only amounts used for loan repayments would give better tax treatment than GIs who cannot exclude recruitment bonuses in the form of loan repayments nor can they use GI Bill benefits (which are excluded from income) to repay student loans.

Eliminate 60-month limit on deductibility of student loan interest

Under current law, student loan interest is deductible, "above-the-line," only during the first 60 months in which interest payments are required. The proposal would eliminate the 60-month limit. Rough five-year estimate: **less than $0.3 billion.**

Pros

- Simplifies calculation of deductible interest payments for students with more than one student loan, as loans may have entered repayment status on different dates.

- 60-month limit is difficult to administer and requires special rules to deal with common situations, such as periods of deferment or hardship forbearance, loan refinancings, and loan consolidations.

- If 60-month limitation is eliminated, interest paid on qualified student loans would be deductible, without regard to whether a student makes voluntary early payments or makes delinquent payments, or whether the lender structures the loan so that interest payments are required every other month (which arguably could extend the present-law 60-month period for 10 years).

- Provides longer-term relief to students with large educational debt. Present-law AGI limitations (which apply at the time the interest payments are made) ensure that relief is targeted to low and middle-income taxpayers.

Con

- Student loan interest constitutes personal interest, which generally is non-deductible. Therefore, it may be inappropriate to provide an above-the-line deduction for an unlimited period of time.

Urban - Empowerment

Green bonds

Under current law, state and local governments may issue tax-exempt bonds without limit to pay for the costs of public environmental remediation projects. In addition, tax-exempt bond money may be lent to private entities to finance facilities for sewage, solid waste, hazardous materials, environmental enhancement of hydro-power facilities, and urban redevelopment, but those bonds are limited by the private activity bond cap. The proposal would create a new financing mechanism--green bonds--to raise funds to finance environment-related public projects. Like qualified zone academy bonds (QZABs), this program would allow state and local governments to issue zero-interest bonds to lenders who could claim a tax credit for the life of the bond in lieu of interest. Green bond authority for each state is capped. The issuer makes no principal or interest payments on the bond until maturity (13 years under the QZAB program). Other options are also being considered: including a credit similar to the low-income housing tax credit model; a new category of private activity tax-exempt bond; and a state-managed revolving fund financed by federal grants used to subsidize interest payments on tax-exempt bonds issued by localities. (Estimate will depend on the caps.)

Pros

- A tax credit bond provides a much larger subsidy to State or Local government issuers than tax-exempt bonds.

- Tax credit bonds may be more efficient than tax-exempt bonds because they do not provide windfall gains to high-bracket taxpayers.

- Limiting the amount that can be issued limits the Federal revenue loss.

Cons

- The tax credit bond is extremely complex and largely untested. It may meet market resistance. Complex rules will be necessary to deter abuse. Many rules are similar to those that apply to tax-exempt bonds, but each element needs to be reexamined to see how it applies to the new bonds. Bond purchasers may thus heavily discount the new bonds, especially in the short run.

- Purchasers will discount bonds further because of uncertainty about future tax liability (and thus the value of the tax credits).

- It is unclear that state and local governments are making inadequate investment in environmental remediation.

- The tax credit bond is essentially a grant disguised as a tax incentive. There is no economic rationale for providing grants this way.

Home ownership tax credit

This proposal aims to encourage home ownership among low-income people. State housing finance agencies would induce investors to purchase low-interest second mortgages by auctioning tax credit authority (paid over ten years) to subsidize the mortgage payments. The unsecured second mortgages of up to 20 percent of purchase price would allow purchasers to qualify for first mortgages with lower incomes and down payments and avoid PMI payments. This program would be targeted at families in underserved areas. It would save a family buying a $75,000 home $750 in up-front costs and $140 per month, primarily in lower mortgage insurance costs. Credit authority is capped; the program is designed to cost about **$0.5 billion** over five years. (Treasury does not have enough information to do a revenue estimate.)

Treasury is concerned that this proposal is extremely complex and encourages home ownership among those least likely to be able to afford it on a sustainable basis. By competing for resources with the low-income housing credit, it might divert tax subsidies from a more effective alternative.

Pros

- This proposal would increase home ownership rates among lower-income families, who have a lower home ownership rate than higher-income families (50 percent vs. 80 percent). Some evidence suggests that home ownership has positive externalities: for example, compared to renters, home owners are more likely to vote in elections, more likely to invest in their communities (e.g., maintain and improve the appearance of their residence); and more likely to get involved in organizations (e.g., PTA).

- This proposal could make the tax system more equitable because lower-income home owners receive smaller benefits from the mortgage interest deduction: first, they are less likely to itemize; second, if they do itemize, they will receive the deduction at a 15-percent rate compared to rates up to 39.6 for the highest income families.

- Whereas evidence from a recent Federal Reserve working paper suggests that current provisions in the tax code help exacerbate urban sprawl, this proposal -- by targeting underserved areas -- would help to revitalize distressed inner-city communities.

- Unlike the mortgage interest deduction which helps lower the cost of monthly payments, this proposal helps lower up-front costs, which the evidence suggests is the greatest impediment to home ownership.

- It will help lower-income families build assets.

Cons

- This program is targeted at people who the private mortgage market has deemed to be un-credit-worthy. Early information suggests that delinquency rates for low down payment mortgages are twice those of conventional mortgages.

- Lowering the down payment requirement is likely to reduce saving among low-income people who would like to be home owners.

- We may not want to encourage poor people, especially those who cannot save, to purchase their homes. In an economic downturn, these home owners may be more vulnerable and more likely to lose their homes.

- It is not clear that home ownership *causes* the salutary effects attributed to home owners.

- This credit is likely to compete for funding with the low-income housing credit, arguably a more efficient mechanism for advancing the housing needs of low-income families.

- The tax credit mechanism itself is likely to be inefficient; the credits are likely to trade at a discount because of the high default risk of the loans, the risk to investors that they may not be able to use the credits, and possible syndication and marketing costs.

- A better approach is to guarantee access to credit and reduce the cost of PMI, as is done currently through the FHA loan program.

- Assistance with down payments and closing costs to lower-income families could be provided more effectively under a grant program.

Tax Credit For Equity Investments in Community Development Financial Institutions

The Community Development Banking and Financial Institutions Act of 1994 created the Community Development Financial Institutions (CDFI) Fund, now housed within the Department of Treasury, to provide equity investments, grants, loans, and technical assistance to qualifying organizations for community development. The CDFI Fund was appropriated $95 million in FY 1999. The proposal would provide $100 million in nonrefundable tax credits to the CDFI Fund to allocate among equity investors in qualified CDFIs between 2000 and 2009. The allocation of credits would be determined by the CDFI Fund using a competitive process similar to the one used for grants, loans, and equity investments. The maximum amount of credit allocable to a particular investment would be 25 percent of the amount invested, though the CDFI Fund could negotiate a lower percentage. Certain special basis and recapture rules would apply and certain design issues remain. Cost: **less than $0.1 billion** over five years.

Pros

- The effectively capped credit ensures that limited resources are targeted to assist those areas most in need.
- Since grants by taxable entities to some tax-exempt CDFIs are already deductible, the tax credit essentially gives similar tax treatment to equity investments in for-profit CDFIs.

Cons

- This proposal does not assist non-profit CDFIs or those that do not issue stock, such as mutual organizations. This could result in the CDFI Fund shifting Federal grants and loans to the non-profit CDFIs. Also, the proposed credit might raise concerns that the CDFIs will receive lower appropriations.
- The CDFI Fund was under attack last year by some in Congress (although the Fund did receive an increased appropriation this fiscal year and its reauthorization was reported favorably out of Subcommittee).
- Since CDFIs are already directly subsidized by grants, it would be straightforward and much more efficient to simply increase the appropriation.

Increase the private activity bond cap

Under current law the volume cap for each state is the greater of $50 per capita or $150 million. The current cap allows about $15 billion of private activity bonds to be issued annually, about $5 billion which are new mortgage revenue bonds. The cap will increased by 50 percent between 2003 and 2007, when it will be the greater of $75 per capita or $225 million. The proposal would make the increase in the cap effective in 2000. The proposal would cost about **$0.5 billion** over 5 years.

Pros

- There is widespread Congressional support for further increasing the volume cap.
- State and local housing agencies strongly support this proposal, hoping to secure larger allocations of issuance authority.
- Increasing the cap might make more bond-financed low-income housing credit projects possible.

Cons

- Tax-exempt bonds are inherently inefficient because the federal revenue loss exceeds the interest savings to the issuer.
- Increasing the volume of private activity bonds puts upward pressure on interest rates, exacerbating the inefficiency, and raising the cost of school bonds and other more worthy public activities.
- Increasing the volume cap reduces the incentive for State and local governments to choose the best projects among competing applicants and to allocate no more volume cap to any one project than necessary.
- Additional mortgage revenue bonds are not needed because market rates are quite low by historical standards, and most bond-generated mortgage funds aid those who would be eligible for mortgages without the subsidy.

WTW/WOTC longer extensions

The work opportunity tax credit (WOTC) and the welfare to work (WTW) tax credit encourage employers to hire members of certain economically disadvantaged targeted groups. The WOTC is limited to wages paid during the first year of employment. Targeted groups include family assistance recipients for any 9 months during an 18 month period, certain economically disadvantaged groups, and vocational rehabilitation referrals. The maximum credit is $2,400. The WTW credit is limited to wages paid during the first two years of employment, and targets long-term welfare recipients and individuals who are no longer eligible for welfare because of federal or state time limits. The maximum credit for the first year is $3,500 and for the second year is $5,000. Both credits will expire on June 30, 1999. The proposal would make the WOTC and WTW credit permanent. Alternatively, the length of extension would be tailored to available revenue offsets. (Last year's budget contained short-term extensions of both credits.) The revenue loss estimates for one-year extensions of the WOTC and WTW credit are **$0.4 billion and $0.1 billion**, respectively.

Pro

- A permanent WOTC and WTW would encourage employers to hire certain economically disadvantaged targeted groups without the uncertainty created by temporary credits.

Con

- Permanent extensions of the WOTC and WTW are premature. The WOTC replaced the prior targeted jobs tax credit which was the subject of some criticism regarding its effectiveness as an employment incentive. The Congress specifically intended the credit to be short-term to provide an opportunity to assess the operation and effectiveness of the new credit. For similar reasons, the WTW credit was enacted as a temporary credit.

Modify Research and Experimentation Tax Credit

Background

The current research credit is 20 percent of qualified research expenses above a base amount. The base amount generally is the product of the taxpayer's "fixed-base percentage" and the average of the taxpayer's gross receipts for the four preceding years. Taxpayers can also elect into an alternative credit that has lower credit rates and lower statutory fixed-base percentages.

Qualified research expenses generally include expenses for wages and supplies used to conduct technological research activities within the United States. Contract research payments also are eligible for the credit, but the amount of payment eligible for the credit is limited to 65 percent of the amount paid by the taxpayer (75 percent in the case of research consortia). In addition, a 20 percent credit is provided for increases in amounts paid by the taxpayer to educational institutions and certain other organizations for basic research over a minimum basic research amount (the "basic research credit"). The research credit expires on June 30, 1999.

There are two options. (Estimates are not available.)

<u>Provide a refundable tax credit for small businesses.</u>
(We are also exploring other proposals to provide relief to small businesses that conduct research.)

Pro

- Many small businesses do not have tax liability against which to claim the research credit and receive no tax benefit in the current year for undertaking research. A refundable credit would provide a current tax benefit for small firms whether they have a tax liability or not.

Cons

- Firms with no tax liability (or sales) could claim that they undertook research to obtain a refundable credit, and it would be extremely difficult for the IRS to police whether qualified research had actually been undertaken.

  - Canada enforces its refundable credit by examining the validity of every claim for a refund. The Canadian government established a separate administrative unit for this purpose.

- Small businesses that are start-ups already receive favorable treatment, which was expanded in 1996.

- Proposals that would expand the availability of the credit would raise the revenue cost of extending the current credit. For that reason, the NEC considered and rejected proposals to expand the research credit in 1994.

<u>Increase the percentage of qualified research expenses paid to certain research consortia that is eligible for the credit</u>.
(Under a special rule enacted in 1996, 75 percent of those research expenses are eligible for the credit.)

Pro

- The proposal would encourage research on problems of industry-wide concern and would avoid duplication of research by competing firms.

Cons

- Research undertaken through consortia already receives favorable tax treatment. Firms that contract out research generally are allowed to claim a credit for 65 percent of those expenditures, whereas for consortia established by non-profit educational organizations or trade associations the percentage is 75 percent.

- Increasing the percentage of eligible research for consortia to 100 percent would provide a larger tax benefit to research conducted through consortia than research performed in house. A portion of the research expenditures paid to consortia (and contractors) is disallowed to provide a level playing field with research conducted in house. Certain expenditures that are not directly related to research conducted in house are ineligible for the credit, such as certain overhead and profit margins. These expenses should also be disallowed when research is conducted through a consortia.

- There is no evidence that research performed through consortia is more beneficial to society than other research, including research conducted in house. Although the spillover benefits to a specific industry may be large, other research may have greater spillover benefits to society (i.e., medical researeh). Absent information on the societal benefits from different forms of research, the Federal government attempts to "pick the winners" may distort the allocation of research spending in ways that reduce the benefits to society.

- The proposal would largely be a windfall to firms that would undertake certain types of research using consortia anyway. Even absent the credit firms have a financial incentive to undertake research through consortia to solve industry-wide problems -- they avoid the cost of duplication of effort in cases where it would be extremely difficult for an individual firm to capture the profits attributable to the research.

- The proposal benefits a small number of research consortia (and their industry supporters). Many of those organizations have also benefitted from significant direct support from the Federal government.

Other

Allow Personal Credits to be Deducted Against the Alternative Minimum Tax

The proposal would extend the deductibility of personal tax credits against Alternative Minimum Tax (AMT) liability for one year, for tax year 1999. The recent omnibus spending bill provided that personal tax credits could offset AMT liability tax year 1998. A one-year extension would cost about **$0.8 billion**.

Pros

- The proposal preserves the ability of people to take advantage of the new child and education credits, both of which were Administration initiatives.

- Permitting personal tax credits to offset AMT liability better targets the AMT to those making excessive use of tax preferences.

- Permitting personal tax credits to offset AMT liability eliminates complex tax computations for many taxpayers, both those who are actually affected and for millions who must do the computations only to find that their tax liability is not affected.

Con

- Permitting tax credits to offset AMT liability may divert attention from needed long term reform, such as indexing the parameters for inflation.

Employee telecommuter expense

Qualified teleeommuting expenses paid for, or reimbursed by, an employer would be exeludable from the income of an employee. Qualified expenses would include charges for an additional telephone line or advanced telecommunication service up to $60 per month (indexed after the initial year). A rough five-year cost estimate is less than **$0.5 billion**.

Treasury has serious concerns that this proposal would be extremely difficult to administer and would largely produce windfalls for those who are currently telecommuting.

Pros

- This would encourage telecommuting and thus reduce the environmental impact of other types of commuting.

- It encourages employers to make more flexible work schedules available to employees.

- The proposal would give telecommuters an income exclusion equivalent to that provided for many actual commuters.

- Abuse will be very difficult to monitor. Because the benefit can be provided by salary reduction (that is, at no cost to the employer), the employer has little or no stake in limiting the benefit to employees' actual business use.

- The proposal favors telecommuting expenses over home office expenses and the expenses of self-employed persons working out of home with respect to the costs of second phone lines.

- It is unclear that the tax subsidy would be an effective means to encourage telecommuting.

Financial security

A number of proposals were part of a Financial Security package sent to the NEC from Treasury. Most of these proposals involve increased spending, and most of the tax proposals were proposed in last year's budget. The only proposal that represents a new tax incentive calls for eliminating user fees for initial determination letters for small businesses adopting a qualified retirement plan for the first time.

Capital Gains Exclusion For Sales of Land for Conservation

Under current laws, sales of land to non-profit organizations or governments for conservation purposes are subject to tax on any capital gain. Such land donated to non-profit organizations generally qualifies for a charitable deduction and avoids tax on the gain. The proposal would provide a 50 percent exclusion for capital gains for land sold to government agencies or qualified non-profit conservation organizations thereby reducing the maximum capital gains rate from 20 percent to 10 percent. The proposal requires that the land be used to protect fish, wildlife or plant habitat or open space for agriculture, outdoor recreation or scenic beauty. (No estimate is available.)

Treasury is concerned that this proposal would add to the complexity and inequity of the tax code without advancing land conservation.

Pros

- The proposal might advance land conservation goals through voluntary sales by property owners rather than by regulation.

- The proposal might reduce the price of land sold to governments and qualified non-profits.

Cons

- Generous tax provisions already exist to benefit land conservation. Landowners can deduct the value of conservation easements and the discount in bargain sales to charities as charitable deductions. Taxpayers can deduct the full market value of appreciated land thereby saving both the value of the charitable deduction and the capital gains tax.

- The proposal might actually hurt conservation programs by favoring sales over donations of land for conservation, thereby forcing the non-profit groups to raise larger amounts of funds for land purchases and reducing the funds available for direct conservation efforts.

- The proposal may allow taxpayers to double dip. The capital gains exclusion would allow a seller to reduce the price of land by the capital gains tax saving. The taxpayer may then be able to claim a charitable deduction for the bargain sale to the charity.

- The proposal has the potential for significant abuses. For example, land could be sold to a non-profit and then leased back to the seller for continued use in ranching or farming.

- The cost of the proposal may be significantly higher than anticipated if some very large properties are transferred or such sales techniques are marketed more broadly to agricultural landholders. In addition to the initial revenue cost, future income would be removed from the income tax base.

- The proposal would add to the onerous complexity of the capital gains tax.

Farm and Ranch Risk Management (FARRM) Accounts

Up to 20% of farming income could be contributed to a FARRM savings account and deducted from income. The income earned on the account is taxable as earned. The contribution plus any accrued capital gain is taxable upon withdrawal from the account. Contributions and earnings must be withdrawn within 5 years; otherwise the balance in the account would be deemed to have been distributed and subject to income tax and a 10 percent penalty. Balances would be deemed to have been distributed and taxable two years after an account holder stops farming.

The Administration strongly opposed adoption of FARRM accounts and prevented the provision from being enacted in the omnibus appropriations bill. It would provide a windfall to a few rich farmers and do nothing to reduce risk or encourage saving.

Cons

- FARRM accounts are of no value to farmers suffering losses. Three-quarters of farmers in 1996–an exceptionally good year–had no taxable farm income. Most of those few who could have benefitted had substantial non-farm income.

- FARRM Accounts are not IRAs, but tax-preferred short-term savings vehicles intended to ameliorate income volatility among farmers.

  - The tax preference for FARRM Accounts differs from that for IRAs because FARRM accounts do not allow tax-free buildup and amounts must be distributed within five years.

- The proposal is apparently meant to respond to a perception of excessive volatility in farmers' incomes. However, other much more effective and equitable tax provisions are in place to address volatility.

  - Farmers can elect to average their farming income over a three-year period. (Made permanent in 1998.)

  - Farmers are allowed to carry back net operating losses over the five previous years. (Most taxpayer are allowed to carry back NOLs for only two years.) (Enacted in 1998.)

  - Taxes on certain payments, including disaster payments, crop insurance and proceeds from emergency livestock sales can be deferred.

- The provision is most valuable to wealthy farmers who are in high income tax brackets and have available substantial wealth to deposit in an account.

  - By perpetually contributing 20 percent of income into a FARRM account, a farmer could eventually shelter about a year's income from tax indefinitely (5 years' contributions each equal to 20 percent of annual income).

- The provision is unlikely to stimulate saving.

- Because basis and earnings must be tracked separately, the taxation of FARRM accounts would be complex.

Pensions

Enterprise zone wage credit extension

Current law provides a 20 percent credit for the first $15,000 of wages for employees who live and work in empowerment zones (EZs) or who live in DC and work in the DC zone (an EZ-like designation covering parts of the District of Columbia). The credit will expire at the end of 2004 for EZs and 2002 in the DC zone. The proposal, put forward by the Department of Labor (DOL), is aimed at encouraging zone employers to provide pension and health benefits to EZ wage credit-eligible employees by including employer's qualifying pension and health insurance contributions as qualifying wages under the current wage cap. For employees who leave before their pension benefits become vested, thereby forfeiting their pensions, the associated credits would be recaptured. The Departments of Housing and Urban Development and Agriculture would certify that the pension and health benefits offered qualify for the credit (although only DOL has expertise in that area). (No estimate is available.)

Treasury is concerned that this proposal has a very high cost-benefit ratio and would make the EZ wage credit more complex.

Pros

- Some minimum wage workers might get pension and health insurance coverage.

- Minimal changes would be needed to the EZ wage credit to accommodate the extension.

Cons

- This proposal will do little for pension security relative to its cost.

  - Low-income workers are much more likely to leave their jobs within one or two years, resulting in little capacity for accumulating vested pension savings.

    - To recapture the associated credits is likely to require additional complexity.

- Expanding what earnings qualify for the wage credit will make the EZ wage credit more complex and difficult to administer. Given that few employers are likely to use this aspect of the credit, the administrative costs could be large relative to the number of additional employees covered.

Employee benefits tax credit for EITC recipients

EITC recipients could claim additional refundable credits if they purchase health insurance or contribute to pension plans. The maximum pension credit would be equal to the lesser of 50 percent of the employee's contribution or $1,000 (indexed). The maximum health credit would be equal to the lesser of 50 percent of the employee's contribution or 50 percent of the employee cost for standard Blue Cross insurance under FEHBP. The credits would not be phased in with earnings; rather, a taxpayer would be eligible for the maximum credit as soon as the taxpayer contributes to a pension plan or purchases health insurance. The credits would be phased out with the EITC. In addition, the definition of non-taxable earned income would be modified to exclude non-taxable contributions to pension plans and health insurance purchases. (No estimate is available.)

Treasury is concerned that this proposal would raise compliance problems with the EITC and do little to enhance health insurance and pension coverage among low-income families.

Cons

- The proposal is inefficient, because it will subsidize saving that is already occurring and is unlikely to increase saving for retirement.
  - Low income workers are unlikely to have the resources to make significant contributions to pension savings plans. Many will prefer to save for more immediate needs, if they are able to save at all.
  - The proposed credit rate (50 percent) is substantially higher than penalties for early withdrawals of tax preferred retirement savings (10 percent). As a result, taxpayers would be able to receive a subsidy for contributing to a savings plan, even if they immediately withdrew the contribution.
- Most EITC recipients wait until the end of the year to claim the credit on their tax return, even when they have the option of claiming advance payments during the year. Workers may be reluctant to claim the credit in advance for fear of overestimating the amount to which they are entitled. If low income workers are unwilling to claim a credit in advance, they will not receive it when they actually need assistance purchasing health insurance.
- The proposal could increase EITC noncompliance. The IRS cannot currently verify health insurance expenditures. The IRS receives information about 401(k) and IRA contributions, but this information is not matched to tax returns before EITC claims are paid.
- From 1991 to 1993, EITC recipients could receive a supplemental credit if they purchased health insurance for their children. Some taxpayers claimed the credit even though they purchased no health insurance. Others were taken advantage of by sellers who claimed that taxpayers had to buy a health plan to receive the EITC. OBRA 1993 repealed this provision.

Increase Welfare-to-Work Credit and Include Pensions in Wage Base

The welfare-to-work tax credit (WTW) is available to employers who hire certain long-term family assistance recipients. The credit is 35 percent of up to $10,000 of first-year wages paid to the employee, plus 50 percent of up to $10,000 of wages paid during the second year of employment with the employer. The maximum credit is $8,500. Eligible wages include amounts paid or incurred by the employer for health insurance, dependent care assistance and certain training. Under the proposal, pension contributions would be added to wages to determine the credit. The maximum amount of compensation eligible for the credit would increase to $15,000.

Pros

- The proposal would encourage employers to provide pension coverage for newly-employed long-term welfare recipients.

- The proposed increase in the maximum amount of eligible wages would help to ensure that an incentive is provided to cover workers under pension and health plans whose wages are near or at the present $10,000 wage limit absent pension and health benefits.

Cons

- The proposal is unlikely to increase significantly pension coverage for long-term welfare recipients. Most eligible employees will not accumulate vested pension savings because eligible employment tends to be short term.

    - A GAO report on the targeted jobs tax credit (TJTC), an earlier program with a similar targeted group, found that 76 percent of TJTC employees worked for less than one year.

- Complex recapture rules would be necessary to prevent employers from claiming credits for forfeited benefits from short-term employees. Most employers who provide coverage for eligible employees would be subject to the recapture rules because most pension benefits will be forfeited. Thus, the administrative costs are likely to be large relative to the small number of employees that will actually be covered.

- An increase in the maximum amount of eligible wages would increase the cost of the credit without necessarily increasing pension or health coverage. Nevertheless, the alternative of providing a separate credit for pension and health coverage would be even more complex, although not necessarily more effective, for the reasons noted above.