1997-se-005950

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INFORMATION

May 30, 1997

**MEMORANDUM FOR SECRETARY ROBERT E. RUBIN**

**FROM:** **DON LUBICK** DL(P)
**ASSISTANT SECRETARY (TAX POLICY)**

**SUBJECT:** Memos on Tax Issues

The following package contains eight memos addressing different aspects of the tax package. They are: AMT reform, capital gains indexing, the home office deduction, small business capital gains tax preferences, refundability of the Kidsave credit, a comparison of our package and the Ways and Means package (unchanged from yesterday), costs of our proposed package over the second 10-years, and distributional effects of the proposed package. The latter two memos will be coming to you by fax this evening.

We did not want to include the following discussion in a memo that might be distributed to NEC members or others, but we wanted to alter your intuition about the long-run costs of indexing capital gains. The general idea is that if inflation and real returns are constant over a period of years, the effective exclusion rate the arises from indexing declines. For example, with 3 percent inflation and a 5 percent real return (for an 8 percent total return), the basis of an asset compounds at a 3 percent rate while price compounds at an 8 percent rate. With compounding, the exclusion from indexing thus falls and real growth dominates. Hence, as holding periods lengthen, an exclusion is more expensive than indexing.

As you will see from our memo on indexing, the fact that the costs of indexing do not necessarily explode in the out years (relative to an exclusion) does not mean that we think indexing is a good or even acceptable idea.

EXECUTIVE SECRETARIAT

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

Information

May 30, 1997

**MEMORANDUM FOR SECRETARY ROBERT E. RUBIN**

**FROM:** **DON LUBICK**
**ACTING ASSISTANT SECRETARY (TAX POLICY)**

**SUBJECT:** A Small Business Capital Gains Proposal (Section 1202)

The following memo describes our suggested modifications to Section 1202. The proposal is designed to appeal to constituencies interested in expanding the scope of Section 1202, but focus incentives on smaller companies that were the target of the Administration's original 1202 proposals.

- The current law 50 percent exclusion and maximum tax rate of 14 percent would be retained. The tax treatment of small business ~~capital gains would~~ still be more favorable than it is for other capital gains, which would have a maximum rate of approximately 20 percent under a 50 percent capital gains exclusion.

- The limit on eligible gains would be increased from $10 million to $20 million and indexed for inflation. Inflation indexing would begin in ~~1999. The alternative limitation of 10 times basis would be repealed as a simplification~~ measure.

- Excluded capital gains would still be treated as a preference item under the AMT, but a special AMT rate would apply to ensure that capital gains qualifying for 1202 under either the ordinary income tax or the AMT would be taxed at a maximum rate of 14 percent.

- Certain anti-abuse rules that could unnecessarily disqualify certain businesses would be liberalized.

  - The working capital rules could be modified to provide that (i) working capital will be treated as an active trade or business asset if it is reasonably expected to be used within 5 years (up from current 2 years); (ii) funds spent on R&D will be treated as creating an active trade or business asset dollar-for-dollar; and (iii) the time period for taking full advantage of these working capital rules would be extended from 2 years to 5 years. These changes would benefit bio-tech companies and other R&D firms that have long development periods before products can be brought to market.

  - The Treasury regulatory initiative to permit stock redemptions in certain situations would be finalized in 1997 and extended to include divorce as well as death, termination of employment, mental incompetence and de minimis cases. It would be made clear that the phrase making firms ineligible because their principal asset is the skill or reputation of one or more employees was not intended to disqualify software or R&D or similar firms. Administration and compliance with the provision would be improved by requiring firms to file an annual eligibility form along with their corporate tax returns.

- The $50 million limit on asset size would be retained (but would be indexed for inflation).

  - Most startup firms require only a few million dollars of capital and increasing the asset limit to $100 million would draw capital away from these smaller firms that are the intended primary beneficiaries of the provision. The 5-year holding period requirement would be retained as an incentive for patient capital. If a general capital gains exclusion is passed, those who have held shares for less than 5 years would be eligible for the general preference for long-term gains.

    -- Proposals for rollover of gains from an eligible small business into investments in other small businesses should be opposed. Such proposals would create complex eligibility questions and create the potential for taxpayers to never pay any capital gains tax if gains are rolled over for life. agreed

- These provisions are most likely to be of interest to Senators Daschle, Roth, Hatch, Lieberman and Mack, and Representatives Matsui, English, McCrery, Dunn, and Watkins who have introduced bills with targeted capital gains provisions for small business. A number of additional Senators and Representatives are co-sponsors of these bills.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

May 30, 1997

INFORMATION

MEMORANDUM FOR SECRETARY ROBERT E. RUBIN

FROM: DON LUBICK DHKS
ACTING ASSISTANT SECRETARY (TAX POLICY)

SUBJECT: Reforming the Alternative Minimum Tax

In the absence of policy changes, the number of taxpayers that pay taxes because of the AMT (as opposed to the regular income tax) will increase by roughly 25 percent per year: from 0.9 million in 1997 to 2.4 million in 2002 to 8.4 million in 2007. The taxpayers who are thrown onto the AMT will increasingly be taxpayers who are not traditionally viewed as aggressive or abusive of the tax system. The items that will force taxpayers onto the AMT are state and local tax deductions, personal exemptions, and the standard deduction; these are not the tax preferences that the AMT was designed to limit. Forcing many millions of taxpayers to fill out a very complicated tax for a parallel tax system will infuriate most taxpayers and may put in peril the survival of the whole progressive tax system.

45,000

The main components of our proposed reforms are (1) index AMT exemption at 2002 levels, (2) allow personal exemptions and the standard deduction to be deducted under the AMT, and (3) allow personal credits (e.g., child-care credit, and the proposed HOPE and child credit) to offset AMT liability. The cost of the proposal would be limited by delaying the effective date until 2003.

There are two major political problems associated with AMT reform. First, because so many taxpayers will be affected by the AMT in the future, the long-run costs of solving the problem are high and the solution disproportionately benefits high-income taxpayers. The distributional consequences are driven by the fact that the AMT has a $45,000 exemption, which eliminates most low-income taxpayers. Even so, rough preliminary calculations suggest that half the benefit of the proposed AMT reforms in 2007 would accrue to taxpayers with adjusted gross income under $110,000 (in 1997 dollars). Second, because the costs of the AMT increase sharply over the 10-year budget window, tackling the problem makes it more difficult to challenge Congressional Leadership proposals with the criticism that costs explode in the out years.

Strategy

Given the impending AMT problem, there are three policy options.

- **Drop the AMT reform proposal altogether**. OTP opposes this option, because tackling the problem will get increasingly expensive over time, and as more taxpayers get affected by the AMT, support for the income tax is likely to erode. Moreover, by not

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tackling the problem now, there will be irresistible pressure for future tax cuts (to fix the AMT problem), with resulting pressure to reduce spending and/or increase the deficit. Over time, the AMT is likely to generate resentment that will be easily exploited by those wishing to "rip the tax system out by its roots."

- o **Embrace the proposed reform**. To do so will require a willingness to make the (conceptually correct) argument that AMT reform is unlike most of the other tax cut proposals in the balanced-budget package. In contrast to capital gains tax cuts or the exploding costs of backloaded IRAs, the rapidly increasing cost of the AMT arises largely from a rapidly increasing number of taxpayers being subjected to the AMT. In contrast, rapidly increasing costs of capital gains tax cuts come from large benefits being granted to relatively small number of taxpayers. Put differently, most of the cost of AMT reform comes from relieving taxpayers from paying a tax in the future that they do not currently pay and may not even know exists. A second argument is that the AMT, if left unreformed, will reduce the value of the child credit and HOPE credit, so to make these initiatives work correctly, the AMT must be changed.

- o **Adopt a middle (though closer to doing nothing) approach**. If the AMT reform package drops indexing and keeps the personal exemption as an AMT preference item (so it eliminates the standard deduction as a preference, eliminates deadwood provisions, allows personal credits to offset AMT liability, and eliminates ties between the parent's AMT return and the kiddie-tax child's AMT return), the package is inexpensive ($5.3 billion in the second five years) and does not explode. This solution <u>does not</u> solve the future AMT problem, but does buy some simplification.

We would welcome your guidance about which AMT approach we should take in our package.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

Close Hold

May 29, 1997

**MEMORANDUM FOR SECRETARY ROBERT E. RUBIN**

**FROM:** **DON LUBICK** DL (ks)
**ACTING ASSISTANT SECRETARY (TAX POLICY)**

**SUBJECT:** Ways and Means Package

The following table compares the elements of the evolving Administration tax package with the package being considered by the Ways and Means Democrats. Numbers shown in the table are quite speculative for the Congressional package, and somewhat less so for the Administration package. Both will be scored more completely by the end of Friday.

| Administration Proposal | $ (billions), through 2002 | Ways and Means Democrats | $ (billions) through 2002 |
|---|---|---|---|
| **Education** | | | |
| Phased-in HOPE Credit ($1,200 through 2000, $1,500 thereafter), no Pell offset, no B- | Roughly $35 billion, combined cost of deduction and credit | $1,500 HOPE credit, no Pell offset, no B- | Roughly $31 billion, combined cost of deduction and credit |
| Phased-in tuition deduction ($5,000 through 2000, $1,500 thereafter) | | 20 percent credit on the first (fill in the blank) dollars of education expenses | |
| Make 127 Permanent | $3.7 billion | Make 127 permanent | $3.7 billion |
| May include some kind of allocable credit (like the low income housing credit) for K-12 school construction | Roughly $3 billion in credits | A new special subsidized bond would be issued for school construction and expenses | No estimate, but W&M guesses $3b |
| **Middle-class tax relief** | | | |
| Refundable Kidsave credit (for kids under 13) | $72 billion | President's credit for children under 18 | $55 billion |
| May include AMT relief, starting after 2003 | $0 | Treasury's full AMT reform (not delayed to 2003) | $8 billion |

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WASHINGTON, D.C. 20220

INFORMATION

May 30, 1997

**MEMORANDUM FOR SECRETARY RUBIN**

**FROM:** **DON LUBICK**
**ACTING ASSISTANT SECRETARY (TAX POLICY)**

**SUBJECT:** **Refundable Child Tax Credit**

This memo discusses the advantages and disadvantages of making the Kidsave proposal refundable.[1] In the past, Treasury has taken a strong position against the creation of new refundable tax credits to subsidize health insurance or child care expenditures of low-income families. We would not, however, object to making the proposed $500 child credit refundable.

A refundable credit will ensure that low-income families, with young children, would receive some of the benefits of the tax package. With capital gains and estate tax relief, the Congressional tax package will distribute much of its benefits to higher income families. The Administration's tax package, with a refundable tax credit for families with children, could offer a stark contrast to these Congressional plans.

On policy grounds, it makes more sense to modify the Administration's current child credit proposal by making it refundable rather than extending the credit to less needy families with children who are 13 or older. Further, a refundable credit is a simple and efficient mechanism for distributing funds to needy families, who might otherwise not have any contact with another government agency. Many observers believe that the high participation rates in the EITC are largely due to the simple, non-stigmatizing application process. By limiting the refundable credit to families with a certain level of earnings, the proposal would also complement our welfare-to-work initiatives.

Our reasons for objecting to refundable credits for health insurance or child care credits do not necessarily apply to the $500 child credit. We have opposed refundable credits as a way of subsiding certain expenditures for three key reasons. First, the IRS cannot verify

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[1] A refundable tax credit allows a taxpayer to receive the full benefits of a subsidy through the tax system, even if the subsidy exceeds his or her tax liability. The earned income tax credit is an example of a refundable tax credit. Low-income working taxpayers are able to receive the full EITC to which they are entitled, even if they have little or no individual income tax liability. Taxpayers can claim the refundable credit on their tax return filed at the end of the year and receive the value of the credit as either a reduction in their outstanding tax liability or as a refund.

health insurance or child care expenditures prior to payment of the tax credit, and it is difficult to recapture erroneous refunds paid to low-income taxpayers once the payment has been made. Second, the refundable credit generally would not be available to claimants in "real time" when they need the assistance in order to make the purchase. Third, individuals who are currently outside the income tax system would have to file a tax return in order to benefit from the tax credit. Given these concerns, our position has been that it would be more efficient to provide certain types of subsidies through non-tax administrative mechanisms.

A refundable $500 child credit does not raise similar concerns. Through verification of social security numbers, the IRS can now prevent refunds from being paid to taxpayers who claim nonexistent children. (The IRS still cannot verify the relationship of the child to the taxpayer, but should be developing better screens as a result of the EITC compliance efforts.) Second, the goal of the $500 child credit is to increase disposable income of families with children -- not to encourage a specific type of purchase or behavior. Third, we recommend that the refundable child credit be made available only if the taxpayer has earnings above a certain threshold, say $2,000, and thus are likely to be filing a return under current law. Establishing an earnings threshold also reinforces the message that "work pays."

It is likely, however, that a proposal to make the $500 child credit refundable will be attacked, and these attacks may increase the vulnerability of the EITC. Some opponents of the EITC believe that its noncompliance problems are caused by refundability. Our analysis of the EITC compliance data suggests otherwise: the overclaim rate among those with a positive pre-EITC tax liability in 1994 was nearly three times larger than the rate among those who did not have a tax liability. Further, nearly 95 percent of EITC claimants have a reason to file a return other than to claim the credit. Noncompliant EITC claimants do not enter the tax system merely to claim the credit, and it is unlikely that a refundable $500 child credit (with an earnings threshold) will change this.

Proposing refundability of the Kidsave credit may also deflect attention from EITC problems. Doing so would send a strong message that not only does the Administration support the EITC, it is willing to go further to increase the progressivity of other elements of the tax system.

A refundable $500 child credit may also be compared, unfavorably, to various negative income tax (NIT) proposals of the early seventies (including proposals by both Senator McGovern and President Nixon). Our proposal would differ from an NIT in two key respects: first, the credit would be limited to families with children; and second, recipients would be limited to workers with earnings above a certain threshold. In contrast, NITs extend assistance to all low-income individuals.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

May 30, 1997

**MEMORANDUM FOR SECRETARY ROBERT E. RUBIN**

**FROM:** **DON LUBICK** DL/JT
**ACTING ASSISTANT SECRETARY (TAX POLICY)**

**SUBJECT:** Capital Gains Indexing

The Office of Tax Policy is opposed to indexing capital gains as part of the tax bill. Doing so, particularly in combination with a capital gains exclusion, would bestow inappropriately large benefits on high-income taxpayers, cause the return of tax shelters and significantly increase the complexity of the tax system. For similar reasons, the New York State Bar Association has "strongly opposed" indexing both in testimony and several reports submitted to Congress. For example, they stated in a 1995 report sent to Mr. Archer that:

> The indexation proposals currently before Congress are fundamentally flawed. The proposals would: permit unwarranted tax avoidance and revenue loss; potentially result in the mass marketing of tax shelters to well advised and high income taxpayers, as in the 1980's; and vastly increase the burden and complexity of the tax system for all taxpayers, as well as the IRS, at a time when many believe that its complexity has already brought it near the breaking point. Moreover, even if a theoretically sound system of indexation could be developed, the additional complexities that would be necessary to do so would completely overwhelm taxpayers and the IRS.

**Principal problems with indexing**

**Double benefit.** One of the principal arguments for a capital gains exclusion is that part of the gain represents the effects of inflation and does not constitute real income. Thus, including both indexing and a capital gains exclusion (or separate rate schedule) in a package would overcompensate for the effects of inflation.

**Out year costs.** Treasury estimates that the indexing provisions in S.2 (indexing on top of a 50 percent exclusion) would add **$40 billion** to the $53 billion ten-year cost of a 50 percent capital gains exclusion. Thus indexing on top of an exclusion, is very costly. compounds

**Complexity.** Any indexing proposal, whether in conjunction with an exclusion or by itself, will introduce significant new complexity into the law. Under current law a taxpayer can generally compute the gain from the sale of an asset simply by comparing the amount received from the sale to the cost of the asset. The date an asset was purchased is relevant only in determining whether any gain is long term or short term--if the asset has been held for more than one year the gain is long term

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and the acquisition date of the asset (and any related improvements) is entirely irrelevant. Under an indexation system, a taxpayer would need to know the date on which an asset was acquired and the date on which any significant improvements were made to the asset. This adds significant complexity to many common situations, as noted by the New York State Bar Association in its testimony before the Finance Committee in 1995: "Activities that are relatively simple today will involve massive calculations under indexing -- buying and improving a home, buying and selling stock, or buying an interest in a mutual fund. You could not invest in a simple dividend reinvestment plan without an accountant." The problems are considerably greater in the case of pass-through investment vehicles (including partnerships, S corporations, real estate investment trusts, and mutual funds). Finally, only certain types of assets typically qualify for indexing, thereby placing additional pressure on distinguishing similar types of assets. For example, debt instruments typically are not indexed, making the distinction between debt or equity more important.

The indexation proposals in recent Republican bills address these concerns with a series of uneasy compromises at best. These compromises are likely to lead to uneconomic transaction motivated solely by the desire to benefit from indexation in inappropriate ways. Capital gains are indexed in the U.K. tax system, but the system allows roughly $20,000 of realized capital gains (per married couple) to be exempt from taxation, so the complexity of indexation is ~~avoided by~~ exempting capital gains from taxation for most taxpayers.

**Arbitrage.** Any form of preferential treatment for capital gains creates the potential for arbitrage and distorts investment incentives in favor of assets qualifying for the preference. Whether the indexation of basis results in greater incentives for arbitrage than a capital gains exclusion depends upon the size of inflationary long-term gains relative to nominal long-term gains. For example, if inflationary gains are more than half of nominal gains, indexing generally creates greater arbitrage potential than a 50 percent exclusion. The Joint Tax Committee staff recently published a table showing that, for assets held for several years and sold in 1994, the inflationary component was generally above 40 percent of nominal gains.

The easiest forms of arbitrage involve borrowing to invest in the tax-favored assets. In the absence of special provisions, the interest expense associated with the borrowing is fully-deductible at ordinary rates while the income on the tax-favored asset is taxed at lower rates. As a result, taxpayers can make money on an after-tax basis from investments that lose money on a pre-tax basis.

> Example: Under current law the highest rate of tax on ordinary income is 39.6 percent. The highest rate of tax on capital gains is 28 percent. A taxpayer borrowing $10,000 at 10 percent to invest in a capital asset that earns a return of 9 percent would lose $100 on a pre-tax basis. On an after tax basis, in the absence of anti-arbitrage rules, the same taxpayer would be $44 ahead (the $1,000 interest deduction would reduce tax liabilities by $396 while the 900 capital gain would produce tax liabilities of $252; the net $144 tax savings would more than offset the $100 pre-tax loss). Note: Lenders are often tax-exempt, so that interest income is not taxed.

The Internal Revenue Code already contains a number of complex provisions intended to prevent (or at least deter) such arbitrage transactions. None of the provisions work perfectly. As discrepancies between the treatment of ordinary income and capital gains are increased, the incentive to engage in arbitrage increases correspondingly, with the result that more pressures are placed on the existing rules and new rules need to be considered.

**Price index.** Typically, CPI is used in the Tax Code to adjust for inflation. Given the recent controversy surrounding CPI's accuracy as a measure of inflation, we would need carefully to consider whether its use would be proper for capital gains indexing.

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

May 30, 1997

MEMORANDUM FOR SECRETARY ROBERT E. RUBIN

FROM: DON LUBICK DL | JT
ACTING ASSISTANT SECRETARY (TAX POLICY)

SUBJECT: Home Office Deduction

## Summary

Taxpayers currently are precluded from taking a home office deduction if they use a home office to perform the administrative and management activities of their business, but perform their business services at another business location. Several proposals have recently been made to allow a home office deduction in these situations. We are supportive of the general approach taken in these proposals, but believe that certain technical modifications are necessary (1) to ensure that de minimis management activities would not qualify the taxpayer for the home office deduction, and (2) to prevent the proposals from affecting the deductibility of commuting expenses.

## Current law

Under current law, a home office deduction is generally allowed with respect to the use of a taxpayer's residence only in limited circumstances, including where a portion of the home is exclusively used on a regular basis as the taxpayer's "principal place of business." In Commissioner v. Soliman, the Supreme Court disallowed a home office deduction to an anesthesiologist who practiced at several hospitals, but performed his administrative activities in a home office because he was not provided office space by the hospitals. The Court held that the home office was not his principal place of business, because his primary services were performed at the hospitals.

## Congressional proposals

In response to the Soliman case, several congressional proposals would allow a home office deduction to taxpayers who manage their business affairs from their home. For example, Senator Bond's "Home-Based Business Fairness Act of 1997" would treat a home office as a "principal place of business" if (i) the office is exclusively used by the taxpayer to conduct "essential" administrative or management activities on a "regular and systematic" basis, and (ii) the taxpayer has no other location to conduct these essential administrative or management activities. Thus, under the bill, a home office deduction would be allowed under circumstances where the taxpayer's home is not in fact the taxpayer's principal place of business.

Under the bill, employees would only be entitled to a home office deduction if the use of the home office is "for the convenience of his employer." Moreover, any deduction by the employee would be subject to the 2% floor on miscellaneous itemized deductions and would not be deductible for AMT purposes.

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While we generally agree with the approach of the bill, certain considerations must be addressed. In particular, the current rules were enacted by Congress in 1976 to reduce the substantial amount of litigation over the circumstances under which a taxpayer who worked in his or her home could deduct as a business expense a portion of the costs associated with maintaining the home. It is important that we make every effort to avoid turning back the clock and creating a level of ambiguity that would result in more disputes between taxpayers and the IRS. To address this concern, we believe that the services being performed in the home office must be both "substantial and essential". This would avoid allowing a home office deduction where only a de minimis amount of administrative or management activities are conducted. Also, we agree with the bill's treatment of employees. Further expansion of the home office deduction for part-time employees and telecommuters would be very expensive and difficult to administer.

We are also concerned that the bill would affect more than home office deductions. By changing what qualifies as a "principal place of business", it would also permit deductions for currently nondeductible commuting expenses. We believe the effects of the proposal should be limited to home office expenses.

**Revised proposal**

We would add a section 280A(c)(1)(D) to allow a home office deduction in cases where (i) the office is exclusively used by the taxpayer to conduct "substantial" and "essential" administrative or management activities on a "regular and systematic" basis, and (ii) the taxpayer has no other location to conduct these essential administrative or management activities. Thus, we would not amend the definition of principal place of business, thereby avoiding any effect on commuting expenses.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

Very close hold

May 30, 1997

**MEMORANDUM FOR SECRETARY ROBERT E. RUBIN**

**FROM:** **DON LUBICK** DL/FS
**ACTING ASSISTANT SECRETARY (TAX POLICY)**

**SUBJECT:** Distributional Effects of a Potential Tax Package

Attached you will find six tables showing distributional effects of different Administration and Congressional tax packages.

- o The first two tables show very preliminary estimates of the distributional effects of a proposed tax package. The package is from Thursday, and includes the complete, costly AMT package and a Kidsave credit for children under 13 for the entire budget period (our packages now expands the Kidsave credit to children under 18 beginning in 2003).

  - The revised package will have a somewhat more progressive distribution since the expansion of the Kidsave credit to families with older children will add roughly $8 billion in 2007 (we distribute the fully phased-in policies) to the bottom and middle quintiles of the income distribution, and, if we adopt the scaled back version of the AMT reform, we will take away nearly $10 billion of tax cuts that are distributed toward the top of the income distribution.

- o The next two tables show the distributional effects of the President's budget proposals. The President's budget proposals targeted 80 percent of the tax relief to families in the middle three quintiles of the income distribution.

- o The last two tables show <u>very preliminary and rough</u> calculations of the distributional effects of S.2. We would be grateful if these tables were not distributed, since the analysis does not meet the typical Treasury quality standard. It is provided here to give you an idea of what the distributional effects of a Congressional Leadership package might look like.

  - We will, of course, quickly do a complete analysis of Chairman Archer's tax bill when it is released to have a comparison of the Republican tax bill and ours.

- o The upshot is the current package targets more relief than either the Budget or S.2 to the bottom two income quintiles, presumably because of the refundable Kidsave credit. It provides less of its total tax relief to families in the third and fourth quintiles of the income distribution than the President's budget, but more than S.2. It provides a greater share of tax relief to the top quintile than the Budget proposals, but less than S.2.

Very Preliminary

# Baseline Tax Package as of May 30, 1997 (1)

(1998 Income Levels)

| Family Economic Income Quintile (2) | Number of Families (millions) | Average Tax Change ($) | Total Tax Change: Amount (3) ($M) | Total Tax Change: Percent Distribution (%) | Tax Change as a Percent of: Current Federal Taxes (4) (%) | Tax Change as a Percent of: Family Economic Income (%) |
|---|---|---|---|---|---|---|
| Lowest (5) | 21.6 | -82 | -1768 | 4.6 | -14.07 | -0.86 |
| Second | 22.2 | 244 | 5435 | 14.3 | -8.62 | -1.00 |
| Third | 22.3 | -296 | -6592 | 17.3 | -4.18 | -0.69 |
| Fourth | 22.3 | -397 | 8841 | 23.2 | -2.86 | -0.55 |
| Highest | 22.3 | -684 | -15228 | 40.0 | -1.67 | -0.37 |
| Total (5) | 111.3 | -342 | -38040 | 100.0 | -2.62 | -0.51 |
| Top 10% | 11.1 | -999 | -11125 | 29.2 | -1.68 | -0.38 |
| Top 5% | 5.6 | -1559 | -8689 | 22.8 | -1.78 | -0.41 |
| Top 1% | 1.1 | -3719 | -4173 | 11.0 | -1.61 | -0.40 |

Department of the Treasury
Office of Tax Analysis

May 30, 1997

(1) This table distributes the estimated change in tax burdens due to the tax proposals in the following illustrative baseline tax package: i) Hope Scholarship credit ($1000 through 1999, $1,500 in 2000, indexed beginning in 2001; no B minus rule; and no Federal grant offset) and tuition tax deduction ($5,000 in 1998 and 1999, $10,000 thereafter); ii) Permanent extension of Section 127; iii) Kidsave credit: a $500 refundable child credit ($2,000 earnings test) for children under 13 with an optional maximum $500 back-loaded IRA for education or retirement; iv) individual AMT reform (includes elimination of personal exemption, personal credits, and standard deduction preferences); v) 40% capital gains exclusion and 24% AMT; vi) small business capital gains preferences; v) $500,000 exclusion of gains on the sale of principal residence (President's FY1998 Budget proposal); vi) distressed areas initiatives and other tax incentives in the President's FY1998 Budget (equitable tolling, Section 936, and FSC software); and vii) as revenue offsets: the excise taxes and some of the corporate raisers in the President's Budget.

(2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and underreported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent that reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.

(3) The change in Federal taxes is estimated at 1998 income levels but assuming fully phased in (2007) law and behavior. For the Kidsave proposal, the change is measured as the present value of the tax savings from one year's contributions. The effect of the capital gains proposal is based on the level of capital gains realizations under current law.

(4) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Federal taxes are estimated at 1998 income levels but assuming 2007 law and, therefore, exclude provisions that expire prior to the end of the Budget period and are adjusted for the effects of unindexed parameters.

(5) Families with negative incomes are excluded from the lowest quintile but included in the total line.

NOTE: Quintiles begin at FEI of: Second $16,950, Third $32,563, Fourth $54,758; Highest $93,222, Top 10% $127,373; Top 5% $170,103; Top 1% $408,551.

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## Baseline Tax Package as of May 30, 1997 (1)

AMT
chld 5%

(1998 Income Levels)

| Family Economic Income Class (2) (000) | Number of Families (millions) | Average Tax Change ($) | Total Tax Change: Amount (3) ($M) | Total Tax Change: Percent Distribution (%) | Tax Change as a Percent of: Current Federal Taxes (4) (%) | Tax Change as a Percent of: Family Economic Income (%) |
|---|---|---|---|---|---|---|
| 0 - 15 | 18.5 | -65 | -1208 | 3.2 | -12.95 | -0.77 |
| 15 30 | 21.8 | -233 | -5084 | 13.4 | -10.13 | -1.05 |
| 30 - 40 | 12.1 | -270 | -3260 | 8.5 | -5.23 | -0.78 |
| 40 - 50 | 9.7 | -299 | -2902 | 7.6 | 3.97 | -0.67 |
| 50 - 60 | 7.9 | -357 | -2814 | 7.4 | -3.58 | -0.65 |
| 60 - 75 | 9.4 | -403 | -3799 | 10.0 | -3.17 | -0.60 |
| 75 - 100 | 11.7 | -395 | -4618 | 12.1 | 2.30 | -0.46 |
| 100 - 200 | 15.6 | -422 | -6575 | 17.3 | -1.52 | -0.32 |
| 200 & over | 3.9 | -1945 | -7613 | 20.0 | -1.80 | -0.42 |
| Total (5) | 111.3 | -342 | -38040 | 100.0 | -2.62 | -0.51 |

Department of the Treasury
Office of Tax Analysis

May 30, 1997

(1) This table distributes the estimated change in tax burdens due to the tax proposals in the following illustrative baseline tax package: i) Hope Scholarship credit ($1000 through 1999, $1,500 in 2000, indexed beginning in 2001; no B minus rule; and no Federal grant offset) and tuition tax deduction ($5,000 in 1998 and 1999, $10,000 thereafter); ii) Permanent extension of Section 127; iii) Kidsave credit: a $500 refundable child credit ($2,000 earnings test) for children under 13 with an optional maximum $500 back-loaded IRA for education or retirement; iv) individual AMT reform (includes elimination of personal exemption, personal credits, and standard deduction preferences); v) 40% capital gains exclusion and 24% AMT; vi) small business capital gains preferences, v) $500,000 exclusion of gains on the sale of principal residence (President's FY1998 Budget proposal); vi) distressed areas initiatives and other tax incentives in the President's FY1998 Budget (equitable tolling, Section 936, and FSC software); and vii) as revenue offsets: the excise taxes and some of the corporate raisers in the President's Budget.

(2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and underreported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent that reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.

(3) The change in Federal taxes is estimated at 1998 income levels but assuming fully phased in (2007) law and behavior. For the Kidsave proposal, the change is measured as the present value of the tax savings from one year's contributions. The effect of the capital gains proposal is based on the level of capital gains realizations under current law.

(4) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Federal taxes are estimated at 1998 income levels but assuming 2007 law and, therefore, exclude provisions that expire prior to the end of the Budget period and are adjusted for the effects of unindexed parameters.

(5) Families with negative incomes are included in the total line but not shown separately.

# Tax Proposals in the President's FY1998 Budget (1)

(1998 Income Levels)

| Family Economic Income Quintile (2) | Number of Families (millions) | Average Tax Change ($) | Total Tax Change: Amount (3) ($M) | Total Tax Change: Percent Distribution (%) | Tax Change as a Percent of: Current Federal Taxes (4) (%) | Tax Change as a Percent of: Family Economic Income (%) |
|---|---|---|---|---|---|---|
| Lowest (5) | 21.6 | 12 | 251 | -1.3 | 2.00 | 0.12 |
| Second | 22.2 | -90 | -1999 | 10.2 | -3.25 | -0.37 |
| Third | 22.3 | -240 | -5331 | 27.3 | -3.38 | -0.56 |
| Fourth | 22.3 | -377 | -8384 | 43.0 | -2.72 | -0.52 |
| Highest | 22.3 | -182 | -4064 | 20.8 | -0.45 | -0.10 |
| Total (5) | 111.3 | -175 | -19518 | 100.0 | -1.34 | -0.26 |
| Top 10% | 11.1 | 34 | 376 | -1.9 | 0.06 | 0.01 |
| Top 5% | 5.6 | 235 | 1,313 | -6.7 | 0.27 | 0.06 |
| Top 1% | 1.1 | 935 | 1,049 | -5.4 | 0.40 | 0.10 |

Department of the Treasury
Office of Tax Analysis

February 13, 1997

(1) This table distributes the estimated change in tax burdens due to the tax proposals in the President's FY1998 Budget.

(2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and underreported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent that reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.

(3) The change in Federal taxes is estimated at 1998 income levels but assuming fully phased in (2007) law and behavior. For the IRA proposal, the change is measured as the present value of the tax savings from one year's contributions.

(4) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Federal taxes are estimated at 1998 income levels but assuming 2007 law and, therefore, exclude provisions that expire prior to the end of the Budget period and are adjusted for the effects of unindexed parameters.

(5) Families with negative incomes are excluded from the lowest quintile but included in the total line.

NOTE: Quintiles begin at FEI of: Second $16,950, Third $32,563, Fourth $54,758, Highest $93,222, Top 10% $127,373; Top 5% $170,103; Top 1% $408,551

# Tax Proposals in the President's FY1998 Budget (1)

(1998 Income Levels)

| Family Economic Income Class (2) (000) | Number of Families (millions) | Average Tax Change ($) | Total Tax Change: Amount (3) ($M) | Total Tax Change: Percent Distribution (%) | Tax Change as a Percent of: Current Federal Taxes (4) (%) | Tax Change as a Percent of: Family Economic Income (%) |
|---|---|---|---|---|---|---|
| 0 - 15 | 18.5 | 15 | 274 | -1.4 | 2.94 | 0.17 |
| 15 - 30 | 21.8 | -70 | -1526 | 7.8 | -3.04 | -0.31 |
| 30 - 40 | 12.1 | -162 | -1952 | 10.0 | -3.14 | -0.47 |
| 40 - 50 | 9.7 | -268 | -2602 | 13.3 | -3.56 | -0.60 |
| 50 - 60 | 7.9 | -337 | -2651 | 13.6 | -3.37 | -0.61 |
| 60 - 75 | 9.4 | -366 | -3441 | 17.6 | -3.93 | -0.75 |
| 75 - 100 | 11.7 | -403 | -4720 | 24.2 | -2.12 | -0.42 |
| 100 - 200 | 15.6 | -272 | 4245 | 21.8 | 0.31 | 0.05 |
| 200 & over | 3.9 | 342 | 1337 | -6.9 | 0.00 | 0.00 |
| Total (5) | 111.3 | -175 | -19518 | 100.0 | -1.34 | -0.26 |

Department of the Treasury
Office of Tax Analysis

February 13, 1997

(1) This table distributes the estimated change in tax burdens due to the tax proposals in the President's FY1998 Budget.

(2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and underreported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits, inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent that reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.

(3) The change in Federal taxes is estimated at 1998 income levels but assuming fully phased in (2007) law and behavior. For the IRA proposal, the change is measured as the present value of the tax savings from one year's contributions.

(4) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Federal taxes are estimated at 1998 income levels but assuming 2007 law and, therefore, exclude provisions that expire prior to the end of the Budget period and are adjusted for the effects of unindexed parameters.

(5) Families with negative incomes are included in the total line but not shown separately.

<u>Very Preliminary</u>

## Tax Provisions in the "American Family Tax Relief Act" (S. 2) (1)

(1996 Income Levels)

| Family Economic Income Quintile (2) | Number of Families (millions) | Average Tax Change ($) | Total Tax Change: Amount (3) ($M) | Total Tax Change: Percent Distribution (%) | Tax Change as a Percent of Current Federal Taxes (%) | Tax Change as a Percent of Income (%) |
|---|---|---|---|---|---|---|
| Lowest (4) | 21.4 | -19 | -409 | 0.7 | -2.89 | -0.22 |
| Second | 21.9 | -109 | -2388 | 4.2 | -3.90 | -0.49 |
| Third | 21.9 | -300 | -6557 | 11.6 | -4.48 | -0.78 |
| Fourth | 21.9 | -528 | -11556 | 20.5 | -4.25 | -0.85 |
| Highest | 21.9 | -1600 | -35007 | 62.1 | -4.49 | -1.01 |
| Total (4) | 109.4 | -516 | -56415 | 100.0 | -4.42 | -0.89 |
| Top 10% | 10.9 | -2330 | -25501 | 45.2 | -4.51 | -1.03 |
| Top 5% | 5.5 | -3527 | -19294 | 34.2 | -4.65 | -1.08 |
| Top 1% | 1.1 | -9595 | -10496 | 18.6 | -4.73 | -1.16 |

Department of the Treasury
Office of Tax Analysis

January 23, 1997

(1) This table distributes the estimated change in tax burdens due to the tax provisions in the "American Family Tax Relief Act" (S. 2), sponsored by Senators Roth and Lott. The Act includes IRA, child credit, and capital gains provisions. This table assumes: i) the IRA provision would have the same distributional impact as that of the backloaded IRA and spousal IRA in the "Contract with America"; ii) the child credit provision is the same as that in the "Revenue Reconciliation Act of 1995" and iii) the capital gains provision is the same as that in the "Revenue Reconciliation Act of 1995" except indexing is not delayed. The Act also includes estate and gift tax provisions which are not included in the table.

(2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and underreported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.

(3) The change in Federal taxes is estimated at 1996 income levels but assuming fully phased in law and long-run behavior. The effect of the IRA proposal is measured as the present value of tax savings on one year's contributions. The incidence assumptions for tax changes is the same as for current law taxes.

NOTE: Quintiles begin at FEI of: Second $15,604; Third $29,717; Fourth $48,600; Highest $79,056; Top 10% $108,704; Top 5% $145,412; Top 1% $349,438.

**Very Preliminary**

## Tax Provisions in the "American Family Tax Relief Act" (S. 2) (1)

(1996 Income Levels)

| Family Economic Income Class (2) (000) | Number of Families (millions) | Average Tax Change ($) | Total Tax Change: Amount (3) ($M) | Total Tax Change: Percent Distribution (%) | Tax Change as a Percent of Current Federal Taxes (%) | Tax Change as a Percent of Income (%) |
|---|---|---|---|---|---|---|
| 0 - 10 | 12.5 | -13 | -166 | 0.3 | -2.92 | -0.23 |
| 10 - 20 | 16.2 | -46 | -743 | 1.3 | -3.46 | -0.31 |
| 20 - 30 | 15.1 | -131 | -1978 | 3.5 | -3.94 | -0.53 |
| 30 - 50 | 22.7 | -306 | -6957 | 12.3 | -4.45 | -0.78 |
| 50 - 75 | 18.3 | -514 | -9439 | 16.7 | -4.21 | -0.84 |
| 75 - 100 | 10.8 | -817 | -8820 | 15.6 | -4.50 | -0.95 |
| 100 - 200 | 10.6 | -1224 | -12932 | 22.9 | -4.27 | -0.94 |
| 200 & over | 2.8 | -5354 | -14883 | 26.4 | -4.70 | -1.11 |
| Total (4) | 109.4 | -516 | -56415 | 100.0 | -4.42 | -0.89 |

Department of the Treasury
Office of Tax Analysis

January 23, 1997

(1) This table distributes the estimated change in tax burdens due to the tax provisions in the "American Family Tax Relief Act" (S. 2), sponsored by Senators Roth and Lott. The Act includes IRA, child credit, and capital gains provisions. This table assumes: i) the IRA provision would have the same distributional impact as that of the backloaded IRA and spousal IRA in the "Contract with America"; ii) the child credit provision is the same as that in the "Revenue Reconciliation Act of 1995" and iii) the capital gains provision is the same as that in the "Revenue Reconciliation Act of 1995" except indexing is not delayed. The Act also includes estate and gift tax provisions which are not included in the table

(2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and underreported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.

(3) The change in Federal taxes is estimated at 1996 income levels but assuming fully phased in law and long-run behavior. The effect of the IRA proposal is measured as the present value of tax savings on one year's contributions. The incidence assumptions for tax changes is the same as for current law taxes.

(4) Families with negative incomes are included in the total line but not shown separately.

# DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

May 30, 1997

**MEMORANDUM FOR SECRETARY ROBERT E. RUBIN**

**FROM:** **DON LUBICK** DL KS
**ACTING ASSISTANT SECRETARY (TAX POLICY)**

**SUBJECT:** Costs of Suggested Potential Packages Over the Second 10 Years

The attached tables show the 10-year cost of two different suggested tax packages. The packages include:

o A refundable Kidsave credit for children under 13 through 2002, and for children under 18 beginning in 2003. The credit is phased in at $200 in 1997, $300 in 1998 and $500 thereafter. Taxpayers eligible for the child credit can also contribute the credit amount to a backloaded IRA to finance the children's college education or the taxpayer's retirement.

o The education package differs somewhat from "Option 4" that was shown to the President. The current package includes a $1,000 HOPE scholarship and $5,000 tuition deduction through 1999 and the full $1,500 HOPE scholarship and $10,000 tuition deduction thereafter.

- The advantage of this package relative to previous packages is that the effective date is six months earlier (7/1/97) than the alternatives (1/1/98) and the President's complete proposals are in place by 2000 rather than 2001. It is easy to go back to an alternative proposal if that is preferable.

o The capital gains proposal includes a general 40 percent exclusion with special 24 percent AMT rate, the latter to ensure that the highest tax rate on capital gains under both the ordinary income tax and AMT is 24 percent. In addition, the President's capital gains proposal for home sales is included, as well as a liberalization of Section 1202, the capital gains preference for venture capital.

o The two tables differ in their individual AMT reforms. The first shows the full-blown AMT reform. The second reflects a much less far-reaching change to the AMT.

- The money saved by not fixing the future AMT problem could be left unspent to demonstrate fiscal responsibility. As is clear below, the extrapolated second ten-year costs of the smaller package is much lower than the competing package.

- Alternatively, the child credit could be expanded beyond its $500 level (it already covers children under 18) or the money could be used in some other way.

o The other proposals either come from the FY98 Budget or are carried over from previous packages (like the Daschle estate tax proposal).

**Costs in the Second 10 Years**

The Center for Budget and Policy Priorities (CBPP) received a great deal of attention last week for their analysis of the costs of the budget agreement in the second ten years. The agreement calls for net tax cuts of $28.8 billion in 2004, $31.4 in 2005, $38.2 in 2006 and $41.8 in 2007. The CBPP extrapolated the $13 billion increase from 2004 to 2007, using the 2007 net tax cut as a base (that is, they assume that the net cut will increase by $4.33 billion per year over the next 10 years), to conclude that the net tax cut from 2008-2017 would be $650 billion.

The CBPP methodology applied to package 1 (with the full AMT reform) would imply that our 2008-2017 net tax cut would be roughly $690 billion. This figure is likely to be overstated, however. Our refundable Kidsave credit does not increase in a uniform manner. Because of the "round-down" rules of indexing, the credit tends to remain at a fixed nominal amount for two or more years and then jump. An increase in the credit coincidentally occurs in the last three years of the Budget agreement, making it appear that the cost of the credit will increase sharply in the out years. This is not the case. When a rough adjustment is made for a reasonable path for the child credit, the 2008-2017 cost of the first package is roughly **$650 billion.**

The CBPP methodology for package 2 (with the minor AMT reform) implies that the 2008-2017 net tax cut is roughly $480 billion. With the adjustment for the non-exploding cost of the refundable Kidsave credit, the 2008-2017 cost of the net tax cut would be roughly **$440 billion.** ?

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440

25

280 85 3 290 240 480

**Illustrative Baseline Tax Package: Very Preliminary Treasury Estimates (except where noted)**
Dollar amounts in millions, May 30, 1997

| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 1998-02 | 1998-07 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Education package** | | | | | | | | | | | | | |
| HOPE scholarship, $1000; Tuition Deduction, $10,000 \1 | -78 | -3,714 | -5,556 | -6,677 | -9,219 | -9,962 | -10,113 | -10,473 | -10,732 | -11,281 | -11,447 | -35,128 | -89,174 |
| Rangel K-12 school finance tax provision (not scored) | | | | | | | | | | | | | |
| Make Section 127 Permanent \2 | -82 | -645 | -670 | -730 | -796 | -833 | -874 | -914 | -951 | -988 | -1,042 | -3,674 | -8,443 |
| **Middle-Class Tax Relief and Saving Provisions** | | | | | | | | | | | | | |
| Refundable Kidsave Credit \3 | -732 | -11,855 | -14,049 | -17,382 | -17,302 | -17,242 | -19,891 | -22,450 | -22,287 | -24,479 | -26,520 | -77,830 | -193,457 |
| Individual AMT reform, start in 2003 \4 | 0 | 0 | 0 | 0 | 0 | 0 | -2,261 | -4,705 | -6,451 | -8,832 | -11,950 | 0 | -34,202 |
| **Capital Gains and Estate Tax Relief** | | | | | | | | | | | | | |
| 40% CapGn Exclusion and 24% AMT | -200 | -835 | 841 | -1,023 | -1,043 | -1,053 | -1,015 | -945 | -940 | -855 | -725 | -3,123 | -7,603 |
| Super-Bumpers Ping Number \5 | 0 | -50 | -150 | -300 | -400 | -500 | -600 | -700 | -800 | -900 | -1,000 | -1,400 | -5,400 |
| President's Home Sales Provisions \5 | -10 | -90 | -241 | -228 | -214 | -199 | 183 | -165 | -147 | -127 | -106 | -972 | -1,700 |
| Daschle Estate Tax Proposals (JCT) | 0 | -440 | -540 | -640 | -740 | -840 | -1,000 | -1,200 | -1,400 | -1,600 | -1,800 | -3,200 | -10,200 |
| **Urban Initiatives** | | | | | | | | | | | | | |
| Distressed Areas Initiatives \6 | -40 | -426 | -505 | -509 | -478 | -421 | -368 | -326 | -292 | -260 | -230 | -2,339 | -3,815 |
| Welfare-to-Work | 0 | -68 | -137 | -163 | -122 | -61 | -20 | -5 | -1 | 0 | 0 | -551 | -577 |
| Other Tax Incentives \7 | -10 | -141 | -214 | -257 | -301 | -369 | -345 | -387 | -429 | -1,395 | -2,465 | -1,282 | -6,243 |
| One-year Extensions of Expiring Provisions | -438 | -968 | -747 | -330 | -145 | -52 | -8 | 0 | 0 | 0 | 0 | -2,242 | -2,250 |
| **Gross Tax Cut** | -1,790 | -19,232 | -21,968 | -28,239 | -30,760 | -31,542 | -36,678 | -42,270 | -44,433 | -50,717 | -57,225 | -131,741 | -363,064 |
| **Revenue Offsets** | 623 | 8,488 | 9,073 | 9,951 | 10,411 | 12,078 | 11,202 | 11,679 | 12,080 | 12,538 | 12,988 | 50,001 | 110,488 |
| **Total Net Cut** (not including Rangel school construction program, expected to cost $3 billion through 2002) | -1,167 | -10,744 | -12,895 | -18,288 | -20,349 | -19,464 | -25,476 | -30,591 | -32,353 | -38,179 | -44,237 | -81,740 | -252,576 |

\1 The proposal drops the B- rule and Pell offset to HOPE. Effective 7/1/97. The HOPE credit is $1,000 in 1998 - 1999 and $1,500 in 2000 and indexed thereafter. The tuition deduction is $5,000 in 1998 and 1999 and $10,000 thereafter.

\2 Includes 10% employer credit for small business training.

\3 A refundable child credit for children under 13 with an optional $500 nondeductible IRA for education or retirement. The credit is refundable only to taxpayers with earnings of $2,000 or more in 1997. The earnings test is indexed beginning in 1998. The nondeductible IRA is available for each child credit allowed. The credit is $200 in 1997, $300 in 1998, and $500 in 1999 and indexed thereafter. The credit is phased-out between $60,000 and $75,000 of AGI. The phase-out range is indexed beginning in 2000.

\4 Assumes the enactment of the refundable Kidsave proposal. Among other things, it eliminates several inappropriate AMT preference items (most importantly the standard deduction), allows personal credits to offset AMT liability, and indexes the AMT in 2003

\5 Stacked after the 50% exclusion

\6 Expand Empowerment Zones and Enterprise Communities, Brownfields, and CDFI

\7 Equitable tolling, Puerto Rico Tax Credit, FSC software, and DC incentives

**Illustrative Baseline Tax Package: Very Preliminary Treasury Estimates (except where noted)**
Dollar amounts in millions, May 30, 1997

| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 1998-02 | 1998-07 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Education package** | | | | | | | | | | | | | |
| HOPE scholarship, $1000; Tuition Deduction, $10,000 \1 | -78 | -3,714 | -5,556 | -6,677 | -9,219 | -9,962 | -10,113 | -10,473 | -10,732 | -11,281 | -11,447 | -35,128 | -89,174 |
| Rangel K-12 school finance tax provision (not scored) | | | | | | | | | | | | | |
| Make Section 127 Permanent \2 | -62 | -645 | -670 | -730 | -796 | -833 | -874 | -914 | -951 | -988 | -1,042 | -3,674 | -8,443 |
| **Middle-Class Tax Relief and Saving Provisions** | | | | | | | | | | | | | |
| Refundable Kidsave Credit \3 | -732 | -11,355 | -14,049 | -17,382 | -17,392 | -17,242 | -19,891 | -22,450 | -22,287 | -24,479 | -26,520 | -77,830 | -193,457 |
| Individual AMT reform, start in 2003 \4 | 0 | 0 | 0 | 0 | 0 | 0 | -382 | -760 | -1,013 | -1,412 | -1,969 | 0 | -5,536 |
| **Capital Gains and Estate Tax Relief** | | | | | | | | | | | | | |
| 40% CapGn Exclusion and 24% AMT | -400 | -835 | 841 | -1,023 | -1,043 | -1,063 | -1,015 | -945 | -940 | -855 | -725 | -3,123 | -7,603 |
| Super-Bumpers Plug Number \5 | 0 | -50 | -150 | -300 | -400 | -500 | -600 | -700 | -800 | -900 | -1,000 | -1,400 | -5,400 |
| President's Home Sales Provisions \5 | -10 | -90 | -241 | -228 | -214 | -199 | -183 | -165 | -147 | -127 | -106 | -972 | -1,700 |
| Daschle Estate Tax Proposals (JCT) | 0 | -440 | -540 | -640 | -740 | -840 | -1,000 | -1,200 | -1,400 | -1,600 | -1,800 | -3,200 | -10,200 |
| **Urban Initiatives** | | | | | | | | | | | | | |
| Distressed Areas Initiatives \6 | -40 | -426 | -505 | -509 | -478 | -421 | -368 | -326 | -292 | -260 | -230 | -2,339 | -3,815 |
| Welfare-to-Work | 0 | -68 | -137 | -163 | -122 | -61 | -20 | -5 | -1 | 0 | 0 | -551 | -577 |
| Other Tax Incentives \7 | -10 | -141 | -214 | -257 | -301 | -369 | -345 | -387 | -429 | -1,395 | -2,405 | -1,282 | -6,243 |
| One-year Extensions of Expiring Provisions | -438 | -968 | -747 | -330 | -145 | -52 | -8 | 0 | 0 | 0 | 0 | -2,242 | -2,250 |
| **Gross Tax Cut** | -1,790 | -19,232 | -21,968 | -28,239 | -30,760 | -31,542 | -34,799 | -38,325 | -38,992 | -43,297 | -47,344 | -131,741 | -334,398 |
| **Revenue Offsets** | 623 | 8,488 | 9,075 | 9,951 | 10,412 | 12,075 | 11,202 | 11,679 | 12,080 | 12,538 | 12,938 | 50,001 | 110,488 |
| **Total Net Cut** | -1,167 | -10,744 | -12,895 | -18,288 | -20,349 | -19,464 | -23,597 | -26,646 | -26,912 | -30,759 | 34,256 | -81,740 | -223,910 |
| **(not including Rangel school construction program, expected to cost $3 billion through 2002 and $8 billion through 2007)** | | | | | | | | | | | | | |

\1 The proposal drops the B- rule and Pell offset to HOPE. Effective 7/1/97. The HOPE credit is $1,000 in 1998 - 1999 and $1,500 in 2000 and indexed thereafter. The tuition deduction is $5,000 in 1998 and 1999 and $10,000 thereafter.

\2 Includes 10% employer credit for small business training.

\3 A refundable child credit for children under 13 with an optional $500 nondeductible IRA for education or retirement. The credit is refundable only to taxpayers with earnings of $2,000 or more in 1997. The earnings test is indexed beginning in 1998. The nondeductible IRA is available for each child credit allowed. The credit is $200 in 1997, $300 in 1998, and $500 in 1999 and indexed thereafter. The credit is phased-out between $60,000 and $75,000 of AGI. The phase-out range is indexed beginning in 2000.

\4 Assumes the enactment of the refundable Kidsave proposal. Among other things, it eliminates several inappropriate AMT preference items (most importantly the standard deduction), allows personal credits to offset AMT liability, and indexes the AMT in 2003

\5 Stacked after the 50% exclusion

\6 Expand Empowerment Zones and Enterprise Communities, Brownfields, and CDFI

\7 Equitable tolling, Puerto Rico Tax Credit, FSC software, and DC incentives

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

June 2, 1997

**MEMORANDUM FOR SECRETARY ROBERT E. RUBIN**
**DEPUTY SECRETARY SUMMERS**

**FROM:** **DON LUBICK** DCL
**ACTING ASSISTANT SECRETARY (TAX POLICY)**

**SUBJECT:** Home Office Deduction

## Summary

Taxpayers currently are precluded from taking a home office deduction if they use a home office to perform the administrative and management activities of their business, but perform their business services at another business location. Several proposals have recently been made to allow a home office deduction in these situations. We are supportive of the general approach taken in these proposals, but believe that certain technical modifications are necessary (1) to ensure that de minimis management activities would not qualify the taxpayer for the home office deduction, and (2) to prevent the proposals from affecting the deductibility of commuting expenses.

## Current law

Under current law, a home office deduction is generally allowed with respect to the use of a taxpayer's residence only in limited circumstances, including where a portion of the home is exclusively used on a regular basis as the taxpayer's "principal place of business." In Commissioner v. Soliman, the Supreme Court disallowed a home office deduction to an anesthesiologist who practiced at several hospitals, but performed his administrative activities in a home office because he was not provided office space by the hospitals. The Court held that the home office was not his principal place of business, because his primary services were performed at the hospitals.

## Congressional proposals

In response to the Soliman case, several congressional proposals would allow a home office deduction to taxpayers who manage their business affairs from their home. For example, Senator Bond's Home-Based Business Fairness Act of 1997" would treat a home office as a "principal place of business" if (I) the office is exclusively used by the taxpayer to conduct essential administrative or management activities on a regular and systematic basis, and (ii) the taxpayer has no other location to conduct these essential administrative or management activities. Thus, under the bill, a home office deduction would be allowed under circumstances where the taxpayer's home is not in fact the taxpayer's principal place of business.

Under the bill, employees would only be entitled to a home office deduction if the use of the home office is for the convenience of his employer. Moreover, any deduction by the employee would be subject to the 2% floor on miscellaneous itemized deductions and would not be deductible for AMT purposes.

While we generally agree with the approach of the bill, certain considerations must be addressed. In particular, the current rules were enacted by Congress in 1976 to reduce the substantial amount of litigation over the circumstances under which a taxpayer who worked in his or her home could deduct as a business expense a portion of the costs associated with maintaining the home. It is important that we make every effort to avoid turning back the clock and creating a level of ambiguity that would result in more disputes between taxpayers and the IRS. To address this concern, we believe that the services being performed in the home office must be both substantial and essential . This would avoid allowing a home office deduction where only a de minimis amount of administrative or management activities are conducted. Also, we agree with the bill's treatment of employees. Further expansion of the home office deduction for part-time employees and telecommuters would be very expensive and difficult to administer.

We are also concerned that the bill would affect more than home office deductions. By changing what qualifies as a principal place of business , it would also permit deductions for currently nondeductible commuting expenses. We believe the effects of the proposal should be limited to home office expenses.

## Revised proposal

We would add a section 280A(c)(1)(D) to allow a home office deduction in cases where (I) the office is exclusively used by the taxpayer to conduct substantial and essential administrative or management activities on a regular and systematic basis, and (ii) the taxpayer has no other location to conduct these essential administrative or management activities. Thus, we would not amend the definition of principal place of business, thereby avoiding any effect on commuting expenses.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

Information

June 2, 1997

MEMORANDUM FOR SECRETARY ROBERT E. RUBIN
DEPUTY SECRETARY SUMMERS

FROM: DON LUBICK DL
ACTING ASSISTANT SECRETARY (TAX POLICY)

SUBJECT: A Small Business Capital Gains Proposal (Section 1202)

The following memo describes our suggested modifications to Section 1202. The proposal is designed to appeal to constituencies interested in expanding the scope of Section 1202, but focus incentives on smaller companies that were the target of the Administration's original 1202 proposals. Each of the provisions described below could be may more generous.

- The current law 50 percent exclusion and maximum tax rate of 14 percent would be retained. The tax treatment of small business capital gains would still be more favorable than it is for other capital gains, which would have a maximum rate of approximately 20 percent under a 50 percent capital gains exclusion.

- The limit on eligible gains would be increased from $10 million to $20 million and indexed for inflation. Inflation indexing would begin in 1999. The alternative limitation of 10 times basis would be repealed as a simplification measure.

- Excluded capital gains would still be treated as a preference item under the AMT, but a special AMT rate would apply to ensure that capital gains qualifying for 1202 under either the ordinary income tax or the AMT would be taxed at a maximum rate of 14 percent.

- Certain anti-abuse rules that could unnecessarily disqualify certain businesses would be liberalized.

  - The working capital rules could be modified to provide that (I) working capital will be treated as an active trade or business asset if it is reasonably expected to be used within 5 years (up from current 2 years); (ii) funds spent on R&D will be treated as creating an active trade or business asset dollar-for-dollar; and (iii) the time period for taking full advantage of these working capital rules would be extended from 2 years to 5 years. These changes would benefit bio-tech companies and other R&D firms that have long development periods before products can be brought to market.

  - The Treasury regulatory initiative to permit stock redemptions in certain situations would be finalized in 1997 and extended to include divorce as well as death, termination of employment, mental incompetence and de minimis cases. It would be made clear that the phrase making firms ineligible because their principal asset is the skill or reputation of one or more employees was not intended to disqualify software or R&D or similar firms. Administration and compliance with the provision would be improved by requiring firms to file an annual eligibility form along with their corporate tax returns.

o The $50 million limit on asset size would be retained (but would be indexed for inflation).

- Most startup firms require only a few million dollars of capital and increasing the asset limit to $100 million would draw capital away from these smaller firms that are the intended primary beneficiaries of the provision. The 5-year holding period requirement would be retained as an incentive for patient capital. If a general capital gains exclusion is passed, those who have held shares for less than 5 years would be eligible for the general preference for long-term gains.

  -- Proposals for rollover of gains from an eligible small business into investments in other small businesses should be opposed. Such proposals would create complex eligibility questions and create the potential for taxpayers to never pay any capital gains tax if gains are rolled over for life.

o These provisions are most likely to be of interest to Senators Daschle, Roth, Hatch, Lieberman and Mack, and Representatives Matsui, English, McCrery, Dunn, and Watkins who have introduced bills with targeted capital gains provisions for small business. A number of additional Senators and Representatives are co-sponsors of these bills.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

June 2, 1997

MEMORANDUM FOR SECRETARY ROBERT E. RUBIN
DEPUTY SECRETARY SUMMERS

FROM: DON LUBICK ACL
ACTING ASSISTANT SECRETARY (TAX POLICY)

SUBJECT: Refundable Child Tax Credit

This memo discusses the advantages and disadvantages of making the Kidsave proposal refundable.[1] In the past, Treasury has taken a strong position against the creation of new refundable tax credits to subsidize health insurance or child care expenditures of low-income families. We would not, however, object to making the proposed $500 child credit refundable.

A refundable credit will ensure that low-income families, with young children, would receive some of the benefits of the tax package. With capital gains and estate tax relief, the Congressional tax package will distribute much of its benefits to higher income families. The Administration's tax package, with a refundable tax credit for families with children, could offer a stark contrast to these Congressional plans.

On policy grounds, it makes more sense to modify the Administration's current child credit proposal by making it refundable rather than extending the credit to less needy families with children who are 13 or older. Further, a refundable credit is a simple and efficient mechanism for distributing funds to needy families, who might otherwise not have any contact with another government agency. Many observers believe that the high participation rates in the EITC are largely due to the simple, non-stigmatizing application process. By limiting the refundable credit to families with a certain level of earnings, the proposal would also complement our welfare-to-work initiatives.

Our reasons for objecting to refundable credits for health insurance or child care credits do not necessarily apply to the $500 child credit. We have opposed refundable credits as a

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[1]A refundable tax credit allows a taxpayer to receive the full benefits of a subsidy through the tax system, even if the subsidy exceeds his or her tax liability. The earned income tax credit is an example of a refundable tax credit. Low-income working taxpayers are able to receive the full EITC to which they are entitled, even if they have little or no individual income tax liability. Taxpayers can claim the refundable credit on their tax return filed at the end of the year and receive the value of the credit as either a reduction in their outstanding tax liability or as a refund.

way of subsiding certain expenditures for three key reasons. First, the IRS cannot verify health insurance or child care expenditures prior to payment of the tax credit, and it is difficult to recapture erroneous refunds paid to low-income taxpayers once the payment has been made. Second, the refundable credit generally would not be available to claimants in "real time" when they need the assistance in order to make the purchase. Third, individuals who are currently outside the income tax system would have to file a tax return in order to benefit from the tax credit. Given these concerns, our position has been that it would be more efficient to provide certain types of subsidies through non-tax administrative mechanisms.

A refundable $500 child credit does not raise similar concerns. Through verification of social security numbers, the IRS can now prevent refunds from being paid to taxpayers who claim nonexistent children. (The IRS still cannot verify the relationship of the child to the taxpayer, but should be developing better screens as a result of the EITC compliance efforts.) Second, the goal of the $500 child credit is to increase disposable income of families with children -- not to encourage a specific type of purchase or behavior. Third, we recommend that the refundable child credit be made available only if the taxpayer has earnings above a certain threshold, say $2,000, and thus are likely to be filing a return under current law. Establishing an earnings threshold also reinforces the message that "work pays."

It is likely, however, that a proposal to make the $500 child credit refundable will be attacked, and these attacks may increase the vulnerability of the EITC. Some opponents of the EITC believe that its noncompliance problems are caused by refundability. Our analysis of the EITC compliance data suggests otherwise: the overclaim rate among those with a positive pre-EITC tax liability in 1994 was nearly three times larger than the rate among those who did not have a tax liability. Further, nearly 95 percent of EITC claimants have a reason to file a return other than to claim the credit. Noncompliant EITC claimants do not enter the tax system merely to claim the credit, and it is unlikely that a refundable $500 child credit (with an earnings threshold) will change this.

Proposing refundability of the Kidsave credit may also deflect attention from EITC problems. Doing so would send a strong message that not only does the Administration support the EITC, it is willing to go further to increase the progressivity of other elements of the tax system.

A refundable $500 child credit may also be compared, unfavorably, to various negative income tax (NIT) proposals of the early seventies (including proposals by both Senator McGovern and President Nixon). Our proposal would differ from an NIT in two key respects: first, the credit would be limited to families with children; and second, recipients would be limited to workers with earnings above a certain threshold. In contrast, NITs extend assistance to all low-income individuals.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

June 2, 1997

**MEMORANDUM FOR SECRETARY ROBERT E. RUBIN**
**DEPUTY SECRETARY SUMMERS**

**FROM:** **DON LUBICK** DCL
**ACTING ASSISTANT SECRETARY (TAX POLICY)**

**SUBJECT:** Costs of Suggested Potential Packages Over the Second 10 Years

The attached tables show the 10-year cost of two different suggested tax packages. The packages include:

- o A refundable Kidsave credit for children under 13 through 2002, and for children under 18 beginning in 2003. The credit is phased in at $200 in 1997, $300 in 1998 and $500 thereafter. Taxpayers eligible for the child credit can also contribute the credit amount to a backloaded IRA to finance the children's college education or the taxpayer's retirement.

- o The education package differs somewhat from "Option 4" that was shown to the President. The current package includes a $1,000 HOPE scholarship and $5,000 tuition deduction through 1999 and the full $1,500 HOPE scholarship and $10,000 tuition deduction thereafter.

  - The advantage of this package relative to previous packages is that the effective date is six months earlier (7/1/97) than the alternatives (1/1/98) and the President's complete proposals are in place by 2000 rather than 2001. It is easy to go back to an alternative proposal if that is preferable.

- o The capital gains proposal includes a general 40 percent exclusion with special 24 percent AMT rate, the latter to ensure that the highest tax rate on capital gains under both the ordinary income tax and AMT is 24 percent. In addition, the President's capital gains proposal for home sales is included, as well as a liberalization of Section 1202, the capital gains preference for venture capital.

- o The two tables differ in their individual AMT reforms. The first shows the full-blown AMT reform. The second reflects a much less far-reaching change to the AMT.

  - The money saved by not fixing the future AMT problem could be left unspent to demonstrate fiscal responsibility. As is clear below, the extrapolated second ten-year costs of the smaller package is much lower than the competing package.

- Alternatively, the child credit could be expanded beyond its $500 level (it already covers children under 18) or the money could be used in some other way.

o The other proposals either come from the FY98 Budget or are carried over from previous packages (like the Daschle estate tax proposal).

**Costs in the Second 10 Years**

The Center for Budget and Policy Priorities (CBPP) received a great deal of attention last week for their analysis of the costs of the budget agreement in the second ten years. The agreement calls for net tax cuts of $28.8 billion in 2004, $31.4 in 2005, $38.2 in 2006 and $41.8 in 2007. The CBPP extrapolated the $13 billion increase from 2004 to 2007, using the 2007 net tax cut as a base (that is, they assume that the net cut will increase by $4.33 billion per year over the next 10 years). to conclude that the net tax cut from 2008-2017 would be $650 billion.

The CBPP methodology applied to package 1 (with the full AMT reform) would imply that our 2008-2017 net tax cut would be roughly $690 billion. This figure is likely to be overstated, however. Our refundable Kidsave credit does not increase in a uniform manner. Because of the "round-down" rules of indexing, the credit tends to remain at a fixed nominal amount for two or more years and then jump. An increase in the credit coincidentally occurs in the last three years of the Budget agreement, making it appear that the cost of the credit will increase sharply in the out years. This is not the case. When a rough adjustment is made for a reasonable path for the child credit, the 2008-2017 cost of the first package is roughly **$650 billion**.

The CBPP methodology for package 2 (with the minor AMT reform) implies that the 2008-2017 net tax cut is roughly $480 billion. With the adjustment for the non-exploding cost of the refundable Kidsave credit, the 2008-2017 cost of the net tax cut would be roughly **$440 billion**.

**Illustrative Baseline Tax Package: Very Preliminary Treasury Estimates (except where noted)**
Dollar amounts in millions, May 30, 1997

| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 1998-02 | 1998-07 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Education package** | | | | | | | | | | | | | |
| HOPE scholarship, $1000; Tuition Deduction, $10,000 \1 | -78 | -3,714 | -5,556 | -6,677 | -9,219 | -9,962 | -10,113 | -10,473 | -10,732 | -11,281 | -11,447 | -35,128 | -89,174 |
| Rangel K-12 school finance tax provision (not scored) | | | | | | | | | | | | | |
| Make Section 127 Permanent \2 | -82 | -645 | -670 | -730 | -796 | -833 | -874 | -914 | -951 | -988 | -1,042 | -3,674 | -8,443 |
| **Middle-Class Tax Relief and Saving Provisions** | | | | | | | | | | | | | |
| Refundable Kidsave Credit \3 | -732 | -11,855 | -14,049 | -17,382 | -17,302 | -17,242 | -19,891 | -22,450 | -22,287 | -24,479 | -26,520 | -77,830 | -193,457 |
| Individual AMT reform, start in 2003 \4 | 0 | 0 | 0 | 0 | 0 | 0 | -2,261 | -4,705 | -6,454 | -8,832 | -11,950 | 0 | -34,202 |
| **Capital Gains and Estate Tax Relief** | | | | | | | | | | | | | |
| 40% CapGn Exclusion and 24% AMT | -400 | -835 | 841 | -1,023 | -1,043 | -1,063 | -1,015 | -945 | -940 | -855 | -725 | -3,123 | -7,603 |
| Super-Bumpers Plug Number \5 | 0 | -50 | -150 | -300 | -400 | -500 | -600 | -700 | -800 | -900 | -1,000 | -1,400 | -5,400 |
| President's Home Sales Provisions \5 | -10 | -90 | -241 | -228 | -214 | -199 | -183 | -165 | -147 | -127 | -106 | -972 | -1,700 |
| Daschle Estate Tax Proposals (JCT) | 0 | -440 | -540 | -640 | -740 | -840 | -1,000 | -1,200 | -1,400 | -1,600 | -1,800 | -3,200 | -10,200 |
| **Urban Initiatives** | | | | | | | | | | | | | |
| Distressed Areas Initiatives \6 | -40 | -426 | -505 | -509 | -478 | -421 | -368 | -326 | -292 | -260 | -230 | -2,339 | -3,815 |
| Welfare-to-Work | 0 | -68 | -137 | -163 | -122 | -61 | -20 | -5 | -1 | 0 | 0 | -551 | -577 |
| Other Tax Incentives \7 | -10 | -141 | -214 | -257 | -301 | -369 | -345 | -387 | -429 | -1,395 | -2,405 | -1,282 | -6,243 |
| One-year Extensions of Expiring Provisions | -438 | -968 | -747 | -330 | -145 | -52 | -8 | 0 | 0 | 0 | 0 | -2,242 | -2,250 |
| **Gross Tax Cut** | -1,790 | -19,232 | -21,968 | -28,239 | -30,760 | -31,542 | -36,678 | -42,270 | -44,433 | -50,717 | -57,225 | -131,741 | -363,064 |
| **Revenue Offsets** | 623 | 8,488 | 9,073 | 9,951 | 10,411 | 12,078 | 11,202 | 11,679 | 12,080 | 12,538 | 12,988 | 50,001 | 110,488 |
| **Total Net Cut (not including Rangel school construction program, expected to cost $3 billion through 2002)** | -1,167 | -10,744 | -12,895 | -18,288 | -20,349 | -19,464 | -25,476 | -30,591 | -32,353 | -38,179 | -44,237 | -81,740 | -252,576 |

\1 The proposal drops the B- rule and Pell offset to HOPE. Effective 7/1/97. The HOPE credit is $1,000 in 1998 - 1999 and $1,500 in 2000 and indexed thereafter. The tuition deduction is $5,000 in 1998 and 1999 and $10,000 thereafter.

\2 Includes 10% employer credit for small business training.

\3 A refundable child credit for children under 13 with an optional $500 nondeductible IRA for education or retirement. The credit is refundable only to taxpayers with earnings of $2,000 or more in 1997. The earnings test is indexed beginning in 1998. The nondeductible IRA is available for each child credit allowed. The credit is $200 in 1997, $300 in 1998, and $500 in 1999 and indexed thereafter. The credit is phased-out between $60,000 and $75,000 of AGI. The phase-out range is indexed beginning in 2000.

\4 Assumes the enactment of the refundable Kidsave proposal. Among other things, it eliminates several inappropriate AMT preference items (most importantly the standard deduction), allows personal credits to offset AMT liability, and indexes the AMT in 2003

\5 Stacked after the 50% exclusion

\6 Expand Empowerment Zones and Enterprise Communities, Brownfields, and CDFI

\7 Equitable tolling, Puerto Rico Tax Credit, FSC software, and DC incentives

Illustrative Baseline Tax Package: Very Preliminary Treasury Estimates (except where noted)
Dollar amounts in millions, May 30, 1997

| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 1998-02 | 1998-07 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Education package** | | | | | | | | | | | | | |
| HOPE scholarship, $1000; Tuition Deduction, $10,000 \1 | -78 | -3,714 | -5,556 | -6,677 | -9,219 | -9,962 | -10,113 | -10,473 | -10,732 | -11,281 | -11,447 | -35,128 | -89,174 |
| Rangel K-12 school finance tax provision (not scored) | | | | | | | | | | | | | |
| Make Section 127 Permanent \2 | -82 | -645 | -670 | -730 | -796 | -833 | -874 | -914 | -951 | -988 | -1,042 | -3,674 | -8,443 |
| **Middle-Class Tax Relief and Saving Provisions** | | | | | | | | | | | | | |
| Refundable Kidsave Credit \3 | -732 | -11,855 | -14,049 | -17,382 | -17,302 | -17,242 | -19,891 | -22,450 | -22,287 | -24,479 | -26,520 | -77,830 | -193,457 |
| Individual AMT reform, start in 2003 \4 | 0 | 0 | 0 | 0 | 0 | 0 | -382 | -760 | -1,013 | -1,412 | -1,969 | 0 | -5,536 |
| **Capital Gains and Estate Tax Relief** | | | | | | | | | | | | | |
| 40% CapGn Exclusion and 24% AMT | -400 | -835 | 841 | -1,023 | -1,043 | -1,063 | -1,015 | -945 | -940 | -855 | -725 | -3,123 | -7,603 |
| Super-Bumpers Plug Number \5 | 0 | -50 | -150 | -300 | -400 | -500 | -600 | -700 | -800 | -900 | -1,000 | -1,400 | -5,400 |
| President's Home Sales Provisions \5 | -10 | -90 | -241 | -228 | -214 | -199 | -183 | -165 | -147 | -127 | -106 | -972 | -1,700 |
| Daschle Estate Tax Proposals (JCT) | 0 | -440 | -540 | -640 | -740 | -840 | -1,000 | -1,200 | -1,400 | -1,600 | -1,800 | -3,200 | -10,200 |
| **Urban Initiatives** | | | | | | | | | | | | | |
| Distressed Areas Initiatives \6 | -40 | -426 | -505 | -509 | -478 | -421 | -368 | -326 | -292 | -260 | -230 | -2,339 | -3,815 |
| Welfare-to-Work | 0 | -68 | -137 | -163 | -122 | -61 | -20 | -5 | -1 | 0 | 0 | -551 | -577 |
| Other Tax Incentives \7 | -10 | -141 | -214 | -257 | -301 | -369 | -345 | -387 | -429 | -1,395 | -2,405 | -1,282 | -6,243 |
| One-year Extensions of Expiring Provisions | -438 | -968 | -747 | -330 | -145 | -52 | -8 | 0 | 0 | 0 | 0 | -2,242 | -2,250 |
| **Gross Tax Cut** | -1,790 | -19,232 | -21,968 | -28,239 | -30,760 | -31,542 | -34,799 | -38,325 | -38,992 | -43,297 | -47,244 | -131,741 | -334,398 |
| **Revenue Offsets** | 623 | 8,488 | 9,073 | 9,951 | 10,411 | 12,078 | 11,202 | 11,679 | 12,080 | 12,538 | 12,988 | 50,001 | 110,488 |
| **Total Net Cut** **(not including Rangel school construction program, expected to cost $3 billion through 2002 and $8 billion through 2007)** | -1,167 | -10,744 | -12,895 | -18,288 | -20,349 | -19,464 | -23,597 | -26,646 | -26,912 | -30,759 | -34,256 | -81,740 | -223,910 |

\1 The proposal drops the B- rule and Pell offset to HOPE. Effective 7/1/97. The HOPE credit is $1,000 in 1998 - 1999 and $1,500 in 2000 and indexed thereafter. The tuition deduction is $5,000 in 1998 and 1999 and $10,000 thereafter.

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\3 A refundable child credit for children under 13 with an optional $500 nondeductible IRA for education or retirement. The credit is refundable only to taxpayers with earnings of $2,000 or more in 1997. The earnings test is indexed beginning in 1998. The nondeductible IRA is available for each child credit allowed. The credit is $200 in 1997, $300 in 1998, and $500 in 1999 and indexed thereafter. The credit is phased-out between $60,000 and $75,000 of AGI. The phase-out range is indexed beginning in 2000.

\4 Assumes the enactment of the refundable Kidsave proposal. Among other things, it eliminates several inappropriate AMT preference items (most importantly the standard deduction), allows personal credits to offset AMT liability, and indexes the AMT in 2003

\5 Stacked after the 50% exclusion

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\7 Equitable tolling, Puerto Rico Tax Credit, FSC software, and DC incentives

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

Very close hold

May 30, 1997

MEMORANDUM FOR SECRETARY ROBERT E. RUBIN
DEPUTY SECRETARY SUMMERS

FROM: DON LUBICK
ACTING ASSISTANT SECRETARY (TAX POLICY)

SUBJECT: Distributional Effects of a Potential Tax Package

Attached you will find six tables showing distributional effects of different Administration and Congressional tax packages.

o The first two tables show very preliminary estimates of the distributional effects of a proposed tax package. The package is from Thursday, and includes the complete, costly AMT package and a Kidsave credit for children under 13 for the entire budget period (our packages now expands the Kidsave credit to children under 18 beginning in 2003).

  - The revised package will have a somewhat more progressive distribution since the expansion of the Kidsave credit to families with older children will add roughly $8 billion in 2007 (we distribute the fully phased-in policies) to the bottom and middle quintiles of the income distribution, and, if we adopt the scaled back version of the AMT reform, we will take away nearly $10 billion of tax cuts that are distributed toward the top of the income distribution.

o The next two tables show the distributional effects of the President's budget proposals. The President's budget proposals targeted 80 percent of the tax relief to families in the middle three quintiles of the income distribution.

o The last two tables show very preliminary and rough calculations of the distributional effects of S.2. We would be grateful if these tables were not distributed, since the analysis does not meet the typical Treasury quality standard. It is provided here to give you an idea of what the distributional effects of a Congressional Leadership package might look like.

  - We will, of course, quickly do a complete analysis of Chairman Archer's tax bill when it is released to have a comparison of the Republican tax bill and ours.

o The upshot is that the current package targets more relief than either the Budget or S.2 to the bottom two income quintiles, presumably because of the refundable Kidsave credit. It provides less of its total tax relief to families in the third and fourth quintiles of the income distribution than the President's budget, but more than S.2. It provides a greater share of tax relief to the top quintile than the Budget proposals, but less than S.2.

Very Preliminary

# Baseline Tax Package as of May 30, 1997 (1)

(1998 Income Levels)

| Family Economic Income Quintile (2) | Number of Families (millions) | Average Tax Change ($) | Total Tax Change Amount (3) ($M) | Total Tax Change Percent Distribution (%) | Tax Change as a Percent of: Current Federal Taxes (4) (%) | Tax Change as a Percent of: Family Economic Income (%) |
|---|---|---|---|---|---|---|
| Lowest (5) | 21.6 | -82 | -1768 | 4.6 | -14.07 | -0.86 |
| Second | 22.2 | -244 | -5435 | 14.3 | -8.82 | -1.00 |
| Third | 22.3 | -296 | -6592 | 17.3 | -4.18 | -0.69 |
| Fourth | 22.3 | -397 | -8841 | 23.2 | -2.86 | -0.55 |
| Highest | 22.3 | -684 | -15228 | 40.0 | -1.67 | -0.37 |
| Total (5) | 111.3 | -342 | -38040 | 100.0 | -2.62 | -0.51 |
| Top 10% | 11.1 | -999 | -11125 | 29.2 | -1.68 | -0.38 |
| Top 5% | 5.6 | -1559 | -8689 | 22.8 | -1.78 | -0.41 |
| Top 1% | 1.1 | -3719 | -4173 | 11.0 | -1.61 | -0.40 |

Department of the Treasury
Office of Tax Analysis

May 30, 1997

(1) This table distributes the estimated change in tax burdens due to the tax proposals in the following illustrative baseline tax package: i) Hope Scholarship credit ($1000 through 1999, $1,500 in 2000, indexed beginning in 2001; no B minus rule; and no Federal grant offset) and tuition tax deduction ($5,000 in 1998 and 1999, $10,000 thereafter); ii) Permanent extension of Section 127; iii) Kidsave credit: a $500 refundable child credit ($2,000 earnings test) for children under 13 with an optional maximum $500 back-loaded IRA for education or retirement; iv) individual AMT reform (includes elimination of personal exemption, personal credits, and standard deduction preferences); v) 40% capital gains exclusion and 24% AMT; vi) small business capital gains preferences; v) $500,000 exclusion of gains on the sale of principal residence (President's FY1998 Budget proposal); vi) distressed areas initiatives and other tax incentives in the President's FY1998 Budget (equitable tolling, Section 936, and FSC software); and vii) as revenue offsets: the excise taxes and some of the corporate raisers in the President's Budget

(2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and under-reported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent that reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.

(3) The change in Federal taxes is estimated at 1998 income levels but assuming fully phased in (2007) law and behavior. For the Kidsave proposal, the change is measured as the present value of the tax savings from one year's contributions. The effect of the capital gains proposal is based on the level of capital gains realizations under current law.

(4) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Federal taxes are estimated at 1998 income levels but assuming 2007 law and, therefore, exclude provisions that expire prior to the end of the Budget period and are adjusted for the effects of unindexed parameters.

(5) Families with negative incomes are excluded from the lowest quintile but included in the total line.

NOTE: Quintiles begin at FEI of: Second $16,950; Third $32,563; Fourth $54,758; Highest $93,222; Top 10% $127,373; Top 5% $170,103; Top 1% $408,551.

Very Preliminary

# Baseline Tax Package as of May 30, 1997 (1)

(1998 Income Levels)

| Family Economic Income Class (2) (000) | Number of Families (millions) | Average Tax Change ($) | Total Tax Change: Amount (3) ($M) | Total Tax Change: Percent Distribution (%) | Tax Change as a Percent of: Current Federal Taxes (4) (%) | Tax Change as a Percent of: Family Economic Income (%) |
|---|---|---|---|---|---|---|
| 0 - 15 | 18.5 | -65 | -1208 | 3.2 | -12.95 | -0.77 |
| 15 - 30 | 21.8 | -233 | -5084 | 13.4 | -10.13 | -1.05 |
| 30 - 40 | 12.1 | -270 | -3250 | 8.5 | -5.23 | -0.78 |
| 40 - 50 | 9.7 | -299 | -2902 | 7.6 | -3.97 | -0.67 |
| 50 - 60 | 7.9 | -357 | -2814 | 7.4 | -3.58 | -0.65 |
| 60 - 75 | 9.4 | -403 | -3799 | 10.0 | -3.17 | -0.60 |
| 75 - 100 | 11.7 | -395 | -4618 | 12.1 | -2.30 | -0.46 |
| 100 - 200 | 15.6 | -422 | -6575 | 17.3 | -1.52 | -0.32 |
| 200 & over | 3.9 | -1945 | -7613 | 20.0 | -1.80 | -0.42 |
| Total (5) | 111.3 | -342 | -38040 | 100.0 | -2.62 | -0.51 |

Department of the Treasury
Office of Tax Analysis

May 30, 1997

(1) This table distributes the estimated change in tax burdens due to the tax proposals in the following illustrative baseline tax package: i) Hope Scholarship credit ($1000 through 1999, $1,500 in 2000, indexed beginning in 2001; no B minus rule; and no Federal grant offset) and tuition tax deduction ($5,000 in 1998 and 1999, $10,000 thereafter); ii) Permanent extension of Section 127; iii) Kidsave credit: a $500 refundable child credit ($2,000 earnings test) for children under 13 with an optional maximum $500 back-loaded IRA for education or retirement; iv) individual AMT reform (includes elimination of personal exemption, personal credits, and standard deduction preferences); v) 40% capital gains exclusion and 24% AMT; vi) small business capital gains preferences; v) $500,000 exclusion of gains on the sale of principal residence (President's FY1998 Budget proposal); vi) distressed areas initiatives and other tax incentives in the President's FY1998 Budget (equitable tolling, Section 936, and FSC software); and vii) as revenue offsets: the excise taxes and some of the corporate raisers in the President's Budget.

(2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and underreported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent that reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.

(3) The change in Federal taxes is estimated at 1998 income levels but assuming fully phased in (2007) law and behavior. For the Kidsave proposal, the change is measured as the present value of the tax savings from one year's contributions. The effect of the capital gains proposal is based on the level of capital gains realizations under current law.

(4) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Federal taxes are estimated at 1998 income levels but assuming 2007 law and, therefore, exclude provisions that expire prior to the end of the Budget period and are adjusted for the effects of unindexed parameters.

(5) Families with negative incomes are included in the total line but not shown separately.

# Tax Proposals in the President's FY1998 Budget (1)

(1998 Income Levels)

| Family Economic Income Quintile (2) | Number of Families (millions) | Average Tax Change ($) | Total Tax Change: Amount (3) ($M) | Total Tax Change: Percent Distribution (%) | Tax Change as a Percent of: Current Federal Taxes (4) (%) | Tax Change as a Percent of: Family Economic Income (%) |
|---|---|---|---|---|---|---|
| Lowest (5) | 21.6 | 12 | 251 | -1.3 | 2.00 | 0.12 |
| Second | 22.2 | -90 | -1999 | 10.2 | -3.25 | -0.37 |
| Third | 22.3 | -240 | -5331 | 27.3 | -3.38 | -0.56 |
| Fourth | 22.3 | -377 | -8384 | 43.0 | -2.72 | -0.52 |
| Highest | 22.3 | -182 | -4064 | 20.8 | -0.45 | -0.10 |
| Total (5) | 111.3 | -175 | -19518 | 100.0 | -1.34 | -0.26 |
| Top 10% | 11.1 | 34 | 376 | -1.9 | 0.06 | 0.01 |
| Top 5% | 5.6 | 235 | 1,313 | -6.7 | 0.27 | 0.06 |
| Top 1% | 1.1 | 935 | 1,049 | -5.4 | 0.40 | 0.10 |

Department of the Treasury
Office of Tax Analysis

February 13, 1997

(1) This table distributes the estimated change in tax burdens due to the tax proposals in the President's FY1998 Budget.

(2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and under-reported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance, tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent that reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.

(3) The change in Federal taxes is estimated at 1998 income levels but assuming fully phased in (2007) law and behavior. For the IRA proposal, the change is measured as the present value of the tax savings from one year's contributions.

(4) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Federal taxes are estimated at 1998 income levels but assuming 2007 law and, therefore, exclude provisions that expire prior to the end of the Budget period and are adjusted for the effects of unindexed parameters.

(5) Families with negative incomes are excluded from the lowest quintile but included in the total line.

NOTE Quintiles begin at FEI of: Second $16,950, Third $32,563, Fourth $54,758, Highest $93,222, Top 10% $127,373, Top 5% $170,103, Top 1% $408,551

# Tax Proposals in the President's FY1998 Budget (1)

(1998 Income Levels)

| Family Economic Income Class (2) (000) | Number of Families (millions) | Average Tax Change ($) | Total Tax Change: Amount (3) ($M) | Total Tax Change: Percent Distribution (%) | Tax Change as a Percent of: Current Federal Taxes (4) (%) | Tax Change as a Percent of: Family Economic Income (%) |
|---|---|---|---|---|---|---|
| 0 - 15 | 18.5 | 15 | 274 | -1.4 | 2.84 | 0.17 |
| 15 - 30 | 21.8 | -70 | -1526 | 7.8 | -3.04 | -0.31 |
| 30 - 40 | 12.1 | -162 | -1952 | 10.0 | -3.14 | -0.47 |
| 40 - 50 | 9.7 | -268 | -2602 | 13.3 | -3.56 | -0.60 |
| 50 - 60 | 7.9 | -337 | -2651 | 13.6 | -3.37 | -0.61 |
| 60 - 75 | 9.4 | -366 | -3441 | 17.6 | -3.93 | -0.75 |
| 75 - 100 | 11.7 | -403 | -4720 | 24.2 | -2.12 | -0.42 |
| 100 - 200 | 15.6 | -272 | -4246 | 21.8 | 0.31 | 0.06 |
| 200 & over | 3.9 | 342 | 1337 | -6.9 | 0.00 | 0.00 |
| Total (5) | 111.3 | -175 | -19518 | 100.0 | -1.34 | -0.26 |

Department of the Treasury
Office of Tax Analysis

February 13, 1997

(1) This table distributes the estimated change in tax burdens due to the tax proposals in the President's FY1998 Budget.

(2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and underreported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent that reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.

(3) The change in Federal taxes is estimated at 1998 income levels but assuming fully phased in (2007) law and behavior. For the IRA proposal, the change is measured as the present value of the tax savings from one year's contributions.

(4) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Federal taxes are estimated at 1998 income levels but assuming 2007 law and, therefore, exclude provisions that expire prior to the end of the Budget period and are adjusted for the effects of unindexed parameters.

(5) Families with negative incomes are included in the total line but not shown separately

Very Preliminary

# Tax Provisions in the "American Family Tax Relief Act" (S. 2) (1)

(1996 Income Levels)

| Family Economic Income Quintile (2) | Number of Families (millions) | Average Tax Change ($) | Total Tax Change: Amount (3) ($M) | Total Tax Change: Percent Distribution (%) | Tax Change as a Percent of Current Federal Taxes (%) | Tax Change as a Percent of Income (%) |
|---|---|---|---|---|---|---|
| Lowest (4) | 21.4 | -19 | -409 | 0.7 | -2.89 | -0.22 |
| Second | 21.9 | -109 | -2388 | 4.2 | -3.90 | -0.49 |
| Third | 21.9 | -300 | -6557 | 11.6 | -4.48 | -0.78 |
| Fourth | 21.9 | -528 | -11555 | 20.5 | -4.25 | -0.85 |
| Highest | 21.9 | -1600 | -35007 | 62.1 | -4.49 | -1.01 |
| Total (4) | 109.4 | -516 | -56415 | 100.0 | -4.42 | -0.89 |
| Top 10% | 10.9 | -2330 | -25501 | 45.2 | -4.51 | -1.03 |
| Top 5% | 5.5 | -3527 | -19294 | 34.2 | -4.65 | -1.08 |
| Top 1% | 1.1 | -9595 | -10496 | 18.6 | -4.73 | -1.16 |

Department of the Treasury
Office of Tax Analysis

January 23, 1997

(1) This table distributes the estimated change in tax burdens due to the tax provisions in the "American Family Tax Relief Act" (S. 2), sponsored by Senators Roth and Lott. The Act includes IRA, child credit, and capital gains provisions. This table assumes: i) the IRA provision would have the same distributional impact as that of the backloaded IRA and spousal IRA in the "Contract with America"; ii) the child credit provision is the same as that in the "Revenue Reconciliation Act of 1995" and iii) the capital gains provision is the same as that in the "Revenue Reconciliation Act of 1995" except indexing is not delayed. Tho Act also includes estate and gift tax provisions which are not included in the table

(2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and underreported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; Inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.

(3) The change in Federal taxes is estimated at 1996 income levels but assuming fully phased in law and long-run behavior. The effect of the IRA proposal is measured as the present value of tax savings on one year's contributions. The incidence assumptions for tax changes is the same as for current law taxes.

NOTE: Quintiles begin at FEI of: Second $15,604; Third $29,717; Fourth $48,660; Highest $79,056; Top 10% $108,704; Top 5% $145,412; Top 1% $349,438.

Very Preliminary

# Tax Provisions in the "American Family Tax Relief Act" (S. 2) (1)

(1996 Income Levels)

| Family Economic Income Class (2) (000) | Number of Families (millions) | Average Tax Change ($) | Total Tax Change Amount (3) ($M) | Total Tax Change Percent Distribution (%) | Tax Change as a Percent of Current Federal Taxes (%) | Tax Change as a Percent of Income (%) |
|---|---|---|---|---|---|---|
| 0 - 10 | 12.5 | -13 | -166 | 0.3 | -2.92 | -0.23 |
| 10 - 20 | 16.2 | -46 | -743 | 1.3 | -3.46 | -0.31 |
| 20 - 30 | 15.1 | -131 | -1976 | 3.5 | -3.94 | -0.53 |
| 30 - 50 | 22.7 | -306 | -6957 | 12.3 | -4.45 | -0.78 |
| 50 - 75 | 18.3 | -514 | -9439 | 16.7 | -4.21 | -0.84 |
| 75 - 100 | 10.8 | -817 | -8820 | 15.6 | -4.50 | -0.95 |
| 100 - 200 | 10.6 | -1224 | -12932 | 22.9 | -4.27 | -0.94 |
| 200 & over | 2.8 | -5354 | -14883 | 26.4 | -4.70 | -1.11 |
| Total (4) | 109.4 | -516 | -56415 | 100.0 | -4.42 | -0.89 |

Department of the Treasury
Office of Tax Analysis

January 23, 1997

(1) This table distributes the estimated change in tax burdens due to the tax provisions in the "American Family Tax Relief Act" (S. 2), sponsored by Senators Roth and Lott. The Act includes IRA, child credit, and capital gains provisions. This table assumes: i) the IRA provision would have the same distributional impact as that of the backloaded IRA and spousal IRA in the "Contract with America"; ii) the child credit provision is the same as that in the "Revenue Reconciliation Act of 1995" and iii) the capital gains provision is the same as that in the "Revenue Reconciliation Act of 1995" except indexing is not delayed. The Act also includes estate and gift tax provisions which are not included in the table

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(3) The change in Federal taxes is estimated at 1996 income levels but assuming fully phased in law and long-run behavior. The effect of the IRA proposal is measured as the present value of tax savings on one year's contributions. The incidence assumptions for tax changes is the same as for current law taxes.

(4) Families with negative incomes are included in the total line but not shown separately.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

June 2, 1997

**MEMORANDUM FOR SECRETARY ROBERT E. RUBIN**
**DEPUTY SECRETARY SUMMERS**

**FROM:** **DON LUBICK**
**ASSISTANT SECRETARY (TAX POLICY)**

**SUBJECT:** Memos on Tax Issues

The following package contains seven memos addressing different aspects of the tax package. They are: AMT reform, capital gains indexing, the home office deduction, small business capital gains tax preferences, refundability of the Kidsave credit, costs of our proposed package over the second 10-years, and distributional effects of the proposed package.

Ncc to RER
Ncc to LS
Ncccc to JBV
MF
SS
6/2/97 MG

Please
Log
In

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

May 30, 1997

**MEMORANDUM FOR SECRETARY ROBERT E. RUBIN**
**DEPUTY SECRETARY SUMMERS**

**FROM:** **DON LUBICK** DCL
**ACTING ASSISTANT SECRETARY (TAX POLICY)**

**SUBJECT:** Reforming the Alternative Minimum Tax

In the absence of policy changes, the number of taxpayers that pay taxes because of the AMT (as opposed to the regular income tax) will increase by roughly 25 percent per year: from 0.9 million in 1997 to 2.4 million in 2002 to 8.4 million in 2007. The taxpayers who are thrown onto the AMT will increasingly be taxpayers who are not traditionally viewed as aggressive or abusive of the tax system. The items that will force taxpayers onto the AMT are state and local tax deductions, personal exemptions, and the standard deduction; these are not the tax preferences that the AMT was designed to limit. Forcing many millions of taxpayers to fill out a very complicated tax for a parallel tax system will infuriate most taxpayers and may put in peril the survival of the whole progressive tax system.

The main components of our proposed reforms are (1) index AMT exemption at 2002 levels, (2) allow personal exemptions and the standard deduction to be deducted under the AMT, and (3) allow personal credits (e.g., child-care credit, and the proposed HOPE and child credit) to offset AMT liability. The cost of the proposal would be limited by delaying the effective date until 2003.

There are two major political problems associated with AMT reform. First, because so many taxpayers will be affected by the AMT in the future, the long-run costs of solving the problem are high and the solution disproportionately benefits higher-income taxpayers. The distributional consequences are driven by the fact that the AMT has a $45,000 exemption, which eliminates most low-income taxpayers. Even so, rough preliminary calculations suggest that half the benefit of the proposed AMT reforms in 2007 would accrue to taxpayers with adjusted gross income under $110,000 (in 1997 dollars). Second, because the costs of the AMT increase sharply over the 10-year budget window, tackling the problem makes it more difficult to challenge Congressional Leadership proposals with the criticism that costs explode in the out years.

Strategy

Given the impending AMT problem, there are three policy options.

o **Drop the AMT reform proposal altogether**. OTP opposes this option, because tackling the problem will get increasingly expensive over time, and as more taxpayers get affected by the AMT, support for the income tax is likely to erode. Moreover, by not tackling the problem now, there will be irresistible pressure for future tax cuts (to fix the AMT problem), with resulting pressure to reduce spending and/or increase the deficit. Over time, the AMT is likely to generate resentment that will be easily exploited by those wishing to "rip the tax system out by its roots."

- o **Embrace the proposed reform.** To do so will require a willingness to make the (conceptually correct) argument that AMT reform is unlike most of the other tax cut proposals in the balanced-budget package. In contrast to capital gains tax cuts or the exploding costs of backloaded IRAs, the rapidly increasing cost of the AMT arises largely from a rapidly increasing number of taxpayers being subjected to the AMT. In contrast, rapidly increasing costs of capital gains tax cuts come from large benefits being granted to relatively small number of taxpayers. Put differently, most of the cost of AMT reform comes from relieving taxpayers from paying a tax in the future that they do not currently pay and may not even know exists. A second argument is that the AMT, if left unreformed, will reduce the value of the child credit and HOPE credit, so to make these initiatives work correctly, the AMT must be changed.

- o **Adopt a middle (though closer to doing nothing) approach.** If the AMT reform package drops indexing and keeps the personal exemption as an AMT preference item (so it eliminates the standard deduction as a preference, eliminates deadwood provisions, allows personal credits to offset AMT liability, and eliminates ties between the parent's AMT return and the kiddie-tax child's AMT return), the package is inexpensive ($5.3 billion in the second five years) and does not explode. This solution <u>does not</u> solve the future AMT problem, but does buy some simplification.

We would welcome your guidance about which AMT approach we should take in our package.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

June 2, 1997

**MEMORANDUM FOR SECRETARY ROBERT E. RUBIN**
**DEPUTY SECRETARY SUMMERS**

**FROM:** **DON LUBICK** DCL
**ACTING ASSISTANT SECRETARY (TAX POLICY)**

**SUBJECT:** Capital Gains Indexing

The Office of Tax Policy is opposed to indexing capital gains as part of the tax bill. Doing so, particularly in combination with a capital gains exclusion, would bestow inappropriately large benefits on high-income taxpayers, adds to the incentive to form tax shelters and significantly increase the complexity of the tax system. For similar reasons, the New York State Bar Association has "strongly opposed" indexing both in testimony and several reports submitted to Congress. For example, they stated in a 1995 report sent to Mr. Archer that:

> The indexation proposals currently before Congress are fundamentally flawed. The proposals would: permit unwarranted tax avoidance and revenue loss; potentially result in the mass marketing of tax shelters to well advised and high income taxpayers, as in the 1980's; and vastly increase the burden and complexity of the tax system for all taxpayers, as well as the IRS, at a time when many believe that its complexity has already brought it near the breaking point. Moreover, even if a theoretically sound system of indexation could be developed, the additional complexities that would be necessary to do so would completely overwhelm taxpayers and the IRS.

**Principal problems with indexing**

**Double benefit.** One of the principal arguments for a capital gains exclusion is that part of the gain represents the effects of inflation and does not constitute real income. Thus, including both indexing and a capital gains exclusion (or separate rate schedule) in a package would overcompensate for the effects of inflation.

**Out year costs.** Treasury estimates that the indexing provisions in S.2 (indexing on top of a 50 percent exclusion) would add **$40 billion** to the $53 billion ten-year cost of a 50 percent capital gains exclusion. Thus indexing on top of an exclusion, is very costly (3 percent compounded over 10 years is 34 percent, over 20 years it is 81 percent). Revenue losses from indexing are exacerbated beyond the simple effect of compounding because with indexing, a portfolio will have a larger share of assets with no inflation-adjusted gain. Thus, taxpayers will have more opportunity to choose to sell only assets with no realized gains, and hence no tax due.

**Complexity.** Any indexing proposal, whether in conjunction with an exclusion or by itself, will introduce significant new complexity into the law. Under current law a taxpayer can generally compute the gain from the sale of an asset simply by comparing the amount received from the sale to the cost of the asset. The date an asset was purchased is relevant only in determining whether any gain is long term or short term--if the asset has been held for more than one year the gain is long term and the acquisition date of the asset (and any related improvements) is entirely irrelevant. Under an indexation system, a taxpayer would need to know the date on which an asset was acquired <u>and</u> the date on which any significant improvements were made to the asset. This adds significant complexity to many common situations, as noted by the New York State Bar Association in its testimony before the Finance Committee in 1995: "Activities that are relatively simple today will involve massive calculations under indexing -- buying and improving a home, buying and selling stock, or buying an interest in a mutual fund. You could not invest in a simple dividend reinvestment plan without an accountant." The problems are considerably greater in the case of pass-through investment vehicles (including partnerships, S corporations, real estate investment trusts, and mutual funds). Finally, only certain types of assets typically qualify for indexing, thereby placing additional pressure on distinguishing similar types of assets. For example, debt instruments typically are not indexed, making the distinction between debt or equity more important.

The indexation proposals in recent Republican bills address these concerns with a series of uneasy compromises at best. These compromises are likely to lead to uneconomic transaction motivated solely by the desire to benefit from indexation in inappropriate ways. Capital gains are indexed in the U.K. tax system, but the system allows roughly $20,000 of realized capital gains (per married couple) to be exempt from taxation, so the complexity of indexation is avoided by exempting capital gains from taxation for most taxpayers.

**Arbitrage.** Any form of preferential treatment for capital gains creates the potential for arbitrage and distorts investment incentives in favor of assets qualifying for the preference. Whether the indexation of basis results in greater incentives for arbitrage than a capital gains exclusion depends upon the size of inflationary long-term gains relative to nominal long-term gains. For example, if inflationary gains are more than half of nominal gains, indexing generally creates greater arbitrage potential than a 50 percent exclusion. The Joint Tax Committee staff recently published a table showing that, for assets held for several years and sold in 1994, the inflationary component was generally above 40 percent of nominal gains.

The easiest forms of arbitrage involve borrowing to invest in the tax-favored assets. In the absence of special provisions, the interest expense associated with the borrowing is fully-deductible at ordinary rates while the income on the tax-favored asset is taxed at lower rates. As a result, taxpayers can make money on an after-tax basis from investments that lose money on a pre-tax basis.

> <u>Example</u>: Under current law the highest rate of tax on ordinary income is 39.6 percent. The highest rate of tax on capital gains is 28 percent. A taxpayer borrowing $10,000 at 10 percent to invest in a capital asset that earns a return of 9 percent would lose $100 on

a pre-tax basis. On an after tax basis, in the absence of anti-arbitrage rules, the same taxpayer would be $44 ahead (the $1,000 interest deduction would reduce tax liabilities by $396 while the 900 capital gain would produce tax liabilities of $252; the net $144 tax savings would more than offset the $100 pre-tax loss). Note: Lenders are often tax-exempt, so that interest income is not taxed.

The Internal Revenue Code already contains a number of complex provisions intended to prevent (or at least deter) such arbitrage transactions. None of the provisions work perfectly. As discrepancies between the treatment of ordinary income and capital gains are increased, the incentive to engage in arbitrage increases correspondingly, with the result that more pressures are placed on the existing rules and new rules need to be considered.

**Price index.** Typically, CPI is used in the Tax Code to adjust for inflation. Given the recent controversy surrounding CPI's accuracy as a measure of inflation, we would need carefully to consider whether its use would be proper for capital gains indexing.

1997-SE-007249

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

July 3, 1997

U.S. House of Representatives
Washington, D.C. 20515

Dear Conferee:

We are pleased that substantial progress has been made toward implementing the terms of the historic bipartisan budget agreement between the President and the Congress. We look forward to continuing bipartisan cooperation as we work together to produce a tax-cut package that fulfills the agreement and best serves the American people. To that end, I would like to share with you the Administration's views on major issues in conference on the tax portions of revenue reconciliation. In addition, we expect to communicate further with you regarding provisions not addressed in this letter.

In general, as we have previously indicated, the Administration strongly believes that any tax-cut package must meet four basic tests to reflect sound policy. First, the tax cuts must be fiscally responsible by avoiding an explosion in revenue costs in later years. Second, the tax cuts must provide a fair balance of benefits for working Americans. Third, the tax cuts must encourage economic growth. Fourth, the tax package must reflect the terms of the bipartisan budget agreement, including a significant expansion of opportunities for higher education for Americans of all ages. Neither bill meets these tests.

While the Senate bill is an improvement over the House bill, both bills provide too little tax relief to middle-income families. In both the House and Senate bills, the middle sixty-percent of families receive just one-third of the tax cut; these families would receive twice as large a share under the President's proposal.

**Education Tax Incentives**

We are pleased that each bill contains a version of the President's HOPE Scholarship proposal. Nonetheless, both the House and Senate bills are inconsistent with the bipartisan budget agreement because they fall far short of meeting the specific agreement of providing roughly $35 billion over five years of higher education incentives along the lines of the President's HOPE Scholarship credit and tuition deduction proposals.

While the HOPE Scholarship credit as modified in the Senate bill is an improvement over the version in the House bill, each bill significantly reduces the value of education benefits for millions of students attending low-cost institutions by cutting the percentage of expenses covered by the credit (50% in the House bill, 50% to 75% in the Senate bill).

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

July 3, 1997

United States Senate
Washington, D.C. 20510

Dear Conferee:

We are pleased that substantial progress has been made toward implementing the terms of the historic bipartisan budget agreement between the President and the Congress. We look forward to continuing bipartisan cooperation as we work together to produce a tax-cut package that fulfills the agreement and best serves the American people. To that end, I would like to share with you the Administration's views on major issues in conference on the tax portions of revenue reconciliation. In addition, we expect to communicate further with you regarding provisions not addressed in this letter.

In general, as we have previously indicated, the Administration strongly believes that any tax-cut package must meet four basic tests to reflect sound policy. First, the tax cuts must be fiscally responsible by avoiding an explosion in revenue costs in later years. Second, the tax cuts must provide a fair balance of benefits for working Americans. Third, the tax cuts must encourage economic growth. Fourth, the tax package must reflect the terms of the bipartisan budget agreement, including a significant expansion of opportunities for higher education for Americans of all ages. Neither bill meets these tests.

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Neither bill includes a widely available tuition deduction or credit to help beyond the first two years of higher education that is consistent with the tuition deduction in the President's budget proposal. We are particularly concerned that neither bill significantly promotes life-long learning, which we believe is a critical component of education in our changing economy. In addition, neither bill offers low-income students and students who work to pay tuition meaningful help beyond the first two years of higher education. Instead, the bills require taxpayers to have the funds available to put into savings in order to be entitled to any assistance other than for the first two years.

We also object to the education IRAs and prepaid tuition account provisions of both bills. These provisions fail to place sufficient limits on the income of contributors, the amounts contributed, and the uses of funds to ensure that the tax benefits go to those who need real relief from the costs of higher education. Because most workers already have an opportunity to contribute to tax deductible IRAs and the President has proposed to allow penalty-free IRA withdrawals to be used to finance higher education expenses, the education IRAs and prepaid tuition plans in the House and Senate bills will largely become vehicles to provide tax breaks for saving by upper income taxpayers that would have occurred anyway. We also object to the provision in the Senate bill that allows tax-free withdrawals from these accounts for primary and secondary school tuition, because it provides Federal subsidies to parents who send their children to private elementary and secondary schools.

Overall, as compared to the President's proposals, both packages direct more benefits toward upper-income families while reducing the benefits to lower-income families, particularly those who rely on their earnings to finance higher education. The packages are clearly inconsistent with the bipartisan budget agreement.

**Administration Position**:

HOPE Scholarship and 20 percent Tuition Credit: The Administration remains strongly committed to the principle that the education tax incentives must be fair, must genuinely expand educational opportunities for Americans, and must promote life-long learning. To accomplish these objectives, the Administration believes the conferees should provide roughly $35 billion over five years for higher education by adopting the HOPE Scholarship, which gives a credit of 100 percent of the first $1,000 of tuition and fees, and 50 percent of the next $1,000 in 1998 through 2002. Students must attend school at least half time in the first two years of a post-secondary degree or certificate program. If a student is not eligible for the HOPE Scholarship but is pursuing a post-secondary degree or certificate or is enrolled in classes to improve job skills, a 20-percent credit for tuition and fees up to $5,000 through 2000 and $10,000 thereafter should be granted.

This proposal addresses Congressional concerns in two ways: it lessens concerns about tuition inflation by limiting the marginal subsidy of the HOPE Scholarship to 50 cents on the dollar (rather than dollar for dollar) for students with tuition between $1,000 and

$2,000. It also increases the progressivity of the tuition deduction by converting it into a 20-percent credit.

Administration Position on Other Features in the Education Packages

In addition to providing $35 billion for the HOPE Scholarship and 20-percent tuition credit, the Administration believes that the tax package should do the following:

- Adopt proposals to aid K-12 public school construction (and other activities) in poor neighborhoods.
- Make permanent the exclusion of employer-provided educational assistance from taxable income and extend the exclusion to graduate education (Section 127).
- Adopt a student-loan interest deduction and a loan forgiveness exemption similar to those contained in the Senate bill.
- Provide tax incentives to help public elementary and secondary schools obtain up-to-date computer technology.
- Include a proposal to repeal the $150 million bond cap for new capital expenditures by private colleges and universities.

**Child Credit**

We are pleased that both the Senate and House bills include credits for families with children. We are deeply concerned, however, that relative to the President's proposals, the Senate bill denies the child credit to 3.8 million low-income, working families who earn less than $30,000, and the House bill denies the credit to 4.8 million of these working families. These families pay significant payroll and other federal taxes, and deserve a child credit to help raise their children just as much as other families. Accordingly, we object to stacking any portion of the child credit after the earned income tax credit unless the child credit is fully refundable. We note that both the 1995 Balanced Budget Act passed by Congress and the legislation introduced by Majority Leader Lott (S.2) this year, stacked the child credit before the EITC, as did the Democratic alternatives drafted by Representative Rangel and Senator Daschle. The Democratic packages also contained refundability features consistent with the Administration's proposal. In addition, we have a major objection to the provision in the House bill that would reduce tax benefits for many working families who are entitled to a tax credit for their child-care expenses under current law.

**Administration Position**: The Administration believes the child credit should be stacked before the EITC. The $500 child credit ($400 in 1998) should be available for children under 17 through 2002 and under 19 thereafter. In addition, the child credit should be refundable to the extent that the family's payroll taxes exceed their earned income tax credit. The credit should be accompanied by an optional Kidsave Account that allows parents the option to contribute up to the amount of the credit plus $500 per child to a nondeductible, backloaded IRA-type savings vehicle. Under this proposal earnings could be distributed tax-free for a child's post-secondary education or purchase of a first home, or for the parent's retirement, and the income limits would be the same as in the President's proposal (phased out between $60,000-$75,000 through 2000, and $80,000-$100,000 thereafter). The child credit and its income thresholds should be indexed for inflation.

We note that the Senate adopted Senator Kohl's amendment to provide new incentives to expand the availability of licensed, accredited day-care facilities for working parents. Improving the quality and availability of child care for working families is an objective we share.

**Capital Gains Relief**

We are pleased that both the Senate and House bills contain the President's proposal to exclude up to $500,000 of capital gains from home sales. The Administration has recently announced its intention to expand the scope of existing provisions for targeted small-business capital gains relief. We are pleased that the Senate bill incorporates a provision that is, in many respects, consistent with our proposal, although we have concerns about certain aspects of the Senate version.

We object to the additional across-the-board capital gains relief in both bills, which is too generous and would disproportionately benefit the wealthy over lower- and middle-income wage earners. Moreover, we are opposed to indexing capital gains as is done in the House bill. Indexing would contribute to an explosive revenue cost after 2007, possibly jeopardizing all our important work on deficit reduction. In addition, indexing is enormously complex and would be difficult to administer. We also object to the provision in the House bill for corporate capital gains relief, which is unwarranted and unlikely to create any significant economic growth.

**Administration Position**: The Administration urges the conferees to provide a 30-percent exclusion for long-term capital gains. This reduces the top rate on capital gains to 27.72 percent for taxpayers in the 39.6 percent bracket. The President's proposal reduces the tax rate to 19.6 percent for taxpayers in the 28 percent bracket and reduces the tax rate to 10.5 percent for taxpayers in the 15 percent bracket. The proposal would include the President's home sale provision and targeted small-business capital gains relief.

**Alternative Minimum Tax Relief**

We are pleased that the House bill incorporates a version of the President's proposal to exempt small corporations from the AMT. We also acknowledge the importance of provisions in each bill designed to compensate for the previous lack of indexing of the individual AMT exclusion for inflation. We object, however, to the House provision that would provide $22 billion over five years in unwarranted AMT relief for large corporations.

**Administration Position**: The House provision for AMT relief for large corporations should not be adopted.

**IRAs and Other Savings Incentives**

The Administration continues to believe strongly in the importance of encouraging savings, particularly for retirement and education, and supports the IRA concept. The President's proposal includes a new saving vehicle targeted toward middle- and lower-income families, allowing parents to contribute to Kidsave accounts for their children's education, first-time home purchase, or the parents' retirement. The Administration's proposal would also encourage increased savings by middle- and lower-income families by making existing IRAs more flexible.

We believe it is important that new savings incentives be sufficiently targeted in order to ensure they generate new savings and to provide savings for those who need them most. The back-loaded IRAs in both the Senate and House bills are not sufficiently targeted to lower- and middle-income families. The lack of income limits for contributors to these back-loaded IRAs compounds the out-year cost explosion. Out-year explosion of revenue cost is inconsistent with the bipartisan budget agreement. Because most workers can contribute to tax-deductible IRAs, the new provisions will largely displace saving that would have otherwise occurred by upper income taxpayers. Targeted incentives such as the Administration's optional Kidsave proposal will be more successful in significantly increasing new saving. The back-loaded IRA provisions contained in the Senate and House bills also add significantly to the problem of unfair distribution of tax benefits.

**Administration Position**: The current structure of IRAs should be continued with the following modifications. Penalty-free withdrawals from existing IRAs should be allowed to finance higher education expenses, for first-time home purchases, and for certain other limited purposes. Optional Kidsave accounts should be provided for taxpayers who are entitled to a child credit, with contributions limited to the amount of the child credit plus $500 per child.

**Estate Tax Relief**

We are pleased that both the Senate and House bills have included versions of the Administration's proposal to provide liquidity relief for estates containing small businesses and farms. We object, however, to the sweeping estate tax relief in both bills because it is too expensive and will be of no benefit to average Americans. It contributes to the problem of exploding out-year costs. We also object to the provisions in the Senate bill that would allow inappropriate tax-planning opportunities by providing special estate and gift tax treatment for pre-paid tuition plans and an estate tax exclusion for conservation easements. Further, the unlimited repeal of the so-called "throw-back" rules in the House bill would allow certain trusts that are already tax-advantaged to reap additional, unwarranted tax benefits. We believe that estate and gift tax relief is most productively targeted to owners of small businesses and farms, along the lines of the small-business and farm provisions in the Senate bill.

**Administration Position**: The Administration believes a special exemption should be given for $900,000 of value in a qualified farm or small business in addition to the $600,000 value of the unified credit; the value of estates eligible for liquidity relief should be included as proposed in the Administration's FY 98 budget. The throw-back rules should be repealed, but the status quo should be retained under the throw-back rules for the pre-1984 trusts that are already entitled to a special exemption from the multiple trust rules.

**Distressed Areas and Urban Tax Initiatives**

The May 15, 1997 letter to the President from Speaker Gingrich and Majority Leader Lott pledged to seek inclusion of the President's proposals intended to revitalize distressed urban and rural areas throughout the country. We object to the inclusion in the Senate and House bills of only very limited aspects of some of these initiatives, and omission of other important initiatives altogether. For example, the President's brownfields proposal, which provides a tax incentive for environmental cleanup and encourages economic development in formerly contaminated areas, has been strongly supported in urban and rural communities and by the Nation's mayors. In addition, while we are pleased the House included a modified version of the President's welfare-to-work tax credit proposal, we are disappointed the Work Opportunity Tax Credit (WOTC) contained in both the House and Senate bills allows employers to claim the WOTC for hiring workers for a very short period of time and does not expand the Food Stamp target group in the WOTC to cover childless, able-bodied adults ages 18-50 who are subject to the Food Stamp time limit and work requirements.

We are also pleased that both the Senate and House bills include tax incentives for the District of Columbia, but we have significant concerns with specific proposals in both bills. We look forward to working with you to pass a package of D.C. incentives that will be of greater benefit low-income District residents.

**Administration Position**: The tax bill should include the following provisions to help address the problems of distressed areas and our cities.

- Include the President's D.C. incentives.
- Provide tax incentives to clean up brownfields in distressed communities across the United States.
- Expand Empowerment Zones and Enterprise Communities.
- Stimulate investments in Community Development Financial Institutions.

While we would support the House provision on the enhanced welfare-to-work tax credit for long-term welfare recipients, the credit should be changed to 50 percent for both years. In addition, we would make no change in the current structure of the WOTC regarding number of hours or credit structure, and would expand the Food Stamp target group to cover the 18-50 year olds. The package should also include provisions to facilitate restructuring our Nation's affordable housing portfolio, and provide tax incentives for new economic activity in Puerto Rico.

**Superfund**

Consistent with the President's 1998 budget, the Administration supports the extension of the current Superfund taxes through 2007 in order to fully carry out the President's initiative to achieve clean-up at two-thirds of the national priority list sites by the year 2000. Funding for this initiative was a protected priority under the bipartisan budget agreement.

**Independent Contractors**

We object to provisions such as those in the House bill that would provide a new safe harbor for independent contractor status. These provisions would permit employers to avoid essential worker protections and could lead to widespread shifting of employees to independent contractor status, resulting in loss of worker protections such as pension and health coverage, and wage and hour protections, unemployment insurance benefits and compensation for work-related injuries. An issue of such significance requires much deeper and fuller study and input from all affected parties.

**Administration Position**: Do not include provisions on independent contractor status.

**Extension of Airport and Airways Trust Fund Taxes**

We object to the changes in the structure of the airport and airways taxes made in the House and Senate bills. Just last year Congress directed the creation of the National Civil Aviation Review Commission to perform a thorough analysis of the costs of providing FAA services to ensure that any new fee structures would reflect the use of those services. Both the House and the Senate bills would set new fee structures without the benefit of the Commission study. These proposed fee structures could have enormous unintended consequences for the U.S. airline industry.

**Administration Position**: Extend the current airport and airways trust fund taxes so the National Civil Aviation Review Commission has sufficient time to study the issue. When it has completed its work, its findings should be taken into account in modifying or amending these taxes.

**Tobacco Tax**

The Senate bill contains a provision to raise tobacco taxes by 20 cents a pack, using part of the tax to fund children's health care. We have a significant concern about the use of the revenues from this tax. All of these revenues should be committed to benefit children and health care, and not to pay for tax cuts. We are also concerned that the funding for children's health derived from the tobacco tax sunsets in FY 2002. We urge the conferees to continue funding for children's health beyond FY 2002.

> **Administration Position**: We support a 20-cent increase in the tobacco tax – we agree that it complements the budget agreement – and we endorse the idea of using all of the revenues raised by such an increase for initiatives that focus on the needs of children and health. We urge the Conferees to invest all of these funds wisely in order to ensure meaningful coverage for millions of uninsured children.

**The Deductibility of Health Insurance Premiums**

The Administration does not support the proposal included in the Senate bill to increase deductibility of health insurance premiums for the self-employed to 100 percent by 2007. It is unlikely that parity between the tax treatment of health insurance costs for employees and for self-employed individuals would result from increasing the tax deductibility of health insurance premiums for the self-employed to 100 percent. Since it is typical for employers to pay for only a portion of their employees' (or retirees') health care costs, the rest often is paid by employees and former employees in the form of after-tax contributions. The increase to an 80-percent deduction that the Administration supported in HIPAA will come closer to providing rough parity between employees over their careers and self-employed individuals than a 100-percent deduction for self-employed individuals. The Administration believes that HIPAA addresses this issue in an appropriate way and will continue to work in support of proposals that expand health insurance coverage in an equitable manner.

**Explosion of Costs in Out Years**

As discussed in the May 15, 1997 letter from Speaker Gingrich and Majority Leader Lott, tax provisions of the budget reconciliation bill "shall not cause costs to explode in the outyears." This statement notwithstanding, the net tax cuts called for in the House bill increase to $40.9 billion in 2007 from $29.7 billion in 2004. The net cuts in the Senate bill increase to $41.1 billion in 2007 from $29.0 billion in 2004. This trajectory of revenue loss is not the inevitable consequence of the tax cuts specified in the bipartisan budget agreement. The net cuts in the President's proposal, for example, only increase from $30.5 billion in 2004 to $34.1 billion in 2007.

The tax items causing out-year costs to increase sharply are those that disproportionately benefit high-income taxpayers. In contrast, provisions that benefit middle-income families, such as the President's education proposals and the child credit, over time become much less significant in the overall revenue loss under the House and Senate bills. Over the first five years, education and child credit provisions account for 84.5 percent of the total tax cut in the President's proposal, 72.1 percent in the House bill, and 70.4 percent in the Senate bill. By 2007, these provisions account for 83.3 percent of the total tax cut in the President's package, but only 38.1 percent in the House bill and 43.2 percent in the Senate bill. While the significance of provisions targeted toward middle-income families diminishes over time in the Congressional packages, the cost of provisions disproportionately benefiting high-income individuals explode. The capital gains, AMT, savings and estate tax provisions increase from 10.8 and 12.4 percent of the total gross tax cuts in the House and Senate bills respectively over the first five years to 55.4 and 53 percent respectively of the total gross tax cuts in 2007. The rapid growth in the cost of these provisions between 2003 and 2007 causes us to be greatly concerned about the cost of the Congressional packages beyond the ten-year budget window.

## Simplification

The Administration is strongly committed to simplifying the tax laws and enhancing taxpayers' rights. In April, we released a revenue-neutral package of some 60 measures designed to further these objectives. We are pleased that 48 of these proposals are reflected in measures included in the House or Senate bills. We urge the conferees to give careful consideration to the remaining simplification measures in the Administration's package, such as the equitable tolling proposal that would protect the rights of disabled taxpayers, the proposal to simplify the child dependency exemption rules, and the proposal to modify the rules that apply to financial hedging transactions.

We are concerned that the sheer multitude of miscellaneous tax code amendments, many with little policy merit, contained in the House and Senate bills will contribute significantly to complexity for taxpayers and tax planners. For instance, a provision in House bill would change the current 110 percent safe harbor for estimated taxes to 109 percent for 1997, to 105 percent for 1998, and back to 110 percent thereafter. This provision is simply a budget gimmick to artificially shift revenues among fiscal years; it will significantly increase complexity for taxpayers who must cope with the changing rules.

We urge that all proposals being considered for inclusion in the conference agreement be carefully analyzed from the standpoint of avoiding needless complexity. Treasury and IRS staff would be pleased to work with Congressional staff on a technical level to simplify and improve the administrability of provisions under consideration.

## Other Issues of Concern

The Administration is pleased that the House and Senate bills include a provision for foreign sales corporation treatment for software licensed abroad. We are also pleased that both the House and Senate bills recognize the importance of the continued assurance of tax benefits for ethanol to encourage the use of alternative fuels. Earlier this year, the Administration proposed extension of the excise tax exemption for ethanol in our ISTEA reauthorization proposal. We would support the Senate bill extending the incentives through 2007, but without phasing down the rates of the benefits. We also oppose the new scorekeeping language included in the House bill.

The House and Senate bills contain other provisions, however, that raise significant concerns. For instance, the Administration has serious concerns about the provision in the Senate bill transferring the 4.3 cents per gallon in fuel taxes currently dedicated to deficit reduction from the General Fund to transportation trust funds. While the transfer provision in itself has no revenue or spending effect, transferring the revenue may spur efforts to move the trust funds off-budget and create pressure to increase ground transportation spending to levels significantly higher than contemplated by the bipartisan budget agreement.

The Administration encourages the Senate to recede to the House regarding the Generalized System of Preferences. While we find the current language in the House bill unacceptable, the Administration looks forward to working with the conferees on language providing enhanced benefits to nations involved in the Caribbean Basin Initiative.

The Administration also has technical and/or policy concerns about a number of other provisions in the House and Senate bills, including, for example: the provision in the House bill that extends reporting and proxy tax requirements for political and lobbying expenditures; the treatment of corporate spin-offs within a consolidated group under the House bill's provision relating to so-called "Morris Trust" transactions; and the provision that removes controlled foreign corporations from the application of the passive foreign investment company rules. We will be communicating with you further about such issues in the future. We believe by working together, our staffs should be able to address many of these problems, and we strongly urge the conferees to authorize the staffs to begin working on such issues as soon as possible.

Both the Senate and House bills are heavily laden with special-interest provisions, such as a special exemption from U.S. income tax for foreign seafarers, special tax benefits for vacation timeshare associations, new tax benefits for friends and family riding corporate jets, and special treatment of travel and meals expenses for targeted groups of taxpayers. We believe that it is inappropriate to use this reconciliation bill as a vehicle for new tax breaks for special interests. We urge the conferees to keep the revenue reconciliation bill clean of all special-interest provisions.

As the revenue reconciliation bill proceeds to conference, we remain eager to work with the Congress on a bipartisan basis to fashion, and ultimately sign, tax-cut legislation that is faithful to the bipartisan budget agreement, meets the four tests outlined at the beginning of the letter, and is fair to all Americans.

Sincerely,

Robert E. Rubin

Robert E. Rubin

1997-SE-010527

September 12, 1997

Memorandum to: Secretary Rubin
Deputy Secretary Summers

From: Alan Cohen
Senior Advisor

David Wilcox

Subject: Impact of "Transferring Budget Surpluses to Social Security

Both OMB and CBO are projecting unified annual budget surpluses beginning in 2002 and continuing for some time thereafter. The suggestion has been made that these surpluses be transferred to the Social Security Trust Fund. The question arose: what impact would this proposal have on the Trust Fund's solvency.

To answer this question it was assumed that these surpluses would grow until 2010 and then diminsh each year until they reached zero near 2020. This pattern is similar to the pattern shown in the analysis in the President's FY 1997 budget of the impact of enacting the policies in the President's February budget.

If the "transfer" proposal were executed beginning in 2002 with the OMB projected surpluses, the life of the OASDI trust fund would be extended from 2029 to 2041. The 75-year actuarial deficit would be lowered from 2.23 to 1.53 percent of payroll if the transferred surpluses earn the government interest rate assumed by the Trustees (2.7 percent real). This is a reduction in the actuarial deficit of approximately one-third. The augmented trust fund would peak at 516 percent of annual outlays in 2016 (see attached table).

Using CBO's surplus estimates, the exhaustion date would be 2035 and the actuarial deficit would be reduced to 1.87 percent of payroll, a reduction of about one-sixth.

Alternatively, the surpluses could be <u>partially</u> invested in equities that earn the same real return assumed by the Advisory Council (7 percent). Under this scenario, half the trust fund addition created by transferring the surpluses would always be invested in equities and half always in government bonds, for an effective real return of 4.85 percent on this "increment" to the trust fund. In this alternative, the augmented trust fund would be exhausted in 2054 -- about 25 years later than the current projection -- assuming the OMB surplus estimates. The actuarial deficit would be reduced to 0.52 percent of payroll for the OMB estimates of the surpluses, a drop of about three-fourths. Using the CBO surpluses, the exhaustion date would be delayed about 10 years (to 2039) and the actuarial deficit would be reduced to 1.29 percent of payroll, about a 40% decline.

**Caveats:**

1. It is true that:

   a. Preserving the currently projected surpluses in the unified budget will help our long-run fiscal position in at least four ways -- as described in Alan Cohen's earlier memo and

   b. "Transferring" these surpluses to the Social Security Trust Fund may provide political fortification against those who would seek to dissipate the surpluses in one way or another

**However, "transferring" the surpluses to the Social Security Trust Fund -- in and of itself -- does nothing to improve the fundamental fiscal health of the overall Federal government (social security plus non-social security).** This statement is true notwithstanding the fact that transfers of the type described here would push back the exhaustion date of the social security trust fund. Why? Because the transfers would neither raise the volume of taxes collected from the public, nor cut the volume of expenditures, and it is the levels of taxes and expenditures that determine the long-term fiscal health of the overall government.

2. Transferring general revenues equal to the unified surplus would be arbitrary because such transfers are not directly related to the surpluses currently projected to accumulate in the Social Security trust fund.

NEC to [illegible] ([illegible])

NEC cc to LS [illegible]

NEC cc to MF SS

9/2/97

please [illegible]

## Transferring Unified Surpluses to the Social Security Trust Fund

| | | Govt. (2.7% real) | | Mixed* (4.35% real) | |
|---|---|---|---|---|---|
| *Effect on OASDI Trust Fund* | *1997 TR*[1] | *CBO* | *OMB* | *CBO* | *OMB* |
| Year of trust fund exhaustion | 2029 | 2035 | 2041 | 2039 | 2054 |
| Increase (years) | --- | 6 | 12 | 10 | 25 |
| 75-year actuarial deficit** | 2.23 | 1.87 | 1.53 | 1.29 | 0.52 |
| Reduction in deficit** | --- | 0.35 | 0.70 | 0.94 | 1.71 |
| Peak trust fund ratio*** | 265 | 389 | 516 | 406 | 561 |
| Year of peak | 2011 | 2015 | 2016 | 2015 | 2017 |

1. TR means Trustees' Report

*Assumes fund increment created by transfer is held in equal amounts at a 2.7% and 7.0 % real return.

** Percent of payroll.

*** Trust fund as a percent of annual outlays.

*Source: SSA-OACT; Sept. 8, 1997.*

1997-SE-010528

September 12, 1997

Memorandum to: Secretary Rubin
Deputy Secretary Summers

From: Alan Cohen

Subject: Budget Surpluses: New Developments

1. Impact of "Transferring" Budgetary Surpluses into the Social Security Trust Fund

Per your request, the attached memo and table provide very rough estimates of the impact on the solvency of the Social Security Trust Fund of "transferring" unified budget surpluses into that Trust Fund. The numbers suggest that such a transfer could have a sizeable impact on delaying Social Security insolvency.

2. Senate Developments on Use of the Surpluses

Senators in the Senate Democratic Leadership have begun discussing what to do with the unified surpluses. Several Senators have suggested the possibility of "transferring the surpluses" into the Social Security Trust Fund. Discussions thus far have been on an ad-hoc basis. Senator Dorgan prefers to put all of the surpluses in the Social Security Trust Fund. Senator Conrad is concerned about the political power of Congressman Shuster's proposal to increase spending on highways. Therefore, Senator Conrad has suggested putting only half of the surpluses into the Social Security Trust Fund and the other half into new highway spending. Senator Lautenberg's staff prefers on policy grounds to put all of it into the Social Security Trust Fund, but is also thinking about using of some of the surpluses for tax cuts; they fear that a package without any tax cuts would be trumped by a Republican package with tax cuts. Presumably, Senator Lautenberg would probably want to use some of the surpluses for transportation spending as well.

These developments suggest that the Administration might need to develop its position on the surpluses soon.

3. Senate Floor Action on Surpluses

Senators may have the opportunity to attach amendments relating to the surpluses onto S. 261, an unrelated bill that creates two-year budgeting. This bill has already been reported out of the Senate Governmental Affairs Committee and is currently before the Senate Budget Committee. Even if the Budget Committee takes no action, the bill will be discharged from its jurisdiction on or about October 4th. It will then go on the Senate calendar where it can be brought to the floor at any time. Some reports have said that Senator Lott has stated that he plans to bring it to the floor this fall. Other reports have indicated that Senator Lott does not intend to bring it to the floor. Larry Stein, of Senator Dachle's leadership office, is checking these rumors out and hopes to have more information on Monday.

The importance of the two-year budgeting legislation to legislation regarding budget surpluses is as follows. Budget process legislative amendments in the Senate are subject to a "Section 306" 60-vote point-of-order, **unless the bill they are amending is a bill that "originated" in the Senate Budget Committee**. The two-year budgeting bill - S. 261 - would be treated as such a bill. Thus, amendments to S. 261 relating to other budget process issues -- such as what to do with the surpluses -- would not be subject to the "Section 306" 60-vote point of order. Note that such amendments might or might not be subject to other 60-vote points-of-order, depending on their content; however, even if there were other 60 vote points-of-order, some Republicans might relish having Democrats trying to use a procedural vote to kill an amendment which reserves surpluses for tax cuts.

NCC to REL (reading)

NCC to LS (reading)

NCC to [illegible]

1/2/97

[illegible]

1998-SE-013081

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

November 18, 1998

MEMORANDUM TO SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

FROM: JON TALISMAN JT
DEPUTY ASSISTANT SECRETARY (TAX POLICY)

LEN BURMAN LB
DEPUTY ASSISTANT SECRETARY (TAX ANALYSIS)

RE: ISSUES IN CURRENT BUDGET PROCESS

As we previously have discussed, we have been involved in a series of meetings chaired by NEC staff regarding potential tax cuts for inclusion in the upcoming budget. Attached is a revised list of the potential tax incentive proposals currently under consideration. Although we previously worked with Chuck Marr to cull a number of non-starters from the list, there has been a recent influx of new starters including pension initiatives from the Department of Labor and PBGC and housing initiatives added by HUD. (The addition of new ideas may be difficult for us to criticize as such because we intend to send over a new package of "financial security" initiatives to the White House soon for budget consideration.)

We have the following points about the process:

o A number of the remaining items under consideration are poor tax policy and may not even be good social policy, as discussed more fully below. Continuing to work on these items detracts from our work on more useful and viable budget proposals, development of revenue raisers to pay for any tax package, and regulatory guidance (which is always heavily weighted toward year end). Each budget item requires OTP staff to attend numerous meetings, work with inter-agency groups, develop specifications, address administrability (including systems issues) and compliance concerns, research economic and industry data, and produce revenue estimates.

o A judgment needs to be made by the principals as soon as possible regarding whether they want to include marriage penalty relief. Given the limited availability of viable revenue offsets, inclusion of marriage penalty relief, which costs $10 billion or more over 5 years, will crowd out other budget initiatives. This would help circumscribe the range of proposals being considered.

- o The principals need to determine the themes for this year's budget. Including a wide range of proposals may dilute the message of the budget.

We have outlined below several of the proposals that we are most concerned about:

Small Business Health Purchasing Cooperatives

NEC proposes to create a new tax-exempt entity, called a Small Business Health Benefits Purchaser (SBHBP), which would act as a health insurance broker for small employers. NEC claims that tax-exemption is necessary to induce foundations to make grants to SBHBPs. We have serious concerns about creating such a tax-exempt entity, which will be indistinguishable in many respects from (and compete with) taxable, for-profit insurance brokers. There is no guarantee that the benefits of tax-exemption would flow through to small employers; they may easily translate into bloated salaries and other inefficiencies for the SBHBPs (e.g., creating the opportunity for small employers to shelter investment income from tax). Also, it is unclear that the purported economies of scale to be gleaned by SBHBPs would ever materialize. Moreover, none of the arguments put forth by proponents claim that SBHBPs need a permanent tax subsidy. We would prefer a direct, temporary grant program to help start these coops. That has been proposed in many past budgets, but killed because of opposition from the insurance industry.

We have worked with NEC on alternative approaches, including a tax credit for small businesses not currently offering insurance that start to purchase insurance from a non-tax-exempt small business insurance cooperative.

Lifelong Learning Savings Account

The proposal is intended to create savings accounts to make it easier for adults to finance their own education. The details have not been specified, but options include expanding the current-law education IRA to permit use of savings for an adult's education (or by creating an employer- or union-sponsored account into which contributions could be made tax-free). We have several concerns with the proposal. The proposal will be very ineffective at increasing educational opportunities for the target group -- families whose adult members have little or no post-secondary education. These families are much more likely to be low-income. Low-income families do not have the financial resources to make significant contributions to an education account. Other tax-favored savings vehicles already compete for their limited discretionary savings. Thus, the benefit of the proposal would largely be limited to high-income people, providing a windfall for saving they are already likely doing. Also, this proposal is a superfluous addition to the myriad subsidies for adult education already in the code, including lifetime learning tax credits; section 127, which allows employers to pay for educational expenses as a tax-free fringe benefit; and penalty-free withdrawals from IRAs (of all flavors) for educational expenses.

We have offered several less complex and better targeted alternatives, including expansion of section 127 to include graduate education and speeding up the phase-in for the lifetime learning credit.

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 is targeted at people who the private mortgage market has deemed to be un-credit-worthy–probably for good reason. By lowering the down payment requirement, it will reduce saving among low-income people who would like to be home owners. Moreover, it is unclear why we want to encourage poor people, especially those who cannot save, to purchase their homes. For example, in an economic downturn, these homeowners may be more vulnerable and more likely to lose their homes. Early information suggests delinquency rates for these low down payment mortgages are twice those of conventional mortgages. 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.

FARRM Savings Accounts

This proposal allows farmers a tax-deductible contribution of up to 20% of income each year into a Farm and Ranch Risk Management ("FARRM") savings account. The contributions must be withdrawn after 5 years, but new tax-deductible contributions may be made to replace the withdrawals. The proposal would allow wealthy and profitable farmers to shelter about a year's income from tax indefinitely (by contributing the maximum amount each year for the first five years and rolling over withdrawals as new contributions). It would be worthless to the majority of farmers who do not have taxable income and tend to be highly cash constrained. It would not encourage saving–it is actually a windfall to rich farmers who shift assets from other accounts into these tax-sheltered vehicles.

The Administration strongly opposed adoption of the FARRM accounts during the negotiations regarding the omnibus appropriations bill and prevented the provision from being enacted.

*Existing and recently-enacted tax reforms provide a much more effective and equitable approach to help farmers reduce net income volatility.*

- As a result of Administration-supported tax reforms in the 1998 omnibus bill, farmers can elect to average their farming income over a three-year period, and they 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.)

- Under current law, taxes on certain payments – including "disaster" payments, crop insurance, and proceeds from emergency livestock sales – can be deferred. Thus, current tax law effectively allows extra benefits to farmers from existing and new insurance or relief programs.

# Possible New Tax Cut Proposals

## Health:

- Long-term Care
- Tax Credit for Disabled Workers
- Small business/Cooperative

## Children and Families

- Stay-at-Home Moms (to complement current DCTC proposal)
- Marriage Penalty

## Education and Training

- Work-Site based schools -- literacy
- Lifetime Learning Tax Credit (savings account, increase percentage, accelerate, carry forward)
- Americorps awards and National Health Service Corps medical scholarships
- Scholarships/Grant aid taxation

## Urban - Empowerment

- Green Bonds
- Home Ownership Tax Credit
- CDFI Tax Credit
- Private Activity Bond Cap
- WTW/WOTC longer extensions
- HUD Proposals

## Research and Experimentation Tax Credit

- Expansion -- research consortia
- Small Business feature

## Other:

- AMT Relief Extension
- Employee Telecommuter Expenses
- Steel
- Farmers
- Family Security
- CEQ Land Conservation/Capital Gains
- UI
- Family Security
- Pensions
- Student Loan Interest

(Note: These ideas are in addition to the President's tax cut package)

DI to RER 11/19/98

DI to LS (READING) 11/19/98

cc: MF
SS
NC/DI/PA/AR

PLEASE LOG IN

1999-SE-004660

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

UNDER SECRETARY

**ACTION**

**MEMORANDUM FOR SECRETARY RUBIN**

**FROM:** **Gary Gensler**
**Under Secretary for Domestic Finance**

**RE:** **Memorandum to the President on FY 1999 Budget Surplus**

OMB would like to send a memorandum to the President from Gene Sperling, Jack Lew and you updating the President on the government's strong financial position and reviewing the potential implications for the FY 2000 budget endgame. The attached memorandum discusses (1) receipts and outlays to date; (2) the possibility that CBO will increase its surplus projections for FY 2000; and (3) implications for spending the surplus windfall.

**Recommendation:**

That you sign the attached memorandum to the President.

__✓__ Agree ________ Disagree ________ Let's Discuss

THE WHITE HOUSE

WASHINGTON

May 6, 1999

MEMORANDUM FOR THE PRESIDENT

'99 MAY 6 PM 2:31

FROM: Jacob J. Lew
Robert E. Rubin
Gene Sperling

SUBJECT: Potential Higher FY 1999 Budget Surplus and FY 2000 Appropriations

**Summary**

Although our next public estimate of the surplus will not be released until the *Mid-Session Review*, recent, but still very preliminary, data have implications for budget strategy.

1. **Recent developments are good news for the economy and the budget surplus.** Treasury yesterday announced that we are paying down $116 billion of federal debt this quarter – the largest debt paydown that has ever been achieved in any year, much less in a single quarter. Year-to-date receipts and outlays point to a higher budget surplus for FY 1999 than we forecasted in February – perhaps $110 billion or more, compared with our forecast of $79 billion.

2. **Those developments may lead CBO to provide a surplus windfall for the FY 2000 appropriations endgame.**

3. **Spending the windfall – if there is one – presents complications because of your policy to "save Social Security first." The Congressional leadership faces no such complications.**

**Outlook for FY 1999 Surplus**

Because of the persistent strength of the economy, receipts for the fiscal year will exceed our February budget estimate, and outlays will be lower than we expected. While there was technically no "April Surprise" of the magnitude of years past, receipts as of early May are $14 billion above our forecast. Outlays for the year thus far are $12 billion under our budget estimate, with Medicare actually down in absolute terms from last year. Thus the surplus is already approximately $26 billion over our budget estimates. Barring unforeseen negative developments, that difference implies a surplus of at least $110 billion. If the economy continues to exceed our expectations, the surplus could be larger. In March, CBO estimated a 1999 surplus of $111 billion.

**Implications for CBO's FY 2000 Surplus and 2000 Appropriations**

The recent economic strength behind our increased surplus numbers could lead CBO to increase its surplus projections when it releases revised estimates on July 1. As you know, CBO is under new leadership, and its choices are therefore difficult to predict. CBO announced yesterday that it does not plan to revise its FY1999 forecast at this time. However, our models suggest that, on the basis of recent economic news alone, CBO could raise its 2000 unified surplus by as much as $20-25 billion when it releases revised estimates on July 1. That would put the FY 2000 budget into an on-budget surplus, the key concept for Republican initiatives. There could well be offsetting economic and technical factors, along with Congressional action on the Kosovo supplemental; and a portion of the additional surplus could fall into Social Security rather than the on-budget category. However, even with these qualifications, CBO's FY 2000 on-budget surplus could be as large as $10-15 billion.

This surplus windfall for FY 2000 could provide part of the solution to the $35 billion budget authority gap between the discretionary caps and our target level for FY 2000 appropriations. The Congressional leadership, of course, would prefer to use any windfall to accelerate tax cuts. Unless Social Security solvency is achieved, use of any on-budget surplus would require that we either adopt the on-budget formulation of the budget proposals of Republicans and some Democrats in the Congress, or rationalize the apparent contradiction between using the surplus windfall and your policy to reserve the surplus pending Social Security reform. The Congressional leadership faces no such constraint, because under their policy any on-budget surplus is fair game for spending or tax cuts.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

**MEMORANDUM TO SECRETARY RUBIN**

FROM: JON TALISMAN
DEPUTY ASSISTANT SECRETARY (TAX POLICY)

SUBJECT: Summary of FY 2000 Budget Initiatives

**Universal Savings Accounts**

Universal Savings Accounts (USAs) are voluntary individual retirement savings accounts that provide a progressive tax benefit. USAs give the opportunity to build wealth and save for retirement to 124 million Americans, including the half of the workforce that is left out of the current employer plan system and the more than 80% of Americans who have no IRA.

***Automatic government contributions***. Moderate- and lower-income workers and their spouses receive a government contribution of $300 as a refundable tax credit deposited in their USAs. The automatic credit is phased out between $40,000 and $80,000 of adjusted gross income (AGI) for joint filers ($20,000 to $40,000 for single filers; $30,000 to $50,000 for head of household filers).

***Individuals' voluntary contributions and government matching contributions.*** Individuals also may make voluntary contributions to their USAs. An individual's voluntary contributions to a USA or salary reduction contributions to an employer-sponsored 401(k)-type plan are matched in the form of a refundable tax credit deposited in the individual's USA. Lower- and moderate-income individuals receive a dollar-for-dollar (100%) match. The match rate phases down to 50% over the same income ranges as the phaseout for the automatic contribution, and remains at 50% until the income level at which USA eligibility ends (if any).

***Limit on contributions***. Total voluntary and government (both automatic and matching) contributions to a USA are capped at $1,000 per year.

***Eligibility***. To be eligible for a USA, an individual must have at least $5,000 of earnings (which can be combined earnings on a joint return), must not be another taxpayer's dependent, and must be between ages 18 and 70. USAs, like traditional IRAs, apply to all individuals who are not covered by an employer-sponsored retirement plan. In addition, USAs extend to individuals covered by an employer plan, if their adjusted gross income (AGI) is not more than $100,000 for joint filers ($50,000 for single filers; $75,000 for head of household filers).

**FY 1999 Budget Carryover Tax Incentives**

***Child And Dependent Care Tax Credit.*** Under current law, taxpayers may receive a nonrefundable tax credit for a percentage of child care expenses they pay in order to work. The Administration proposes to increase the maximum child and dependent care tax credit rate from 30 percent to 50 percent and to extend eligibility for the maximum credit rate to taxpayers with adjusted gross incomes of $30,000 or less. The credit rate would be phased down gradually for taxpayers with adjusted gross incomes between $30,000 and $59,000. The credit rate would be 20 percent for taxpayers with adjusted gross incomes over $59,000. (Also, see discussion of stay-at-home parents below in "Major New Tax Cut Initiatives.)

***Public school construction bonds.*** The budget would allow State and local governments (including U.S. possessions) to issue up to $11 billion and Native American tribal governments to issue up to $200 million of`qualified school construction bonds" in each of 2000 and 2001. Holders of these bonds would receive annual federal income tax credits, set according to market interest rates by the Treasury Department, in lieu of interest. The Administration also proposes to authorize the issuance of additional qualified zone academy bonds in 2000 and 2001 of $1.0 billion and $1.4 billion, respectively. Thus, a total of $24.8 billion in tax credit bonds would be authorized under the budget.

***Extend Exclusion for Employer-provided Educational Assistance.*** Under current law, up to $5250 paid by an employer for educational assistance may be excluded annually from an employee's gross income. The exclusion currently is limited to undergraduate courses beginning before June 1, 2000. The budget proposes to extend the current law exclusion by one year to apply to undergraduate courses beginning before June 1, 2001. In addition, the exclusion would be expanded to cover graduate expenses beginning after June 30, 1999 and before June 1, 2001.

***Climate change package.*** The budget provides a series of climate change initiatives, including (i) a tax credit for the purchase of certain highly efficient building equipment technologies, (ii) a tax credit to taxpayers who purchase, as a principal residence, certain newly constructed homes that are highly energy efficient, (iii) a tax credit for qualifying combined heat and power systems in order to encourage more efficient energy usage, (iv) a tax credit for purchasers of roof-top photovoltaic systems and solar water heating systems located on or adjacent to the building for uses other than heating swimming pools; (v) a tax credit for certain fuel-efficient vehicles; and (vi) an extension of the current wind and biomass tax credit for five years.

***Increase low-income housing tax credit per capita cap.*** The amount of first-year credits that can be awarded in each State is currently limited to $1.25 per capita. The budget would increase the annual State housing credit limitation to $1.75 per capita.

***Retirement savings package.*** The budget proposes a series of retirement savings incentives that would expand the availability of retirement plans and other workplace-based savings opportunities, particularly for moderate-and lower-income workers not currently covered by employer-sponsored plans. The budget also seeks to improve existing retirement plans for employers of all sizes by increasing retirement security for women, promoting portability, expanding workers' and spouses' rights to know about their retirement benefits, and simplifying the pension rules.

***Extenders package.*** The budget proposes one-year extensions of the R&E tax credit, the welfare-to-work tax credit, the work opportunity tax credit and the D.C. homebuyer's tax credit. The budget proposes a permanent extension of the provision allowing expensing of brownfields remediation costs.

**Major New Tax Cut Initiatives**

***Long-Term Care Tax Credit*** A new long-term tax credit of $1,000 could be claimed by a chronically ill taxpayer, or for a chronically ill spouse, or for each chronically ill dependent. To qualify for the credit, a chronically ill individual must generally be certified by a licensed physician as being unable for at least six months to perform at least three activities of daily living without substantial assistance from another individual. The credit would be phased out in combination with the child credit--for taxpayers with adjusted gross income (AGI) in excess of the following thresholds: $110,000 for married taxpayers filing a joint return, $75,000 for a single taxpayer or head of household, and $55,000 for married taxpayers filing a separate return.

***Disabled Workers Tax Credit*** Disabled workers would be able to claim a $1,000 tax credit. In order to be considered a disabled worker, a taxpayer would be required to submit a licensed physician's certification that the taxpayer has been unable for at least 12 months to perform at least one activity of daily living without substantial assistance from another individual. The credit would be phased out at the same levels as the long term care tax credit.

***Small Business Health Purchasing Cooperatives.*** The budget makes certain changes to encourage use of qualified health benefit purchasing coalitions by small businesses that currently do not provide health insurance to their workforces. For example, a temporary tax credit would be provided for qualifying small employers equal to ten percent of employer contributions to employee health plans purchased through a qualified cooperative, up to $200 for a single plan and $500 for a family plan. This credit would be available for two years.

***Stay-at-Home Parents.*** The budget proposes to allow taxpayers with children under the age of one, whether or not they incur out-of-pocket child care expenses, to claim the child and dependent care tax credit. They would be able to claim a credit equal to the applicable credit rate multiplied by $500 for a child under the age of one ($1,000 for two or more children under the age of one). (See discussion of child and dependent care tax credit above).

***Workplace literacy credit.*** Employers who provide certain workplace literacy, English literacy, or basic education programs for their eligible employees would be allowed a credit against Federal income taxes equal to 10 percent of the employer's qualified expenses, up to a maximum credit of $525 per participating employee. Qualified education would be limited to basic instruction at or below the level of a high school degree and to English literacy instruction.

***Eliminate 60-month limit on student loan interest deduction.*** Current law provides an income tax deduction for certain interest paid on a qualified education loan during the first 60 months that interest payments are required. To simplify the calculation of deductible interest payments, reduce administrative burdens, and provide longer-term relief to low-and middle-income taxpayers with large educational debt, the budget proposes to eliminate the 60-month limitation.

***Better America Bonds***. State and local governments (including U.S. possessions and Indian tribal governments) would be allowed to issue tax credit bonds to finance projects to protect open spaces, to remediate certain property, or to otherwise improve the environment. Like school modernization bonds, holders of these bonds would receive annual federal income tax credits, set according to market interest rates by the Treasury Department, in lieu of interest. The EPA will allocate $1.9 billion in bond authority each year for five years starting in 2000 based on competitive applications.

***New Markets Tax Credit***. To help attract new capital to businesses located in low-income urban and rural communities, taxpayers would be allowed a credit against Federal income taxes for certain investments made to acquire stock or other equity interests in a community development investment entity selected by the Treasury Department to receive a credit allocation. On a present value basis, the credit is equal to approximately 25% of the amount of the investment. During the period 2000-2004, the Treasury Department would authorize selected community development investment entities to issue $6 billion of new stock or equity interests with respect to which credits could be claimed.

***Allow personal credits against the AMT.*** The budget would extend for two years an expiring provision that allows taxpayers to take their nonrefundable personal credits (e.g., child credits, Hope Scholarship credits, etc.) regardless of the amount of their tentative minimum tax.

***Extend NOL carryback period for steel companies***. Under current law, a net operating loss (NOL) of a taxpayer generally may be carried back 2 years and forward 20 years. The budget proposes to provide an immediate benefit to troubled steel companies by extending the carryback period for the NOL of a steel company to 5 years.

***Tax credit for qualified zone academies***. To encourage corporations to become sponsors of qualified zone academies, a credit against Federal income tax would be provided equal to 50 percent of the amount of corporate sponsorship payments made to a qualified zone academy located in a designated empowerment zone or enterprise community.

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*** ACTIVITY REPORT ***
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| TX/RX NO. | 0102 |
| CONNECTION TEL | 89147645393P |
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| USAGE TIME | 03'46 |
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| RESULT | OK |

#1280

W.O. faxed to RER 6/27/99

DI to LS (READING) 6/27/99

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CLASSIFICATION

DATE 6-27-99

# DEPARTMENT OF THE TREASURY
# WATCH OFFICE
# FAX COVERSHEET

– If received INCOMPLETE, call (202)622-1825

**TO:** Secretary Rubin

**FROM:** Jon Talismann / thru Neal Comstock

**OFFICE PHONE NUMBER:** ________

**FAX NUMBER:** (202)622-1829 (unsecure) (202)622-1851 (secure)

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**Page 1 of 5 Pages**

**COMMENTS:**

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SERIAL NR. 1280

1999-SE-012920

INFORMATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

November 30, 1999

MEMORANDUM FOR SECRETARY SUMMERS
DEPUTY SECRETARY EIZENSTAT

FROM: Assistant Secretary Wilcox DW
Deputy Assistant Secretary Elmendorf DE

SUBJECT: **Possible Budget Frameworks**

We have constructed two illustrative budget frameworks for FY2001. The attached tables highlight two key issues:

- If we maintain the current real level of discretionary spending, the remaining on-budget surplus will be only about $40 billion over the next five years and $550 billion over the next ten years. **These amounts are significantly smaller than the amounts allocated in the MSR to USAs and Medicare (including interest), implying that some contraction of those initiatives will be necessary. In particular, there will be essentially no surplus in 2001 and 2003, making it difficult to launch a drug benefit or tax cut before 2004.**

- The favorable revision to the Social Security surplus will imply more debt reduction, greater decline in interest expense, and hence larger transfers to Social Security under the formula embodied in our legislation. **Together with discretionary spending, a tax cut, and a drug benefit, these larger transfers will generate an on-budget deficit beginning in 2011.**

The tables are based on budget estimates of the final Troika forecast from the "hits" model. We have also incorporated some expected legislative and technical revisions to the baseline, including tax extenders, BBA givebacks, and the effect of lower-than-expected Medicare spending last year. For comparability with the MSR and with CBO's likely presentation of the budget, the tables use a capped baseline and show the increase in discretionary spending needed to reach our estimate of the "current services" level. We assume no discretionary offsets, consistent with OMB's recent comments.

The projected on-budget surpluses are about $450 billion for FY2001-05, $1600 billion for FY2001-10, and $3700 billion for FY2001-15. After accounting for discretionary spending (and associated interest), those figures fall to about $40 billion, $550 billion, and $1700 billion. The attached tables show two frameworks with different allocations of that remaining surplus. Both frameworks would require further changes to reach on-budget balance.

**Scenario A** divides the 10-year surplus (after discretionary spending) roughly equally between a tax cut and Medicare, leaving Social Security transfers to begin in year 11.

- The Medicare path shows the net cost of the proposed drug benefit plus additional solvency transfers in 2002 and 2007-10. These transfers have 30 percent of the present value of the MSR transfers. If our various estimates are correct, achieving on-budget balance in 2003-04 will require a cut in discretionary spending (from current services).

- Under our interest-savings rationale, the "earned transfer" to Social Security based on debt reduction is shown in the far-right column. We will need to devise an alternative rationale for these transfers to eliminate the on-budget deficits in FY2011 and beyond. (The numbers shown here begin the calculation of cumulative debt reduction in FY2000, as specified in our legislation. Beginning the calculation in FY2001 has only a small effect on the size of the transfers.)

- The discretionary spending path shown here, like that used by OMB, makes no allowance for emergencies. Including a contingency fund for emergencies would be an alternative use of part of the projected surpluses.

**Scenario B** divides the 10-year surplus (after discretionary spending) roughly equally between a tax cut, Medicare, and Social Security transfers.

- The Medicare path includes the drug benefit, but it has solvency transfers equal to only 15 percent of the MSR transfers.

- Social Security transfers within the ten-year window need to be much smaller than would be justified by our existing rationale. Moving the transfers up to the level implied by that rationale would again create an on-budget deficit beginning in 2011.

Attachment

SCENARIO A: 50% ENTITLEMENTS / 50% TAX CUT

| year | baseline on-bud surp | discret | taxes | Medicare | Soc Sec transfers | extra debt svce | reported on-bud sur | SS surp adj for eq | earned transfer |
|---|---|---|---|---|---|---|---|---|---|
| | | | | 0.29 | | | | | |
| 2001-05: | 460 | 375 | 5 | 44 | 0 | 51 | -15 | | |
| 2001-10: | 1607 | 820 | 254 | 269 | 0 | 279 | -15 | | |
| 2001-15: | 3673 | 1332 | 571 | 304 | 831 | 907 | -272 | | |
| 2000 | 12 | 0 | 0 | 0 | 0 | 0 | 12 | 146 | 0 |
| 2001 | 62 | 60 | 0 | 0 | 0 | 1 | 0 | 160 | 7 |
| 2002 | 98 | 75 | 0 | 18 | 0 | 5 | 0 | 173 | 15 |
| 2003 | 86 | 78 | 0 | 10 | 0 | 10 | -11 | 185 | 24 |
| 2004 | 99 | 80 | 0 | 9 | 0 | 15 | -4 | 197 | 34 |
| 2005 | 115 | 82 | 5 | 8 | 0 | 20 | 0 | 216 | 44 |
| 2006 | 164 | 83 | 45 | 9 | 0 | 27 | -0 | 229 | 55 |
| 2007 | 199 | 86 | 47 | 30 | 0 | 36 | -0 | 245 | 67 |
| 2008 | 226 | 89 | 50 | 42 | 0 | 45 | 0 | 258 | 79 |
| 2009 | 260 | 92 | 52 | 61 | 0 | 55 | 0 | 269 | 93 |
| 2010 | 298 | 94 | 55 | 83 | 0 | 65 | 0 | 280 | 106 |
| 2011 | 343 | 97 | 57 | 7 | 121 | 80 | -19 | 410 | 121 |
| 2012 | 379 | 100 | 60 | 7 | 142 | 100 | -29 | 443 | 142 |
| 2013 | 414 | 102 | 63 | 7 | 164 | 123 | -46 | 475 | 164 |
| 2014 | 448 | 105 | 66 | 7 | 189 | 148 | -68 | 509 | 189 |
| 2015 | 482 | 108 | 70 | 7 | 215 | 177 | -95 | 543 | 215 |

SCENARIO B: 33% SOCIAL SECURITY / 33% MEDICARE / 33% TAX CUT

| year | baseline on-bud surp | discret | taxes | Medicare | Soc Sec transfers | extra debt svce | reported on-bud sur | SS surp adj for eq | earned transfer |
|---|---|---|---|---|---|---|---|---|---|
| | | | | 0.15 | | | | | |
| 2001-05: | 460 | 375 | 5 | 44 | 0 | 51 | -15 | | |
| 2001-10: | 1607 | 820 | 171 | 168 | 173 | 291 | -15 | | |
| 2001-15: | 3673 | 1332 | 382 | 203 | 1065 | 950 | -260 | | |
| 2000 | 12 | 0 | 0 | 0 | 0 | 0 | 12 | 146 | 0 |
| 2001 | 62 | 60 | 0 | 0 | 0 | 1 | 0 | 160 | 7 |
| 2002 | 98 | 75 | 0 | 18 | 0 | 5 | 0 | 173 | 15 |
| 2003 | 86 | 78 | 0 | 10 | 0 | 10 | -11 | 185 | 24 |
| 2004 | 99 | 80 | 0 | 9 | 0 | 15 | -4 | 197 | 34 |
| 2005 | 115 | 82 | 5 | 8 | 0 | 20 | 0 | 216 | 44 |
| 2006 | 164 | 83 | 30 | 8 | 16 | 27 | 0 | 245 | 55 |
| 2007 | 199 | 86 | 32 | 8 | 37 | 36 | -0 | 284 | 68 |
| 2008 | 226 | 89 | 33 | 17 | 40 | 47 | -0 | 303 | 82 |
| 2009 | 260 | 92 | 35 | 35 | 40 | 58 | -0 | 316 | 98 |
| 2010 | 298 | 94 | 36 | 56 | 40 | 71 | 0 | 330 | 114 |
| 2011 | 343 | 97 | 38 | 7 | 131 | 86 | -16 | 432 | 131 |
| 2012 | 379 | 100 | 40 | 7 | 153 | 106 | -27 | 466 | 153 |
| 2013 | 414 | 102 | 42 | 7 | 177 | 129 | -43 | 501 | 177 |
| 2014 | 448 | 105 | 44 | 7 | 202 | 154 | -66 | 538 | 202 |
| 2015 | 482 | 108 | 47 | 7 | 230 | 183 | -93 | 576 | 230 |

1999-SE-013427

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

**INFORMATION**

ASSISTANT SECRETARY

December 13, 1999

**MEMORANDUM FOR SECRETARY SUMMERS
DEPUTY SECRETARY EIZENSTAT**

**FROM:** Assistant Secretary Wilcox DW
Deputy Assistant Secretary Elmendorf DE

**SUBJECT:** **Suggested Budget Framework**

The discussion about a new budget framework is now focused on how to allocate roughly $600 billion over the next 10 years. This amount represents the current forecast of the on-budget surplus remaining after meeting our discretionary spending goals, which are described below. Revisions to the revenue and health technicals (available later this month) could push the estimate of remaining surplus in either direction by a substantial amount.

We have attached a table showing our suggested allocation of the surplus, and discuss the motivations for that framework here:

**1. Social Security poses the biggest problem in constructing a new framework.**

- We cannot afford to make the transfers that would result from the formula included in our legislation. This formula would now produce much larger transfers than we initially estimated, because larger baseline Social Security surpluses and higher interest rates both imply greater interest savings from using the Social Security surpluses to pay down debt.

- We cannot even afford to make transfers as large as those we proposed initially. The increase in the baseline surplus for 2011 through 2015 is much smaller than the increase in discretionary spending and the associated interest. Thus, the remaining surplus is significantly smaller in those years.

| | Aggregate Amounts 2011-2015 (billions of dollars) | |
|---|---|---|
| | Mid-Session Review | Now |
| Baseline on-budget surplus assuming discretionary caps | 1967 | 2278 |
| Discretionary spending above capped baseline | - 201 | - 592 |
| Associated interest | - 160 | - 388 |
| Remaining surplus | 1606 | 1299 |

- Consider the on-budget surplus remaining after the allocations discussed below. Transferring *all* of that surplus to Social Security in 2011 and beyond would likely be insufficient to extend solvency to 2050, which is the date we have used since the summer. We need to find a way to reconcile "save Social Security first" with slipping the target trust fund exhaustion date in the face of favorable budget news. Making equity investments in the trust fund would improve this situation.

**2. Momentum for allocations to discretionary spending, a drug benefit, and a tax cut appears strong.**

*A. Over 10 years, $750 billion for discretionary spending, relative to the capped baseline*

- This would maintain nondefense discretionary spending at its FY2000 level adjusted for inflation. Meeting this target would actually require more restraint in this category than we have seen during the 1990s as a whole or even since the Republicans took control of Congress in 1994.

- This would allow for an increase in inflation-adjusted defense spending, as we proposed earlier this year.

*B. Over 10 years, $150 billion for our proposed Medicare drug benefit, net of reform savings*

- Government subsidies for the drug benefit are now projected at about $190 billion, an increase of 60 percent from last summer. This jump will fuel concerns that our proposed new entitlement would soon wreak havoc on the budget. At the same time, the corresponding jump in private premiums (given our proposed subsidy rate) greatly worries the Administration's political team. In light of the advantages and disadvantages of alternative approaches discussed earlier in the year, we do not think that fundamental changes in the drug benefit would be useful.

- We believe that the Administration should continue to press for money-saving reforms, including BBA extenders and modernization of the traditional fee-for-service program. However, many in the Administration believe that proposing more than $40 billion of the $80 billion in ten-year savings that we proposed last summer would be unrealistic.

- This benefit uses almost the entire on-budget surplus projected for the next 5 years after discretionary spending, leaving only token amounts for other unpaid-for initiatives.

*C. Over 10 years, $250 billion for tax cuts net of tax raisers*

- We understand that opening the door to a tax cut could be dangerous, but we think the alternative position is not credible. The ten-year on-budget surplus assuming the discretionary caps is likely to exceed $1500 billion. If we propose no net tax cut, Republicans will accuse the Administration of devoting $1½ trillion to new spending and zero dollars to tax relief. Even with a net tax cut of this size, we will be accused of devoting $5 to new spending for every $1 going to tax relief.

- A major problem is devising a tax cut that involves de minimis amounts over the next 5 years, and then expends quite significant amounts in years 6 through 10, but does not mushroom irresponsibly after year 10.

3. **We need to think hard about how to allocate the remaining $200 billion or so.**

- Under *current* assumptions, we would need to make transfers of $150 to $200 billion in the next 10 years to extend the solvency of the HI trust fund until 2020. In comparison, the MSR reforms and transfers were announced as extending solvency to 2027 ("more than a quarter century"), and the actuaries' correction of their scoring error extended solvency under that plan to 2030.

- Next Spring's report of the Medicare Trustees may well show that – without reform or transfers – the HI trust fund will not be exhausted until the 2020s. In the natural course of things, this fact will not be known publicly when the budget is presented. And since the Administration has emphasized for a year the importance of devoting additional resources to extending solvency, having no transfers would be difficult. W*e need to explore possible avenues of disseminating good Medicare news earlier.*

- We understand that adding too much money could weaken the impetus for reform. But we could state that these transfers are conditional on reform, and it is hard to imagine their being legislated except as part of reform. Even so, a framework that included $200 billion of solvency transfers in addition to the drug benefit would appear very heavy on entitlements.

- Another possible use of surplus funds would be to establish a "rainy day fund" for emergencies. Leaving aside the cap-related emergency designations of the past two years, genuine emergencies have been running around $6 billion per year, so $50 billion over 10 years would be a reasonable figure. In any event, we would not envision setting up a separate trust fund, but simply reserving this portion of the on-budget surplus for unanticipated needs.

- Yet another possible use of surplus funds in the ten-year window would be to initiate Social Security transfers.

SUGGESTED SCENARIO

| year | baseline on-bud surp | discret | taxes | Medicare net drugs | Med. solv. transfers | Soc Sec transfers | extra debt svce | reported on-bud sur | earned transfer |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | 0.32 | | | | |
| 2001-05: | 468 | 319 | 16 | 38 | 45 | 0 | 50 | 0 | |
| 2001-10: | 1637 | 757 | 237 | 148 | 204 | 0 | 290 | 0 | |
| 2001-15: | 3915 | 1349 | 519 | 300 | 204 | 582 | 962 | -0 | |
| 2000 | 17 | 0 | 0 | 0 | 0 | 0 | 0 | 17 | 0 |
| 2001 | 62 | 57 | 0 | 0 | 4 | 0 | 2 | -0 | 8 |
| 2002 | 100 | 60 | 4 | 0 | 31 | 0 | 5 | -0 | 17 |
| 2003 | 90 | 62 | 4 | 7 | 8 | 0 | 9 | 0 | 27 |
| 2004 | 100 | 65 | 4 | 15 | 2 | 0 | 14 | 0 | 37 |
| 2005 | 116 | 75 | 4 | 17 | 0 | 0 | 20 | 0 | 48 |
| 2006 | 167 | 82 | 40 | 18 | 0 | 0 | 27 | -0 | 59 |
| 2007 | 202 | 78 | 42 | 20 | 25 | 0 | 37 | 0 | 72 |
| 2008 | 230 | 87 | 44 | 22 | 30 | 0 | 47 | -0 | 85 |
| 2009 | 265 | 92 | 46 | 24 | 44 | 0 | 58 | 0 | 99 |
| 2010 | 305 | 99 | 49 | 26 | 60 | 0 | 71 | 0 | 113 |
| 2011 | 358 | 105 | 51 | 27 | 0 | 88 | 87 | -0 | 128 |
| 2012 | 406 | 111 | 54 | 29 | 0 | 104 | 108 | 0 | 148 |
| 2013 | 455 | 118 | 56 | 30 | 0 | 119 | 132 | -0 | 170 |
| 2014 | 504 | 125 | 59 | 32 | 0 | 131 | 158 | -0 | 193 |
| 2015 | 554 | 132 | 62 | 33 | 0 | 140 | 187 | 0 | 217 |

2000-SE-007973

**INFORMATION**


DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220


August 2, 2000

MEMORANDUM FOR SECRETARY SUMMERS

FROM: David W. Wilcox DW
Alan Cohen

SUBJECT: Comparison of 1990 Budget Agreement with the 1993 Agreement

Attached is a rough draft of a piece comparing the 1990 Budget agreement with the 1993 agreement. This reflects input from Wilcox, Cohen, Minarik, and Furman. No one other than Wilcox has seen this draft. All statements need to be fact checked.

Currently, the anniversary of the 1993 Deficit Reduction Package is planned to be part of the President's Weekly Radio Address.

# The Facts About The 1990 and 1993 Budget Agreements

Both the 1990 and the 1993 agreements were landmark fiscal actions. The 1990 agreement instituted important procedural changes, but it did not get the job done: Three years later, the budget was still deeply in deficit, and the latest projections from the Office of Management and Budget and the Congressional Budget Office showed deficits getting worse. The 1993 agreement kicked off a virtuous cycle, tipping the economy into the longest economic expansion in history.

**The 1990 agreement introduced important reforms in budget process.** The 1990 agreement replaced the unsuccessful Gramm-Rudman process, which was based on numerical deficit targets, with the caps-and-paygo system that we have used since.

- Gramm-Rudman failed, among other reasons, because it encouraged sham compliance through rosy economic assumptions and time shifts, which either assumed the problem away or moved it into adjacent fiscal years without actually solving it; and because its targets and enforcement mechanism were unrealistic.

- The caps-and-paygo system, as we now know, controlled spending increases and tax cuts without requiring unrealistic policy, especially in bad economic times.

**The 1990 agreement did not put the nation on track to fiscal stability, nor did it revive the economy.**

- Despite its merits on procedural grounds, the 1990 agreement did not get the job done. Indeed, in FY1992, the Federal government ran a unified deficit of $290 billion, the largest ever. Moreover, the deficit excluding Social Security and Medicare surpluses was $351 billion.

- The last projection executed before enactment of the 1993 budget plan showed deficits of this magnitude continuing indefinitely into the future.

- The economy continued to stagnate. In the business press, there was widespread concern about a double-dip or even a triple-dip recession:

  - **Bruce Steinberg,** Merrill Lynch: "The economy is comatose and shows only the faintest signs of life right now." [Quoted in the *Washington Post,* 9/26/92]

  - **Alan Sinai:** "There are real signs here that the economy is sliding badly, surprisingly badly." [Quoted in the *Washington Post*, 9/26/92]

  - **Washington Post,** article by Steven Mufson and John Berry, 9/10/92: "Americans have been unable to mount a convincing economic recovery… the economy is crawling forward so slowly that it appears to be standing still… In some statistical categories… there has even been a 'triple dip.'"

- **USA Today,** article by Mark Memmot, 7/23/92: "First came the recession, which began in July '90 and seemed to end in early '91. Then there was the disappointing stall the second half of last year – not another recession, but enough of a slowdown in sales and rise in unemployment to get people talking about a double-dip economy. Now there are rumblings about a triple dip."

- **Charles Krauthammer:** "The most recent economic news points to the possibility that the country may be heading for a triple-dip recession. Historians may look back on the Bush presidency as the beginning of a Great Recession, a period of prolonged economic stagnation." [*Chicago Sun Times*, 7/12/92]

**On an apples-to-apples comparison, the 1990 and 1993 agreements were projected to produce about the same amount of deficit reduction.**

- Measured in terms of 1996 dollars, the 1990 agreement was scored by the Congressional Budget Office as reducing the unified deficit over five years by $509 billion.

- Again in terms of 1996 dollars, and scoring against the Administration's baseline, the Congressional Budget Office scored the 1993 agreement as reducing the unified deficit over five years by $474 billion. This figure ignored another $5 billion from auction of spectrum, and $xx billion from shortening the maturity of the publicly held debt.

- All together, the two packages were therefore of nearly the same size.

- Robert Reischauer exaggerated the difference in size between the two packages with faulty methodology. He added together each of the five yearly savings from the 1990 agreement, treated the sum as if it were all 1990 dollars, and then inflated the total to 1997 dollars. He performed a similar exercise with the savings from the 1993 agreement. Because projected inflation was higher in 1990 than in 1993, this flawed approach exaggerates the relative size of the 1990 package.

**The 1993 agreement was expected to produce dollar for dollar as much reduction in spending as it produced increase in revenues.**

- The 1993 agreement was carefully calibrated to be balanced between spending reduction and revenue increases.

- Robert Reischauer concluded differently by ignoring interest savings (whereas the Administration treated interest savings as reductions in outlays) and by scoring a part of the increase in the Earned Income Tax Credit as outlays (whereas the Administration treated the entire cost of the EITC as a tax cut).

**The 1993 agreement required the tougher choices.**

- The 1990 deal could harvest the low-hanging fruit. Coming along just three years later, the 1993 program could choose only from savings that were rejected as too difficult in 1990; caps and mandatory programs had to be cut deeper, and taxes had to be raised further. Thus, dollar for dollar, the 1993 program would fairly be given a higher grade for effort.

**The 1993 agreement set off a virtuous circle of lower interest rates, stronger growth, and an improved fiscal position, which helped interest rates come down further.**

- The huge deficits that President Clinton inherited acted to keep interest rates high, diminish confidence, lower investment and stifle growth. Budgets were based on economic assumptions that were far too optimistic. When these assumptions failed to materialize, the result was higher deficits than forecast, and cynicism about the budget process.

- The 1993 agreement was based on conservative economic assumptions. It increased confidence, helped bring interest rates down, and that, in turn, helped generate and sustain the economic recovery, which, in turn, reduced the deficit further. The result was a healthy, mutually reinforcing interaction of deficit reduction policy and consequent economic growth.

**Although the 1990 and 1993 agreements were scored as producing about the same deficit reduction as of the time of enactment, the outcomes were dramatically different.**

- In its budget document for FY1992 – the first official projection incorporating the impact of the 1990 agreement – the Bush Administration projected that the unified deficit would decline to $212 billion by FY1993. In actuality, the deficit came in at $255 billion.

    - In part, the failure of the 1990 agreement to live up to expectations reflected overly optimistic assumptions. For example, GNP growth was assumed to run at 4.1 percent in 1993 and 3.7 percent in 1994, when the Blue Chip forecasts for those same years were 2.6 percent and 2.3 percent, respectively.

- By contrast, in its Mid-Session Review for FY1994 – the first official projection to incorporate the impact of OBRA93 – the Clinton Administration projected that the unified deficit would decline from $259 billion in 1994 to $181 billion in 1998. In actuality, the budget in 1998 recorded its first unified surplus in nearly 30 years, to the tune of $69 billion.

**Interest rates dropped by more in 1993.**

- In late January 1993, before the Administration had unveiled its budget plans, the 30-year bond rate fluctuated in the neighborhood of 7.30 percent.

- By early September, 1993, one month after the Senate passed OBRA93, the rate on 30-year Treasury securities had fallen below 6.0 percent. Over the course of less than nine months, the price of 30-year Treasuries had therefore increased by XX percent.

- By contrast, in 1990, …

**Unemployment came down by more in the wake of the 1993 agreement than after the 1990 agreement.**

- Fact to be supplied.

**Productivity increased by more after the 1993 agreement than after the 1990 agreement.**

- Fact to be supplied.

## THE CLINTON FISCAL LEGACY

**President Clinton dramatically changed the context for budget debates by shifting the focus to the surpluses *excluding Social Security and Medicare.* Provided we do not lose our fiscal discipline, this simple action will guarantee that $2.85 trillion more is used for debt reduction than would have been the case had we continued to focus on balancing the *unified* budget**

- In 1990, President Bush confronted a *unified deficit* of $221 billion.
  - Excluding both Social Security and Medicare Part A surpluses, the budget was in deficit by $291 billion.
  - The combined Social Security and Medicare Part A surpluses of $71 billion was used to help finance the deficit in the rest of government.
  - As the economy weakened, and the full costs of the S&L debacle were reflected in the Federal budget, the unified deficit ballooned further, to $290 billion in 1992, and the on-budget deficit excluding Social Security and Medicare widened to $351 billion. The unified and on-budget deficits in 1992 were the largest in history, both in absolute terms and as a percent of GDP.

- This year, President Clinton confronts a *unified surplus* of $211 billion, the largest ever.
  - Excluding Social Security and Medicare, the budget will be in surplus by an estimated $39 billion.
  - All of the Social Security and Medicare surpluses (a total of $172 billion) will be used to reduce the debt held by the public.
  - Surpluses in both the on-budget and off-budget accounts are currently projected to persist throughout the decade and beyond.
- *By putting the Social Security and Medicare surpluses off limits, and focusing on the surplus excluding those amounts, President Clinton has preserved an estimated $2.86 trillion more for debt reduction than would have been used for that purpose had we stuck with the old failed model for the conduct of fiscal policy.*

## Congressional Republicans Attacked the 1990 Plan from the Beginning

**Congressional Republicans attacked President Bush for having concluded the 1990 agreement, and argued that the agreement would damage the economy.**

- Quotes here of the same style as what we have for 1993 will be supplied.

## Congressional Republicans Also Attacked the 1993 Plan from the Beginning

**The Republicans also attacked the 1993 agreement from the beginning. They were wrong then, and they are wrong now.**

- **Representative Newt Gingrich,** Atlanta Journal-Constitution, 8/6/93: "The tax increase will kill jobs and lead to a recession, and the recession will force people off of work and onto unemployment and will actually increase the deficit."
- **Senator Phil Gramm,** Congressional Record, 8/5/93: "We are buying a one-way ticket to a recession."

- **Representative John Kasich,** Congressional Record, 3/18/93: "It's like a snake bite. The venom is going to be injected into the body of this economy, in our judgement and it's going to spread throughout the body and it's going to begin to kill the jobs that Americans have."

- **Representative Dick Armey,** CNN, 8/2/93: "The impact on job creation is going to be devastating."

- **Senator Connie Mack,** Congressional Record, 8/6/93: "This bill will cost America jobs, no doubt about it."

- **Representative John Boehner,** 3/31/93: "...we want to do something about reducing the budget deficits in this country and this budget resolution does nothing, absolutely nothing to reduce the huge budget deficits that we have had."

- **Senator Bob Packwood,** Congressional Record, 8/6/93: "So I will make you this bet. I am willing to risk the mortgage on it, Mr. President. One year from now ... the deficit will be bigger than we are now predicting... [T]he deficit will be up, unemployment will be up; in my judgement, inflation will be up."

## THE 1990 AND 1993 PLANS WERE ENACTED ON THE STRENGTH OF DEMOCRATIC SUPPORT

- In 1990, a majority of Democrats voted *for* the final bill in both the House and the Senate, while a majority of Republicans voted *against.*

| HOUSE VOTE ON FINAL 1990 AGREEMENT | |
|---|---|
| | **Percent For** |
| **Democrats** | 71.0 |
| **Republicans** | 27.2 |
| **Total** | 53.3 |

| SENATE VOTE ON FINAL 1990 AGREEMENT | |
|---|---|
| | **Percent For** |
| **Democrats** | 63.6 |
| **Republicans** | 43.2 |
| **Total** | 54.5 |

- In 1993, the Omnibus Reconciliation Act passed in the House by a vote of xxx-yyy, with *not a single Republican voting in favor* of the plan. In the Senate, the vote was tied at 50-50; Vice President Gore cast the tie-breaking vote in favor of the Act.

| **HOUSE VOTE ON FINAL 1993 AGREEMENT** | |
|---|---|
| | **Percent For** |
| **Democrats** | 84.2 |
| **Republicans** | 0.0 |
| **Total** | 50.1 |

| **SENATE VOTE ON FINAL 1993 AGREEMENT** | |
|---|---|
| | **Percent For** |
| **Democrats** | 89.3 |
| **Republicans** | 0.0 |
| **Total** | 50.0 |

- During the 1992 Presidential campaign, President Bush repudiated the 1990 agreement. "I thought this one compromise - and it was a compromise - would result in no more tax increases. I thought it would result in total control of domestic discretionary spending. And now we see Congress talking about raising taxes again. So I'm disappointed, and given all of that, yes, a mistake." March 23, 1992.

2000-SE-010394

**INFORMATION**

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

October 25, 2000

**MEMORANDUM FOR SECRETARY SUMMERS**
**DEPUTY SECRETARY EIZENSTAT**

**FROM:** David Wilcox DW
Douglas Elmendorf DE

**SUBJECT:** Long-Term Budget Projections from CBO and the Administration

The Congressional Budget Office (CBO) recently released new long-term budget projections. CBO projects that government spending ultimately will grow faster than revenues, leading to large and growing deficits and unsustainable levels of public debt. This outlook contrasts sharply with the long-term outlook consistent with the near-term projection presented in the OMB Mid-Session Review (MSR); this MSR-consistent projection (which was not published) shows large and growing surpluses relative to GDP throughout the 75-year projection.

CBO's budget pessimism appears to stem primarily from faster projected growth in Medicare costs and discretionary spending. Different economic assumptions play little role in the first 40 years, but matter more later when rising debt causes slower GDP growth in the CBO methodology. Even in CBO's outlook, the government runs unified surpluses until the late 1930s and holds net assets equal to 37 percent of GDP in 2040.

***Discussion***

CBO reports alternative scenarios based on different assumptions about productivity growth, health cost increases, demographic changes, and how much of the budget surplus is saved over the next decade. We focus on their so-called midrange parameters and the "Save Total Surpluses" scenario, which corresponds to the traditional budget baseline.

CBO's projected path of nominal GDP is virtually identical to OMB's projected path through 2040. Thus, the difference in budget outlook for 2040 can be usefully summarized as follows (with a more detailed breakdown in the attached table):[1]

| | Impact on surplus of CBO relative to OMB (% of GDP) |
|---|---|
| Medicare outlays | - 2.2 % (i.e., CBO has higher outlays) |
| Discretionary spending | - 1.9 % |
| All other non-interest outlays | +0.1 % |
| Receipts | - 0.3 % (i.e., CBO has lower receipts) |
| Interest | - 3.6 % |
| Surplus | - 7.9 % |

[1] The figures for CBO are adjusted from the NIPA-based numbers they reported in their document to an approximate budgetary basis so comparisons can be made to the OMB numbers.

Prepared by John Kitchen

*Economic Assumptions:*

CBO uses a neoclassical growth model with exogenous *multifactor* productivity growth that allows for investment and interest rates to respond to government saving. OMB sets *labor* productivity growth exogenously and allows no feedback from government saving.[2] Between 2010 and 2040, CBO's effective labor productivity growth rate appears to be higher than OMB's by roughly 0.2 percentage point.

With similar demographic assumptions, this translates into faster real GDP growth – which should improve CBO's budget outlook relative to OMB's. At the same time, CBO's "wedge" (the excess of CPI growth relative to GDP price index growth) is slightly higher than OMB's – which should hurt their budget outlook relative to OMB's. These differences appear to roughly offset in their budget effects.

In addition, CBO's assumed rate of GDP price inflation is 0.2 percentage points lower than OMB's, which offsets their higher rate of real GDP growth to produce virtually identical paths for nominal GDP. This similarity allows us to compare forecasts in terms of budget components relative to GDP. Note that CBO reports numerical values only through 2040, as growing budget deficits thereafter generate snowballing deficits and debt and a collapsing capital stock and GDP.

*Technical Assumptions:*

CBO assumes that discretionary spending will increase with GDP growth, while OMB assumes that discretionary spending will increase at the current-services rate. Under the OMB approach, discretionary spending falls from about 6 percent of GDP today to 3-1/2 percent by 2040 and 2-1/4 percent by 2075.

CBO had previously assumed, along with OMB (who follow the Medicare trustees in this regard), that cost growth per Medicare enrollee relative to underlying economic growth would slow from about 2 percent to about 0 percent between 2010 and 2025. CBO now bills that assumption as "optimistic," and bases its midrange projection on the assumption that excess cost growth slows only to 1.1 percent.[3]

As the table on the following page shows, CBO projects somewhat lower spending than OMB on Social Security, and somewhat higher spending on Medicaid and other programs – roughly a wash overall. Note that the Medicare spending difference does not flow through to Medicaid, where OMB appears to be somewhat more aggressive in its projection of cost growth.

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[2] OMB is now developing a neoclassical growth model with endogenous response to government saving for its long-term projections.
[3] The Medicare technical panel recently agreed to recommend to the Trustees that the actuaries adopt a higher medical cost growth rate in making their projections.

**Long-Run Projections of Receipts and Outlays, % of GDP**

| | 2010 | 2020 | 2030 | 2040 |
|---|---|---|---|---|
| **CBO, "Save Total Surpluses" Scenario** | | | | |
| Receipts | 20.0 | 20.0 | 20.0 | 20.0 |
| Outlays | | | | |
| Discretionary | 5.2 | 5.2 | 5.2 | 5.2 |
| Mandatory | | | | |
| Social Security | 4.2 | 5.1 | 5.9 | 6.0 |
| Medicare | 2.5 | 3.8 | 5.3 | 6.2 |
| Medicaid | 1.7 | 2.4 | 3.0 | 3.7 |
| Other | 2.2 | 2.0 | 1.9 | 2.1 |
| Net Interest | -0.2 | -2.5 | -3.3 | -2.9 |
| Total | 15.6 | 16.0 | 18.0 | 20.3 |
| Surplus(+) / Deficit(-) | 4.4 | 4.0 | 2.0 | -0.3 |
| Public Debt | -8 | -41 | -50 | -37 |
| Nominal GDP ($Trillions) | 15.7 | 24.0 | 36.2 | 54.6 |
| **Administration, MSR Current Services Baseline** | | | | |
| Receipts | 19.5 | 19.9 | 20.1 | 20.3 |
| Outlays | | | | |
| Discretionary | 4.9 | 4.3 | 3.8 | 3.3 |
| Mandatory | | | | |
| Social Security | 4.4 | 5.6 | 6.7 | 6.9 |
| Medicare | 2.3 | 2.9 | 3.6 | 4.0 |
| Medicaid | 1.6 | 2.1 | 2.7 | 3.3 |
| Other | 2.2 | 1.9 | 1.6 | 1.4 |
| Net Interest | -0.1 | -2.5 | -4.6 | -6.5 |
| Total | 15.3 | 14.3 | 13.8 | 12.4 |
| Surplus(+) / Deficit(-) | 4.2 | 5.6 | 6.3 | 7.9 |
| Public Debt | -4 | -45 | -81 | -113 |
| Nominal GDP ($Trillions) | 15.9 | 24.1 | 36.0 | 54.3 |
| **DIFFERENCE, ADMIN - CBO** | | | | |
| Receipts | -0.5 | -0.1 | 0.1 | 0.3 |
| Outlays | | | | |
| Discretionary | -0.3 | -0.9 | -1.4 | -1.9 |
| Mandatory | | | | |
| Social Security | 0.2 | 0.5 | 0.8 | 0.9 |
| Medicare | -0.2 | -0.9 | -1.7 | -2.2 |
| Medicaid | -0.1 | -0.3 | -0.3 | -0.4 |
| Other | 0.0 | -0.1 | -0.3 | -0.7 |
| Net Interest | 0.1 | 0.0 | -1.3 | -3.6 |
| Total | -0.3 | -1.7 | -4.2 | -7.9 |
| Surplus(+) / Deficit(-) | -0.2 | 1.6 | 4.3 | 8.2 |
| Public Debt | 4 | -4 | -31 | -76 |
| Nominal GDP ($Trillions) | 0.2 | 0.1 | -0.2 | -0.3 |

# COMMODITY EXCHANGE ACT

1997-SE-001270

DEPARTMENT OF THE TREASURY
WASHINGTON

GENERAL COUNSEL

February 3, 1997

MEMORANDUM FOR J. BENJAMIN H. NYE
EXECUTIVE SECRETARY

FROM: EDWARD S. KNIGHT ESK
GENERAL COUNSEL

SUBJECT: Transmittal to the Congress of Treasury's draft bill to revise the "Treasury Amendment" to the Commodity Exchange Act

ACTION FORCING EVENT:

OMB has approved transmittal to the Congress of the document in the attached legislative package (Tab A). The document previously had been approved by the appropriate Treasury policy and legal offices, and by the Assistant Secretary (Legislative Affairs).

RECOMMENDATIONS:

That the document be brought to the attention of the Secretary and that you advise the Associate General Counsel whether transmittal to the Congress is approved by initialing below and returning these materials to Room 1417.

________Agree ________Disagree ________Let's Discuss

ANALYSIS:

The document, which is summarized on the Summary and Coordination Sheet, is consistent with Treasury and Administration policy and is ready for transmittal to the Congress following coordination with the Executive Secretary. Substantive revisions requested by OMB, if any, have been cleared by the appropriate offices and are indicated at the "OMB" Tab.

ATTACHMENTS: Tab A Legislative Package

THE SECRETARY OF THE TREASURY
WASHINGTON

February 3, 1997

The Honorable Richard G. Lugar
Chairman
Committee on Agriculture,
Nutrition and Forestry
United States Senate
Washington, D.C. 20515

Dear Chairman Lugar:

The staffs of the Commodity Futures Trading Commission and the Treasury Department have met over the past thirteen months to discuss the policy underlying the provision of the Commodity Exchange Act (CEA) commonly referred to as the "Treasury Amendment." Both agencies agree on the need to clarify the scope of the CFTC's authority to protect retail customers against fraud by entities that are not currently subject to any federal regulation or supervision. Unfortunately, Treasury and the CFTC have been unable to reach agreement on the proper approach for achieving this goal and continue to disagree on several key issues. During that time, we have also worked to protect the interests of the Department in litigation, including the Dunn case before the Supreme Court. This letter will not restate the legal arguments put forward in that context, which are still valid today.

The CFTC recently transmitted to you a proposal for changes to the Treasury Amendment. Treasury objects to the proposal that the CFTC has offered. Enclosed for your consideration is a Treasury proposal to amend the Treasury Amendment in a way that addresses the retail fraud issue in a clear and direct manner without creating new ambiguities or unnecessarily increasing the regulatory burden of entities already subject to federal regulation.

One of the key points of difference between Treasury and the CFTC relates to the treatment of the over-the-counter institutional market for foreign exchange and the other instruments enumerated in the Treasury Amendment. Treasury believes this market should be entirely exempt from the CEA, as it is under the current Treasury Amendment. The public is well served by deep and liquid foreign exchange markets which provide access to foreign exchange instruments for a wide range of U.S. businesses that need to participate in global commerce. Although the CFTC acknowledges that it agrees with Treasury that the "interbank market [should] remain exempt from regulation under the CEA," the draft legislation proposed by the CFTC does not provide an unambiguous exemption for all segments of the over-the-counter institutional markets. If enacted, the CFTC's legislation would likely result in additional litigation concerning the scope of

exempted activities. Continued uncertainty would have a harmful effect on these important markets and may cause an increasing share of such markets to move overseas. Treasury understands that the staffs of the bank regulatory agencies share its concern about the potentially harmful impact of continued uncertainty in the institutional markets.

Treasury is also concerned that the CFTC's proposal imposes an unwarranted overlay of CFTC jurisdiction on federally regulated entities, such as banks, that may sell Treasury Amendment instruments to small businesses or members of the general public. There is no evidence that existing regulatory structures fail to ensure that there is adequate federal oversight of such transactions. Moreover, we believe that it is unwise to impose additional layers of regulation upon entities that are already under the jurisdiction of one or more federal regulators.

Thank you for your consideration of Treasury's proposal. We continue to discuss these issues with the CFTC and anticipate discussing our proposal with the federal banking agencies and the Securities and Exchange Commission. We look forward to working with you and your staff.

Sincerely,

Robert E. Rubin

# Treasury Legislative Proposal to Amend the Treasury Amendment

## Background

Under the CEA, the CFTC generally is given jurisdiction over contracts for the sale of commodities for future delivery (commonly referred to as futures contracts) and options on commodities. Before 1974, the term "commodity" in the CEA included only tangible agricultural commodities. In 1974, when the CFTC was created, the definition of the term "commodity" was significantly expanded. The new definition was open-ended, encompassing "all services, rights and interests in which contracts for future delivery are presently or in the future dealt in." The concepts of "futures contracts" and "options" remained undefined. The Treasury Department proposed language exempting off-exchange derivative transactions in foreign currency, government securities, and certain other financial instruments from the newly expanded CEA. This exemption was adopted virtually unchanged by Congress and is known as the Treasury Amendment.

In proposing the amendment, Treasury's primary concern was to protect the foreign currency market in the United States from potentially harmful regulation. In a letter to the Chairman of the Senate Committee on Agriculture and Forestry, Treasury noted that the foreign currency market "has proved highly efficient in serving the needs of international business in hedging the risks that stem from foreign exchange rate movements." S. Rep. No. 1131, 93rd Cong., 2d Sess. 50 (1974). Since that market consisted primarily of banks and dealers, Treasury believed that it would be inappropriate for any additional regulation of this complex function to be carried out by the CFTC. Treasury argued that granting the CFTC jurisdiction over the foreign currency market would confuse an already highly regulated business sector and that new regulatory limitations and restrictions could have an adverse impact on the usefulness and efficiency of foreign exchange markets for traders and investors. For similar reasons, Treasury argued that the CEA should exempt derivative transactions involving government securities and a variety of other financial instruments, unless conducted on organized exchanges.

Since the enactment of the Treasury Amendment, the size and importance of the markets for both foreign currency and government securities have increased dramatically. As a result, the goal of the Treasury Amendment, to preserve the efficiency of these markets by avoiding unnecessary regulation and uncertainty, is even more compelling today. Indeed, when it enacted the Government Securities Act of 1986, Congress recognized that unnecessary or inflexible regulation could increase the government's borrowing costs, and it acknowledged the need to preserve both the efficiency and the integrity of that market. S. Rep. No. 1416, 99th Cong., 1st Sess. 10 (1985).

Given this dramatic growth in the size of the financial markets since 1974, the open-ended nature of CEA coverage makes it even more crucial that the scope of the exemption from the CEA be absolutely clear. However, since the Treasury Amendment's enactment, the scope of CEA

coverage has continued to be a troublesome source of legal uncertainty for the financial markets. Determining how to draw the line between instruments that are subject to the CEA and those that are not, in a manner that provides logical consistency and predictability for new instruments, has been difficult under current law.

In the mid-1980's, a greater focus on these issues resulted from various interpretive and rule-making activities of the CFTC. In the CFTC's view, the concepts of "futures contracts" and "options," particularly when applied to transactions involving non-agricultural commodities, were potentially very far-reaching. For example, under the CFTC's Hybrid Instruments Rule, 17 C.F.R. pt. 34, the CFTC has asserted jurisdiction over certain securities and bank deposits whose value is linked to the price of commodities, unless such instruments meet certain criteria for exemption set forth in the Rule. Instruments such as bonds linked to the price of foreign currency and certain types of deposits of foreign currency in U.S. bank accounts may potentially be viewed by the CFTC as commodity futures or options subject to CEA regulation.

Recently, the CFTC has brought a number of enforcement actions asserting jurisdiction over foreign currency derivative transactions that have created significant interpretative issues about the scope of the Treasury Amendment. The CFTC's goal in bringing these enforcement actions -- the protection of unsophisticated investors from the unsavory or fraudulent practices of bucket shops or other unregulated entities -- is an important one, as Treasury has long acknowledged.[1] Unfortunately, the ambiguity created by these enforcement actions has significantly diminished the efficacy of the Treasury Amendment in providing a bright-line exclusion from the CEA for the markets in the enumerated financial instruments. Treasury does not believe that it would be good public policy to solve a discrete enforcement problem in a way that generates legal uncertainty throughout enormously important financial markets.

The CEA's language strongly tends to favor exchange trading, a mode of conducting transactions that developed in connection with agricultural commodities. Various financial futures and options have developed in that environment so successfully that the volume of financial futures and options on the various commodities exchanges, measured in terms of notional value of transactions, far exceeds that of agricultural commodities. However, there is a fundamental question whether that mode of conducting transactions is appropriate for all transactions involving financial instruments that, in the view of the CFTC, may constitute futures contracts or options. The financial markets have provided their own answer to this question: the notional amount of foreign exchange futures contracts traded over-the-counter is several orders of magnitude greater than that traded on exchanges.

The CFTC has some flexibility to address this fundamental question through the general exemptive authority granted to it by Congress in 1992. However, Treasury does not believe that

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[1] Letter from Charles O. Sethness, Assistant Secretary (Domestic Finance), United States Department of the Treasury, to Susan M. Phillips, Chairman, Commodity Futures Trading Commission (May 5, 1986).

reliance on this exemptive authority will provide the needed level of certainty for the foreign currency and government securities markets. One concern is that reliance on the exemptive authority could be interpreted as an implicit conclusion that the exempted transactions in question are futures or options subject to CFTC jurisdiction. Thus, reliance on exemptive authority requires market participants to operate, as a matter of caution, as if the transactions at issue are futures or options and structure their transactions to qualify for the regulatory exemption. If the CFTC later decides to change the parameters of the exemption, market participants would be forced to restructure their transactions accordingly or fall back on the position that the transactions are not, in fact, futures or options subject to the CEA, with all the accompanying legal uncertainty.

Treasury Proposal

In drafting the attached proposal, Treasury was guided by the principle that the appropriate legal standard should provide adequate protection of retail participants while achieving maximum legal certainty for the derivative markets in foreign currency and government securities, as well as the other enumerated financial instruments. Our proposal is structured to provide a broad exemption from the CEA for these transactions without resorting to terms that are undefined, open-ended, or both. Instead, we have attempted to draw the relevant lines by reference to objective factors that can be determined by all interested parties, including market participants. Although we have not expanded the list of covered instruments, we believe consideration must be given to whether the list should be updated and expanded to reflect some of the expansion in the variety of financial instruments since 1974, and the significance of certain products to investors. Recognizing that the resolution of certain issues raised by Treasury's proposal may require us to modify our approach, we would welcome the opportunity to continue to work with the Committee, as necessary, to expand the list of covered instruments, and to resolve other matters raised by our and others' proposals.

1. Exemption for Government Securities Transactions.

Treasury's proposal is structured to provide a complete exclusion for transactions in, or in any way involving, government securities unless those transactions are conducted on an organized exchange. Certain other securities transactions currently sheltered by the Treasury Amendment are similarly excluded. Treasury shares the CFTC's concern that the law should not provide a loophole for unregulated entities to defraud retail investors. With respect to these transactions, however, the federal securities laws serve that purpose. Indeed, the government securities market itself is now subject to a regulatory regime that did not exist at the time the Treasury Amendment was adopted. The proposal retains similar treatment for resales of installment loan contracts, mortgages, and mortgage purchase commitments

The CFTC's proposal, by contrast, would subject entire classes of transactions involving government securities (and other Treasury Amendment instruments) to an additional regulatory scheme that may or may not be consistent with existing law. In particular, the CFTC's draft

makes reference to the "when issued" government securities market, in which investors enter into contracts for the purchase of government securities to be issued at a later date. This market is of vital importance to the liquidity of the government securities market and helps to reduce the cost of government borrowing. Treasury believes this market is currently appropriately regulated and that CFTC regulation, or the threat of such regulation, of this market could be detrimental to government finance. Although CFTC staff has stated its belief that the "when issued" market is a "cash" market that is not, and should not be, the subject of CFTC regulation, the draft legislation prepared by the CFTC does not clearly exempt this market from CFTC regulation.

2. Exemption for Foreign Currency Transactions.

A. Transactions between Unregulated Entities and Retail Customers.

Treasury's proposal would permit the CFTC to regulate transactions involving foreign currency that are conducted on an organized exchange. It would also confer antifraud authority over foreign currency transactions conducted between any unregulated person and a retail customer. The term "unregulated person" is defined as a person who is not currently regulated by one of the federal bank regulators or is not a broker-dealer or investment company regulated by the Securities and Exchange Commission. A "retail customer" is defined in terms of net worth and income, to include any natural person other than a natural person with a net worth above $1,000,000 or with an annual income of more than $200,000 (or $300,000 when combined with one's spouse). This definition is drawn from the SEC's definition in Regulation D, 17 C.F.R. § 230.501, which delineates a class of sophisticated investors for whom the full protections of federal securities regulation are deemed unnecessary.[2] Drawing the line in this fashion clearly permits the CFTC to take regulatory or enforcement actions in the area where needed[3] while preserving the legal certainty originally intended by the Treasury Amendment.

B. Transactions between Regulated Entities and Retail Customers.

Treasury perceives no need for CFTC regulation of transactions involving regulated entities, such as banks and broker-dealers, that may sell foreign currency instruments to small businesses or individuals that do not meet certain net worth or income thresholds. Such customers may have

[2] By contrast, the CFTC's draft legislation refers to the CEA's existing definition of "appropriate persons." That definition includes, among other persons, banks, insurance companies, investment companies, governmental entities, broker-dealers, and corporations with a net worth exceeding $1,000,000 or total assets exceeding $5,000,000. It is unclear, however, whether the definition would also extend to other persons (such as high-net worth individuals) that are partially exempt from the CEA under current CFTC regulations, but that are not explicitly listed in the statutory definition.

[3] The recent CFTC enforcement actions have involved foreign currency transactions between unregulated entities and retail customers.

legitimate risk-management needs for specialized instruments that are not available on exchanges, such as futures contracts on particular foreign currencies. The extent of such transactions is extremely limited at present, probably due in part to the uncertain legal environment surrounding such transactions. Granting the CFTC regulatory authority over such transactions could mean that they do not occur, since the CEA is based on the presumption that most non-exchange derivative transactions should be illegal, unless demonstrated otherwise. We believe, however, that regulation of this nature is unwarranted where the entities involved are already subject to extensive schemes of federal regulation. Such entities should not be constrained from meeting the needs of their customers.

C. The Institutional Markets.

Finally, Treasury believes that it is neither necessary nor appropriate to expand the scope of the CFTC's jurisdiction to regulate any segment of the institutional markets. Thus, we believe that transactions engaged in by persons other than retail customers -- including, but not limited to, banks, broker-dealers, corporations, and individuals whose net worth or income takes them outside of the definition of retail customer -- should not be subject to regulation under the CEA. Institutional participants, whether currently regulated or not, have the sophistication and the financial means to protect themselves and to handle their disputes without the assistance of the CFTC. As noted, the limited number of enforcement actions the CFTC has brought over the years have been in the context of bucket shops dealing with unsophisticated retail customers.

Creating a more restrictive or legally uncertain regulatory environment could detrimentally affect the institutional market, causing the foreign currency market to migrate overseas to a more favorable environment. Migration of the foreign currency futures and options market could have a spillover effect on that market, resulting in restricted access to these markets for many participants. The United States foreign currency market is too large and too important to be subjected to unnecessary regulation or the vagaries of case law created in the context of retail enforcement actions.

We note that the CFTC's draft legislation provides that transactions in "defined financial instruments" entered into by "appropriate persons" are entirely exempt from the CEA if the conduct of the persons is "subject to provisions of civil federal law prohibiting fraud and price manipulation other than the [CEA]." It appears that this provision is designed to exempt transactions between banks, broker-dealers, and other regulated entities from the provisions of the CEA, a goal shared by Treasury. The law would be greatly clarified, however, if the categories of exempted entities were listed, as they are in Treasury's proposal, rather than leaving the question of coverage open to interpretation by the CFTC and/or the courts. Moreover, the CFTC's proposal does not clearly establish whether all, or only some, of the "appropriate persons" in a given transaction must be subject to other federal laws before the exemption from the CEA would be available. Thus, the proposal does not provide a clear exemption for other sophisticated institutional market participants, such as corporations and high-net worth individuals, that are not directly subject to federal regulation.

3. Definition of "Organized Exchange"

Under the existing Treasury Amendment, the CFTC retains jurisdiction to regulate certain transactions in Treasury Amendment instruments that occur on a "board of trade." The use of this term, however, has given rise to many of the interpretive difficulties that exist under current law. Treasury's proposal allows continued CFTC jurisdiction over transactions occurring on an "organized exchange" and supplies a detailed definition of this new term. The definition clarifies that entities engaged in the business of buying or selling Treasury Amendment instruments, such as banks, broker-dealers, futures commission merchants, and government securities dealers and brokers, will not be deemed to be organized exchanges; rather, the definition includes entities that serve as a marketplace for arms' length transactions.

# Treasury Amendment Legislation

SEC. 101. TREASURY AMENDMENT CLARIFICATION.

Section 2(a)(1)(A) of the Commodity Exchange Act (7 U.S.C. 2(ii)) is amended--

(a) by striking clause (ii) and inserting the following:

"(ii) Except as provided for in subsection (iii), this chapter shall not apply to and the Commission shall have no jurisdiction over transactions in or in any way involving foreign currency, unless the transaction is a contract of sale for future delivery or an option and is conducted on an organized exchange."

(b) by adding at the end the following new subsections:

"(iii) Sections 4b and 4o of the Commodity Exchange Act (7 U.S.C. 6b & 6o) and any antifraud regulation promulgated by the Commission pursuant to 4c(b) of the Act (7 U.S.C. 6c(b)) shall be applicable to transactions in or in any way involving foreign currency if the transaction is a contract of sale for future delivery or an option and is conducted between any unregulated person and a retail customer."

"(iv) This chapter shall not apply to and the Commission shall have no jurisdiction over transactions in or in any way involving security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless the transaction--

(I) is a contract of sale for future delivery, or an option on either a future or a commodity that is not a security, and

(II) is conducted on an organized exchange.

"(v) The following definitions shall apply for purposes of this section:

(I) REGULATED PERSON

(a) The term "regulated person" means a person that is regulated or supervised by an appropriate federal banking agency as the term is defined in section 903 of International Lending Supervision Act (12 U.S.C. 3902); a government securities broker, a government securities dealer, or a registered broker or dealer as defined in section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C.

78c(a)); or an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8); or

(b) an affiliate of a person described in subclause (a), but only to the extent that the affiliate conducts a transaction (other than a transaction conducted on an organized exchange) covered by section 2(a)(1)(A)(ii) or section 2(a)(1)(A)(iv) through such a person.

(II) UNREGULATED PERSON

The term "unregulated person" means any person other than a regulated person.

(III) RETAIL CUSTOMER

The term "retail customer" means any natural person other than--

(a) a natural person whose net worth, or, in the case of a natural person who is married, joint net worth with that person's spouse, exceeds $1,000,000, or

(b) a natural person who had an income in excess of $200,000 in each of the two most recent years, or in the case of a natural person who is married, joint income with that person's spouse in excess of $300,000 in each of those years.

*Provided*, that the term "retail customer" shall not include any person to the extent that such person is represented by a regulated person in a transaction (other than a transaction conducted on an organized exchange) described in section 2(a)(1)(A)(ii) or section 2(a)(1)(A)(iv).

(IV) ORGANIZED EXCHANGE

(a) Except as otherwise provided in this subclause, the term "organized exchange" means--

(1) a board of trade designated by the Commission as a contract market or a physical or electronic market place or similar facility affiliated with a board of trade so designated as a contract market, or

(2) a physical or electronic market place or similar facility through which unaffiliated persons, for their own accounts or for the accounts of customers, enter into and execute arms' length binding transactions by accepting bids and offers made by one person that are open to all persons who conduct business through such market place or similar facility.

(b) Notwithstanding subclause (III)(a), the term "organized exchange" does not include--

(1) parties engaged in privately negotiated bilateral transactions, even if such parties use electronic means to communicate or execute transactions, or

(2) government securities dealers or brokers, as defined in section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)).

(V) OPTION

The term "option" means a transaction described in Section 4c(b) of this Act."

SEC. 102. SAVINGS CLAUSE.

Nothing in section 101 of this Act shall be interpreted as altering the Futures Trading Act of 1982 (Pub. L. No. 97-444).

Explanation:

In general, the amendment would exempt transactions in or in any way involving foreign currency from the Commodity Exchange Act (CEA), that would otherwise be subject to the CEA, unless the transactions were conducted on an organized exchange. The amendment would permit over-the-counter foreign exchange transactions between unregulated persons and retail customers, but such transactions would be subject to CFTC anti-fraud authority under sections 4b and 4o of the CEA. The amendment adds the term "in any way involving" to clarify that options and cash settled transactions are within the scope of the Treasury Amendment exemption, as are transactions involving the values, yields, or rates on the listed instruments.

Additionally, transactions in or, in any way, involving security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments are exempted from the CEA unless the transaction is a future or an option on a future or a commodity that is not a security and is conducted on an organized exchange.

The amendment would add new definitions of "regulated person", "unregulated person", "retail customer", "organized exchange" and "option" to the CEA. A "regulated person" is a person who is currently regulated by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Office of Thrift Supervision and the Federal Deposit Insurance Corporation. The definition is intended to include banks, savings associations, foreign banks, holding companies, operating subsidiaries, affiliates, service corporations, Edge Act corporations, and Agreement Corporations operating under section 25 of the Federal Reserve Act. Additionally, the term includes particular entities registered with the Securities and Exchange Commission such as government securities brokers and dealers. Finally, the term includes affiliates of such persons, but only to the extent that the affiliate conducts a covered transaction through such persons. The term "unregulated person" means any person other than a regulated person.

The term "retail customer" has been defined to mean any natural person other than (a) a natural person whose net worth exceeds $1,000,000, or (b) a natural person whose annual income exceeded $200,000 (or whose joint income with that person's spouse exceeded $300,000) in each of the last two years. The term does not include, however, a person who is represented by a regulated person.

The term "organized exchange" has been defined to mean both (1) a board of trade designated by the CFTC as a contract market and affiliated exchange-like facilities, and (2) a physical or electronic market place or similar facility by means of which unaffiliated persons engage in arms' length binding transactions by accepting bids or offers made by one person that are open to all persons who conduct business on the facility. The definition is intended to clarify that entities that are engaged in the business of buying or selling Treasury Amendment instruments, such as banks, broker-dealers, futures commission merchants, and government securities dealers and brokers, are not "organized exchanges".

The term "option" is defined to include any transaction involving any commodity regulated under the CEA which is of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty".

The amendment includes a savings clause to clarify that the amendment may not be interpreted as altering the Futures Trading Act of 1982, Pub. L. No. 97-444, the so-called "Shad-Johnson Accord." Among other things, this Act imposed restrictions on the CFTC jurisdiction over options on securities and options on foreign currency traded on a national securities exchange, which are now regulated by the Securities and Exchange Commission.

THE SECRETARY OF THE TREASURY
WASHINGTON

February 3, 1997

The Honorable Tom Harkin
Ranking Democrat
Committee on Agriculture,
Nutrition and Forestry
United States Senate
Washington, D.C. 20515

Dear Chairman Lugar:

The staffs of the Commodity Futures Trading Commission and the Treasury Department have met over the past thirteen months to discuss the policy underlying the provision of the Commodity Exchange Act (CEA) commonly referred to as the "Treasury Amendment." Both agencies agree on the need to clarify the scope of the CFTC's authority to protect retail customers against fraud by entities that are not currently subject to any federal regulation or supervision. Unfortunately, Treasury and the CFTC have been unable to reach agreement on the proper approach for achieving this goal and continue to disagree on several key issues. During that time, we have also worked to protect the interests of the Department in litigation, including the Dunn case before the Supreme Court. This letter will not restate the legal arguments put forward in that context, which are still valid today.

The CFTC recently transmitted to you a proposal for changes to the Treasury Amendment. Treasury objects to the proposal that the CFTC has offered. Enclosed for your consideration is a Treasury proposal to amend the Treasury Amendment in a way that addresses the retail fraud issue in a clear and direct manner without creating new ambiguities or unnecessarily increasing the regulatory burden of entities already subject to federal regulation.

One of the key points of difference between Treasury and the CFTC relates to the treatment of the over-the-counter institutional market for foreign exchange and the other instruments enumerated in the Treasury Amendment. Treasury believes this market should be entirely exempt from the CEA, as it is under the current Treasury Amendment. The public is well served by deep and liquid foreign exchange markets which provide access to foreign exchange instruments for a wide range of U.S. businesses that need to participate in global commerce. Although the CFTC acknowledges that it agrees with Treasury that the "interbank market [should] remain exempt from regulation under the CEA," the draft legislation proposed by the CFTC does not provide an unambiguous exemption for all segments of the over-the-counter institutional markets. If enacted, the CFTC's legislation would likely result in additional litigation concerning the scope of

exempted activities. Continued uncertainty would have a harmful effect on these important markets and may cause an increasing share of such markets to move overseas. Treasury understands that the staffs of the bank regulatory agencies share its concern about the potentially harmful impact of continued uncertainty in the institutional markets.

Treasury is also concerned that the CFTC's proposal imposes an unwarranted overlay of CFTC jurisdiction on federally regulated entities, such as banks, that may sell Treasury Amendment instruments to small businesses or members of the general public. There is no evidence that existing regulatory structures fail to ensure that there is adequate federal oversight of such transactions. Moreover, we believe that it is unwise to impose additional layers of regulation upon entities that are already under the jurisdiction of one or more federal regulators.

Thank you for your consideration of Treasury's proposal. We continue to discuss these issues with the CFTC and anticipate discussing our proposal with the federal banking agencies and the Securities and Exchange Commission. We look forward to working with you and your staff.

Sincerely,

Robert E. Rubin

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Background

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In proposing the amendment, Treasury's primary concern was to protect the foreign currency market in the United States from potentially harmful regulation. In a letter to the Chairman of the Senate Committee on Agriculture and Forestry, Treasury noted that the foreign currency market "has proved highly efficient in serving the needs of international business in hedging the risks that stem from foreign exchange rate movements." S. Rep. No. 1131, 93rd Cong., 2d Sess. 50 (1974). Since that market consisted primarily of banks and dealers, Treasury believed that it would be inappropriate for any additional regulation of this complex function to be carried out by the CFTC. Treasury argued that granting the CFTC jurisdiction over the foreign currency market would confuse an already highly regulated business sector and that new regulatory limitations and restrictions could have an adverse impact on the usefulness and efficiency of foreign exchange markets for traders and investors. For similar reasons, Treasury argued that the CEA should exempt derivative transactions involving government securities and a variety of other financial instruments, unless conducted on organized exchanges.

Since the enactment of the Treasury Amendment, the size and importance of the markets for both foreign currency and government securities have increased dramatically. As a result, the goal of the Treasury Amendment, to preserve the efficiency of these markets by avoiding unnecessary regulation and uncertainty, is even more compelling today. Indeed, when it enacted the Government Securities Act of 1986, Congress recognized that unnecessary or inflexible regulation could increase the government's borrowing costs, and it acknowledged the need to preserve both the efficiency and the integrity of that market. S. Rep. No. 1416, 99th Cong., 1st Sess. 10 (1985).

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Treasury perceives no need for CFTC regulation of transactions involving regulated entities, such as banks and broker-dealers, that may sell foreign currency instruments to small businesses or individuals that do not meet certain net worth or income thresholds. Such customers may have

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[2] By contrast, the CFTC's draft legislation refers to the CEA's existing definition of "appropriate persons." That definition includes, among other persons, banks, insurance companies, investment companies, governmental entities, broker-dealers, and corporations with a net worth exceeding $1,000,000 or total assets exceeding $5,000,000. It is unclear, however, whether the definition would also extend to other persons (such as high-net worth individuals) that are partially exempt from the CEA under current CFTC regulations, but that are not explicitly listed in the statutory definition.

[3] The recent CFTC enforcement actions have involved foreign currency transactions between unregulated entities and retail customers

legitimate risk-management needs for specialized instruments that are not available on exchanges, such as futures contracts on particular foreign currencies. The extent of such transactions is extremely limited at present, probably due in part to the uncertain legal environment surrounding such transactions. Granting the CFTC regulatory authority over such transactions could mean that they do not occur, since the CEA is based on the presumption that most non-exchange derivative transactions should be illegal, unless demonstrated otherwise. We believe, however, that regulation of this nature is unwarranted where the entities involved are already subject to extensive schemes of federal regulation. Such entities should not be constrained from meeting the needs of their customers.

C. The Institutional Markets.

Finally, Treasury believes that it is neither necessary nor appropriate to expand the scope of the CFTC's jurisdiction to regulate any segment of the institutional markets. Thus, we believe that transactions engaged in by persons other than retail customers -- including, but not limited to, banks, broker-dealers, corporations, and individuals whose net worth or income takes them outside of the definition of retail customer -- should not be subject to regulation under the CEA. Institutional participants, whether currently regulated or not, have the sophistication and the financial means to protect themselves and to handle their disputes without the assistance of the CFTC. As noted, the limited number of enforcement actions the CFTC has brought over the years have been in the context of bucket shops dealing with unsophisticated retail customers.

Creating a more restrictive or legally uncertain regulatory environment could detrimentally affect the institutional market, causing the foreign currency market to migrate overseas to a more favorable environment. Migration of the foreign currency futures and options market could have a spillover effect on that market, resulting in restricted access to these markets for many participants. The United States foreign currency market is too large and too important to be subjected to unnecessary regulation or the vagaries of case law created in the context of retail enforcement actions.

We note that the CFTC's draft legislation provides that transactions in "defined financial instruments" entered into by "appropriate persons" are entirely exempt from the CEA if the conduct of the persons is "subject to provisions of civil federal law prohibiting fraud and price manipulation other than the [CEA]." It appears that this provision is designed to exempt transactions between banks, broker-dealers, and other regulated entities from the provisions of the CEA, a goal shared by Treasury. The law would be greatly clarified, however, if the categories of exempted entities were listed, as they are in Treasury's proposal, rather than leaving the question of coverage open to interpretation by the CFTC and/or the courts. Moreover, the CFTC's proposal does not clearly establish whether all, or only some, of the "appropriate persons" in a given transaction must be subject to other federal laws before the exemption from the CEA would be available. Thus, the proposal does not provide a clear exemption for other sophisticated institutional market participants, such as corporations and high-net worth individuals, that are not directly subject to federal regulation.

3. Definition of "Organized Exchange"

Under the existing Treasury Amendment, the CFTC retains jurisdiction to regulate certain transactions in Treasury Amendment instruments that occur on a "board of trade." The use of this term, however, has given rise to many of the interpretive difficulties that exist under current law. Treasury's proposal allows continued CFTC jurisdiction over transactions occurring on an "organized exchange" and supplies a detailed definition of this new term. The definition clarifies that entities engaged in the business of buying or selling Treasury Amendment instruments, such as banks, broker-dealers, futures commission merchants, and government securities dealers and brokers, will not be deemed to be organized exchanges; rather, the definition includes entities that serve as a marketplace for arms' length transactions.

## Treasury Amendment Legislation

SEC. 101. TREASURY AMENDMENT CLARIFICATION.

Section 2(a)(1)(A) of the Commodity Exchange Act (7 U.S.C. 2(ii)) is amended--

(a) by striking clause (ii) and inserting the following:

"(ii) Except as provided for in subsection (iii), this chapter shall not apply to and the Commission shall have no jurisdiction over transactions in or in any way involving foreign currency, unless the transaction is a contract of sale for future delivery or an option and is conducted on an organized exchange."

(b) by adding at the end the following new subsections:

"(iii) Sections 4b and 4o of the Commodity Exchange Act (7 U.S.C. 6b & 6o) and any antifraud regulation promulgated by the Commission pursuant to 4c(b) of the Act (7 U.S.C. 6c(b)) shall be applicable to transactions in or in any way involving foreign currency if the transaction is a contract of sale for future delivery or an option and is conducted between any unregulated person and a retail customer."

"(iv) This chapter shall not apply to and the Commission shall have no jurisdiction over transactions in or in any way involving security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless the transaction--

(I) is a contract of sale for future delivery, or an option on either a future or a commodity that is not a security, and

(II) is conducted on an organized exchange.

"(v) The following definitions shall apply for purposes of this section:

(I) REGULATED PERSON

(a) The term "regulated person" means a person that is regulated or supervised by an appropriate federal banking agency as the term is defined in section 903 of International Lending Supervision Act (12 U.S.C. 3902); a government securities broker, a government securities dealer, or a registered broker or dealer as defined in section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C.

78c(a)); or an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8); or

(b) an affiliate of a person described in subclause (a), but only to the extent that the affiliate conducts a transaction (other than a transaction conducted on an organized exchange) covered by section 2(a)(1)(A)(ii) or section 2(a)(1)(A)(iv) through such a person.

(II) UNREGULATED PERSON

The term "unregulated person" means any person other than a regulated person.

(III) RETAIL CUSTOMER

The term "retail customer" means any natural person other than--

(a) a natural person whose net worth, or, in the case of a natural person who is married, joint net worth with that person's spouse, exceeds $1,000,000, or

(b) a natural person who had an income in excess of $200,000 in each of the two most recent years, or in the case of a natural person who is married, joint income with that person's spouse in excess of $300,000 in each of those years.

*Provided*, that the term "retail customer" shall not include any person to the extent that such person is represented by a regulated person in a transaction (other than a transaction conducted on an organized exchange) described in section 2(a)(1)(A)(ii) or section 2(a)(1)(A)(iv).

(IV) ORGANIZED EXCHANGE

(a) Except as otherwise provided in this subclause, the term "organized exchange" means--

(1) a board of trade designated by the Commission as a contract market or a physical or electronic market place or similar facility affiliated with a board of trade so designated as a contract market, or

(2) a physical or electronic market place or similar facility through which unaffiliated persons, for their own accounts or for the accounts of customers, enter into and execute arms' length binding transactions by accepting bids and offers made by one person that are open to all persons who conduct business through such market place or similar facility.

(b) Notwithstanding subclause (III)(a), the term "organized exchange" does not include--

(1) parties engaged in privately negotiated bilateral transactions, even if such parties use electronic means to communicate or execute transactions, or

(2) government securities dealers or brokers, as defined in section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)).

(V) OPTION

The term "option" means a transaction described in Section 4c(b) of this Act."

SEC. 102. SAVINGS CLAUSE.

Nothing in section 101 of this Act shall be interpreted as altering the Futures Trading Act of 1982 (Pub. L. No. 97-444).

Explanation:

In general, the amendment would exempt transactions in or in any way involving foreign currency from the Commodity Exchange Act (CEA), that would otherwise be subject to the CEA, unless the transactions were conducted on an organized exchange. The amendment would permit over-the-counter foreign exchange transactions between unregulated persons and retail customers, but such transactions would be subject to CFTC anti-fraud authority under sections 4b and 4o of the CEA. The amendment adds the term "in any way involving" to clarify that options and cash settled transactions are within the scope of the Treasury Amendment exemption, as are transactions involving the values, yields, or rates on the listed instruments.

Additionally, transactions in or, in any way, involving security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments are exempted from the CEA unless the transaction is a future or an option on a future or a commodity that is not a security and is conducted on an organized exchange.

The amendment would add new definitions of "regulated person", "unregulated person", "retail customer", "organized exchange" and "option" to the CEA. A "regulated person" is a person who is currently regulated by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Office of Thrift Supervision and the Federal Deposit Insurance Corporation. The definition is intended to include banks, savings associations, foreign banks, holding companies, operating subsidiaries, affiliates, service corporations, Edge Act corporations, and Agreement Corporations operating under section 25 of the Federal Reserve Act. Additionally, the term includes particular entities registered with the Securities and Exchange Commission such as government securities brokers and dealers. Finally, the term includes affiliates of such persons, but only to the extent that the affiliate conducts a covered transaction through such persons. The term "unregulated person" means any person other than a regulated person.

The term "retail customer" has been defined to mean any natural person other than (a) a natural person whose net worth exceeds $1,000,000, or (b) a natural person whose annual income exceeded $200,000 (or whose joint income with that person's spouse exceeded $300,000) in each of the last two years. The term does not include, however, a person who is represented by a regulated person.

The term "organized exchange" has been defined to mean both (1) a board of trade designated by the CFTC as a contract market and affiliated exchange-like facilities, and (2) a physical or electronic market place or similar facility by means of which unaffiliated persons engage in arms' length binding transactions by accepting bids or offers made by one person that are open to all persons who conduct business on the facility. The definition is intended to clarify that entities that are engaged in the business of buying or selling Treasury Amendment instruments, such as banks, broker-dealers, futures commission merchants, and government securities dealers and brokers, are not "organized exchanges".

The term "option" is defined to include any transaction involving any commodity regulated under the CEA which is of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty".

The amendment includes a savings clause to clarify that the amendment may not be interpreted as altering the Futures Trading Act of 1982, Pub. L. No. 97-444, the so-called "Shad-Johnson Accord." Among other things, this Act imposed restrictions on the CFTC jurisdiction over options on securities and options on foreign currency traded on a national securities exchange, which are now regulated by the Securities and Exchange Commission.

THE SECRETARY OF THE TREASURY
WASHINGTON

February 3, 1997

The Honorable Patrick J. Leahy
Committee on Agriculture,
Nutrition and Forestry
United States Senate
Washington, D.C. 20515

Dear Senator Leahy:

The staffs of the Commodity Futures Trading Commission and the Treasury Department have met over the past thirteen months to discuss the policy underlying the provision of the Commodity Exchange Act (CEA) commonly referred to as the "Treasury Amendment." Both agencies agree on the need to clarify the scope of the CFTC's authority to protect retail customers against fraud by entities that are not currently subject to any federal regulation or supervision. Unfortunately, Treasury and the CFTC have been unable to reach agreement on the proper approach for achieving this goal and continue to disagree on several key issues. During that time, we have also worked to protect the interests of the Department in litigation, including the Dunn case before the Supreme Court. This letter will not restate the legal arguments put forward in that context, which are still valid today.

The CFTC recently transmitted to you a proposal for changes to the Treasury Amendment. Treasury objects to the proposal that the CFTC has offered. Enclosed for your consideration is a Treasury proposal to amend the Treasury Amendment in a way that addresses the retail fraud issue in a clear and direct manner without creating new ambiguities or unnecessarily increasing the regulatory burden of entities already subject to federal regulation.

One of the key points of difference between Treasury and the CFTC relates to the treatment of the over-the-counter institutional market for foreign exchange and the other instruments enumerated in the Treasury Amendment. Treasury believes this market should be entirely exempt from the CEA, as it is under the current Treasury Amendment. The public is well served by deep and liquid foreign exchange markets which provide access to foreign exchange instruments for a wide range of U.S. businesses that need to participate in global commerce. Although the CFTC acknowledges that it agrees with Treasury that the "interbank market [should] remain exempt from regulation under the CEA," the draft legislation proposed by the CFTC does not provide an unambiguous exemption for all segments of the over-the-counter institutional markets. If enacted, the CFTC's legislation would likely result in additional litigation concerning the scope of exempted activities. Continued uncertainty would have a harmful effect on these important

exempted activities. Continued uncertainty would have a harmful effect on these important markets and may cause an increasing share of such markets to move overseas. Treasury understands that the staffs of the bank regulatory agencies share its concern about the potentially harmful impact of continued uncertainty in the institutional markets.

Treasury is also concerned that the CFTC's proposal imposes an unwarranted overlay of CFTC jurisdiction on federally regulated entities, such as banks, that may sell Treasury Amendment instruments to small businesses or members of the general public. There is no evidence that existing regulatory structures fail to ensure that there is adequate federal oversight of such transactions. Moreover, we believe that it is unwise to impose additional layers of regulation upon entities that are already under the jurisdiction of one or more federal regulators.

Thank you for your consideration of Treasury's proposal. We continue to discuss these issues with the CFTC and anticipate discussing our proposal with the federal banking agencies and the Securities and Exchange Commission. We look forward to working with you and your staff.

Sincerely,

Robert E. Rubin

## Treasury Legislative Proposal to Amend the Treasury Amendment

Background

Under the CEA, the CFTC generally is given jurisdiction over contracts for the sale of commodities for future delivery (commonly referred to as futures contracts) and options on commodities. Before 1974, the term "commodity" in the CEA included only tangible agricultural commodities. In 1974, when the CFTC was created, the definition of the term "commodity" was significantly expanded. The new definition was open-ended, encompassing "all services, rights and interests in which contracts for future delivery are presently or in the future dealt in." The concepts of "futures contracts" and "options" remained undefined. The Treasury Department proposed language exempting off-exchange derivative transactions in foreign currency, government securities, and certain other financial instruments from the newly expanded CEA. This exemption was adopted virtually unchanged by Congress and is known as the Treasury Amendment.

In proposing the amendment, Treasury's primary concern was to protect the foreign currency market in the United States from potentially harmful regulation. In a letter to the Chairman of the Senate Committee on Agriculture and Forestry, Treasury noted that the foreign currency market "has proved highly efficient in serving the needs of international business in hedging the risks that stem from foreign exchange rate movements." S. Rep. No. 1131, 93rd Cong., 2d Sess. 50 (1974). Since that market consisted primarily of banks and dealers, Treasury believed that it would be inappropriate for any additional regulation of this complex function to be carried out by the CFTC. Treasury argued that granting the CFTC jurisdiction over the foreign currency market would confuse an already highly regulated business sector and that new regulatory limitations and restrictions could have an adverse impact on the usefulness and efficiency of foreign exchange markets for traders and investors. For similar reasons, Treasury argued that the CEA should exempt derivative transactions involving government securities and a variety of other financial instruments, unless conducted on organized exchanges.

Since the enactment of the Treasury Amendment, the size and importance of the markets for both foreign currency and government securities have increased dramatically. As a result, the goal of the Treasury Amendment, to preserve the efficiency of these markets by avoiding unnecessary regulation and uncertainty, is even more compelling today. Indeed, when it enacted the Government Securities Act of 1986, Congress recognized that unnecessary or inflexible regulation could increase the government's borrowing costs, and it acknowledged the need to preserve both the efficiency and the integrity of that market. S. Rep. No. 1416, 99th Cong., 1st Sess. 10 (1985).

Given this dramatic growth in the size of the financial markets since 1974, the open-ended nature of CEA coverage makes it even more crucial that the scope of the exemption from the CEA be absolutely clear. However, since the Treasury Amendment's enactment, the scope of CEA

coverage has continued to be a troublesome source of legal uncertainty for the financial markets. Determining how to draw the line between instruments that are subject to the CEA and those that are not, in a manner that provides logical consistency and predictability for new instruments, has been difficult under current law.

In the mid-1980's, a greater focus on these issues resulted from various interpretive and rule-making activities of the CFTC. In the CFTC's view, the concepts of "futures contracts" and "options," particularly when applied to transactions involving non-agricultural commodities, were potentially very far-reaching. For example, under the CFTC's Hybrid Instruments Rule, 17 C.F.R. pt. 34, the CFTC has asserted jurisdiction over certain securities and bank deposits whose value is linked to the price of commodities, unless such instruments meet certain criteria for exemption set forth in the Rule. Instruments such as bonds linked to the price of foreign currency and certain types of deposits of foreign currency in U.S. bank accounts may potentially be viewed by the CFTC as commodity futures or options subject to CEA regulation.

Recently, the CFTC has brought a number of enforcement actions asserting jurisdiction over foreign currency derivative transactions that have created significant interpretative issues about the scope of the Treasury Amendment. The CFTC's goal in bringing these enforcement actions -- the protection of unsophisticated investors from the unsavory or fraudulent practices of bucket shops or other unregulated entities -- is an important one, as Treasury has long acknowledged.[1] Unfortunately, the ambiguity created by these enforcement actions has significantly diminished the efficacy of the Treasury Amendment in providing a bright-line exclusion from the CEA for the markets in the enumerated financial instruments. Treasury does not believe that it would be good public policy to solve a discrete enforcement problem in a way that generates legal uncertainty throughout enormously important financial markets.

The CEA's language strongly tends to favor exchange trading, a mode of conducting transactions that developed in connection with agricultural commodities. Various financial futures and options have developed in that environment so successfully that the volume of financial futures and options on the various commodities exchanges, measured in terms of notional value of transactions, far exceeds that of agricultural commodities. However, there is a fundamental question whether that mode of conducting transactions is appropriate for all transactions involving financial instruments that, in the view of the CFTC, may constitute futures contracts or options. The financial markets have provided their own answer to this question: the notional amount of foreign exchange futures contracts traded over-the-counter is several orders of magnitude greater than that traded on exchanges.

The CFTC has some flexibility to address this fundamental question through the general exemptive authority granted to it by Congress in 1992. However, Treasury does not believe that

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[1] Letter from Charles O. Sethness, Assistant Secretary (Domestic Finance), United States Department of the Treasury, to Susan M. Phillips, Chairman, Commodity Futures Trading Commission (May 5, 1986).

reliance on this exemptive authority will provide the needed level of certainty for the foreign currency and government securities markets. One concern is that reliance on the exemptive authority could be interpreted as an implicit conclusion that the exempted transactions in question are futures or options subject to CFTC jurisdiction. Thus, reliance on exemptive authority requires market participants to operate, as a matter of caution, as if the transactions at issue are futures or options and structure their transactions to qualify for the regulatory exemption. If the CFTC later decides to change the parameters of the exemption, market participants would be forced to restructure their transactions accordingly or fall back on the position that the transactions are not, in fact, futures or options subject to the CEA, with all the accompanying legal uncertainty.

Treasury Proposal

In drafting the attached proposal, Treasury was guided by the principle that the appropriate legal standard should provide adequate protection of retail participants while achieving maximum legal certainty for the derivative markets in foreign currency and government securities, as well as the other enumerated financial instruments. Our proposal is structured to provide a broad exemption from the CEA for these transactions without resorting to terms that are undefined, open-ended, or both. Instead, we have attempted to draw the relevant lines by reference to objective factors that can be determined by all interested parties, including market participants. Although we have not expanded the list of covered instruments, we believe consideration must be given to whether the list should be updated and expanded to reflect some of the expansion in the variety of financial instruments since 1974, and the significance of certain products to investors. Recognizing that the resolution of certain issues raised by Treasury's proposal may require us to modify our approach, we would welcome the opportunity to continue to work with the Committee, as necessary, to expand the list of covered instruments, and to resolve other matters raised by our and others' proposals.

1. Exemption for Government Securities Transactions.

Treasury's proposal is structured to provide a complete exclusion for transactions in, or in any way involving, government securities unless those transactions are conducted on an organized exchange. Certain other securities transactions currently sheltered by the Treasury Amendment are similarly excluded. Treasury shares the CFTC s concern that the law should not provide a loophole for unregulated entities to defraud retail investors. With respect to these transactions, however, the federal securities laws serve that purpose. Indeed, the government securities market itself is now subject to a regulatory regime that did not exist at the time the Treasury Amendment was adopted. The proposal retains similar treatment for resales of installment loan contracts, mortgages, and mortgage purchase commitments.

The CFTC's proposal, by contrast, would subject entire classes of transactions involving government securities (and other Treasury Amendment instruments) to an additional regulatory scheme that may or may not be consistent with existing law. In particular, the CFTC's draft

makes reference to the "when issued" government securities market, in which investors enter into contracts for the purchase of government securities to be issued at a later date. This market is of vital importance to the liquidity of the government securities market and helps to reduce the cost of government borrowing. Treasury believes this market is currently appropriately regulated and that CFTC regulation, or the threat of such regulation, of this market could be detrimental to government finance. Although CFTC staff has stated its belief that the "when issued" market is a "cash" market that is not, and should not be, the subject of CFTC regulation, the draft legislation prepared by the CFTC does not clearly exempt this market from CFTC regulation.

2. Exemption for Foreign Currency Transactions.

A. Transactions between Unregulated Entities and Retail Customers.

Treasury's proposal would permit the CFTC to regulate transactions involving foreign currency that are conducted on an organized exchange. It would also confer antifraud authority over foreign currency transactions conducted between any unregulated person and a retail customer. The term "unregulated person" is defined as a person who is not currently regulated by one of the federal bank regulators or is not a broker-dealer or investment company regulated by the Securities and Exchange Commission. A "retail customer" is defined in terms of net worth and income, to include any natural person other than a natural person with a net worth above $1,000,000 or with an annual income of more than $200,000 (or $300,000 when combined with one's spouse). This definition is drawn from the SEC's definition in Regulation D, 17 C.F.R. § 230.501, which delineates a class of sophisticated investors for whom the full protections of federal securities regulation are deemed unnecessary.[2] Drawing the line in this fashion clearly permits the CFTC to take regulatory or enforcement actions in the area where needed[3] while preserving the legal certainty originally intended by the Treasury Amendment.

B. Transactions between Regulated Entities and Retail Customers.

Treasury perceives no need for CFTC regulation of transactions involving regulated entities, such as banks and broker-dealers, that may sell foreign currency instruments to small businesses or individuals that do not meet certain net worth or income thresholds. Such customers may have

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[2] By contrast, the CFTC's draft legislation refers to the CEA's existing definition of "appropriate persons." That definition includes, among other persons, banks, insurance companies, investment companies, governmental entities, broker-dealers, and corporations with a net worth exceeding $1,000,000 or total assets exceeding $5,000,000. It is unclear, however, whether the definition would also extend to other persons (such as high-net worth individuals) that are partially exempt from the CEA under current CFTC regulations, but that are not explicitly listed in the statutory definition.

[3] The recent CFTC enforcement actions have involved foreign currency transactions between unregulated entities and retail customers.

legitimate risk-management needs for specialized instruments that are not available on exchanges, such as futures contracts on particular foreign currencies. The extent of such transactions is extremely limited at present, probably due in part to the uncertain legal environment surrounding such transactions. Granting the CFTC regulatory authority over such transactions could mean that they do not occur, since the CEA is based on the presumption that most non-exchange derivative transactions should be illegal, unless demonstrated otherwise. We believe, however, that regulation of this nature is unwarranted where the entities involved are already subject to extensive schemes of federal regulation. Such entities should not be constrained from meeting the needs of their customers.

C. The Institutional Markets.

Finally, Treasury believes that it is neither necessary nor appropriate to expand the scope of the CFTC's jurisdiction to regulate any segment of the institutional markets. Thus, we believe that transactions engaged in by persons other than retail customers -- including, but not limited to, banks, broker-dealers, corporations, and individuals whose net worth or income takes them outside of the definition of retail customer -- should not be subject to regulation under the CEA. Institutional participants, whether currently regulated or not, have the sophistication and the financial means to protect themselves and to handle their disputes without the assistance of the CFTC. As noted, the limited number of enforcement actions the CFTC has brought over the years have been in the context of bucket shops dealing with unsophisticated retail customers.

Creating a more restrictive or legally uncertain regulatory environment could detrimentally affect the institutional market, causing the foreign currency market to migrate overseas to a more favorable environment. Migration of the foreign currency futures and options market could have a spillover effect on that market, resulting in restricted access to these markets for many participants. The United States foreign currency market is too large and too important to be subjected to unnecessary regulation or the vagaries of case law created in the context of retail enforcement actions.

We note that the CFTC's draft legislation provides that transactions in "defined financial instruments" entered into by "appropriate persons" are entirely exempt from the CEA if the conduct of the persons is "subject to provisions of civil federal law prohibiting fraud and price manipulation other than the [CEA]." It appears that this provision is designed to exempt transactions between banks, broker-dealers, and other regulated entities from the provisions of the CEA, a goal shared by Treasury. The law would be greatly clarified, however, if the categories of exempted entities were listed, as they are in Treasury's proposal, rather than leaving the question of coverage open to interpretation by the CFTC and/or the courts. Moreover, the CFTC's proposal does not clearly establish whether all, or only some, of the "appropriate persons" in a given transaction must be subject to other federal laws before the exemption from the CEA would be available. Thus, the proposal does not provide a clear exemption for other sophisticated institutional market participants, such as corporations and high-net worth individuals, that are not directly subject to federal regulation.

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(a) by striking clause (ii) and inserting the following:

"(ii) Except as provided for in subsection (iii), this chapter shall not apply to and the Commission shall have no jurisdiction over transactions in or in any way involving foreign currency, unless the transaction is a contract of sale for future delivery or an option and is conducted on an organized exchange."

(b) by adding at the end the following new subsections:

"(iii) Sections 4b and 4o of the Commodity Exchange Act (7 U.S.C. 6b & 6o) and any antifraud regulation promulgated by the Commission pursuant to 4c(b) of the Act (7 U.S.C. 6c(b)) shall be applicable to transactions in or in any way involving foreign currency if the transaction is a contract of sale for future delivery or an option and is conducted between any unregulated person and a retail customer."

"(iv) This chapter shall not apply to and the Commission shall have no jurisdiction over transactions in or in any way involving security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless the transaction--

(I) is a contract of sale for future delivery, or an option on either a future or a commodity that is not a security, and

(II) is conducted on an organized exchange.

"(v) The following definitions shall apply for purposes of this section:

(I) REGULATED PERSON

(a) The term "regulated person" means a person that is regulated or supervised by an appropriate federal banking agency as the term is defined in section 903 of International Lending Supervision Act (12 U.S.C. 3902); a government securities broker, a government securities dealer, or a registered broker or dealer as defined in section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C.

78c(a)); or an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8); or

(b) an affiliate of a person described in subclause (a), but only to the extent that the affiliate conducts a transaction (other than a transaction conducted on an organized exchange) covered by section 2(a)(1)(A)(ii) or section 2(a)(1)(A)(iv) through such a person.

(II) UNREGULATED PERSON

The term "unregulated person" means any person other than a regulated person.

(III) RETAIL CUSTOMER

The term "retail customer" means any natural person other than--

(a) a natural person whose net worth, or, in the case of a natural person who is married, joint net worth with that person's spouse, exceeds $1,000,000, or

(b) a natural person who had an income in excess of $200,000 in each of the two most recent years, or in the case of a natural person who is married, joint income with that person's spouse in excess of $300,000 in each of those years.

*Provided*, that the term "retail customer" shall not include any person to the extent that such person is represented by a regulated person in a transaction (other than a transaction conducted on an organized exchange) described in section 2(a)(1)(A)(ii) or section 2(a)(1)(A)(iv).

(IV) ORGANIZED EXCHANGE

(a) Except as otherwise provided in this subclause, the term "organized exchange" means--

(1) a board of trade designated by the Commission as a contract market or a physical or electronic market place or similar facility affiliated with a board of trade so designated as a contract market, or

(2) a physical or electronic market place or similar facility through which unaffiliated persons, for their own accounts or for the accounts of customers, enter into and execute arms' length binding transactions by accepting bids and offers made by one person that are open to all persons who conduct business through such market place or similar facility.

(b) Notwithstanding subclause (III)(a), the term "organized exchange" does not include--

(1) parties engaged in privately negotiated bilateral transactions, even if such parties use electronic means to communicate or execute transactions, or

(2) government securities dealers or brokers, as defined in section 3(a) of the Securities Exchange Act of 1934 (15 U S.C. 78c(a)).

(V) OPTION

The term "option" means a transaction described in Section 4c(b) of this Act."

SEC. 102. SAVINGS CLAUSE.

Nothing in section 101 of this Act shall be interpreted as altering the Futures Trading Act of 1982 (Pub. L. No. 97-444).

Explanation:

In general, the amendment would exempt transactions in or in any way involving foreign currency from the Commodity Exchange Act (CEA), that would otherwise be subject to the CEA, unless the transactions were conducted on an organized exchange. The amendment would permit over-the-counter foreign exchange transactions between unregulated persons and retail customers, but such transactions would be subject to CFTC anti-fraud authority under sections 4b and 4o of the CEA. The amendment adds the term "in any way involving" to clarify that options and cash settled transactions are within the scope of the Treasury Amendment exemption, as are transactions involving the values, yields, or rates on the listed instruments.

Additionally, transactions in or, in any way, involving security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments are exempted from the CEA unless the transaction is a future or an option on a future or a commodity that is not a security and is conducted on an organized exchange.

The amendment would add new definitions of "regulated person", "unregulated person", "retail customer", "organized exchange" and "option" to the CEA. A "regulated person" is a person who is currently regulated by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Office of Thrift Supervision and the Federal Deposit Insurance Corporation. The definition is intended to include banks, savings associations, foreign banks, holding companies, operating subsidiaries, affiliates, service corporations, Edge Act corporations, and Agreement Corporations operating under section 25 of the Federal Reserve Act. Additionally, the term includes particular entities registered with the Securities and Exchange Commission such as government securities brokers and dealers. Finally, the term includes affiliates of such persons, but only to the extent that the affiliate conducts a covered transaction through such persons. The term "unregulated person" means any person other than a regulated person.

The term "retail customer" has been defined to mean any natural person other than (a) a natural person whose net worth exceeds $1,000,000, or (b) a natural person whose annual income exceeded $200,000 (or whose joint income with that person's spouse exceeded $300,000) in each of the last two years. The term does not include, however, a person who is represented by a regulated person.

The term "organized exchange" has been defined to mean both (1) a board of trade designated by the CFTC as a contract market and affiliated exchange-like facilities, and (2) a physical or electronic market place or similar facility by means of which unaffiliated persons engage in arms' length binding transactions by accepting bids or offers made by one person that are open to all persons who conduct business on the facility. The definition is intended to clarify that entities that are engaged in the business of buying or selling Treasury Amendment instruments, such as banks, broker-dealers, futures commission merchants, and government securities dealers and brokers, are not "organized exchanges".

The term "option" is defined to include any transaction involving any commodity regulated under the CEA which is of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty".

The amendment includes a savings clause to clarify that the amendment may not be interpreted as altering the Futures Trading Act of 1982, Pub. L. No. 97-444, the so-called "Shad-Johnson Accord." Among other things, this Act imposed restrictions on the CFTC jurisdiction over options on securities and options on foreign currency traded on a national securities exchange, which are now regulated by the Securities and Exchange Commission.

# TREASURY CLEARANCE SHEET

NO. ______

Date 2/3/97

MEMORANDUM FOR: ☐ SECRETARY ☐ DEPUTY SECRETARY ☒ EXECUTIVE SECRETARY
☐ ACTION ☐ BRIEFING ☐ INFORMATION ☒ LEGISLATIO
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER ______

FROM: Edward S. Knight, General Counsel
THROUGH:
SUBJECT: Treasury Legislation, Revision to "Treasury Amendment" to Commodity Exchange Act

REVIEW OFFICES (Check when office clears)

☒ Under Secretary for Finance
- ☐ Domestic Finance
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- ☒ International Affairs

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- ☐ FAC
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☐ Inspector General
☐ IRS
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- ☐ Scheduling

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☐ Tax Policy
☐ Treasurer
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- ☐ Savings Bonds

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| NAME (Please Type) | INITIAL | DATE | OFFICE | TEL. NO. |
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| INITIATOR(S) | | | | |
| Rutledge | VR | 1/27/97 | Asst. Gen. Counsel (Bkg.) | 622-1963 |
| Gould | DG | 1/27/97 | Asst. Gen. Counsel (Bkg.) | 622-1958 |
| Barber | FB | 1/27/97 | Asst. Gen. Counsel (Int.) | 622-1947 |
| REVIEWERS | | | | |
| Anderson | RA | 1/27/97 | Federal Finance | 622-2640 |
| Hawke | JH | 1/28/97 | Domestic Finance | 622-1703 |
| Geithner | TG | 1/28/97 | International | 622-0656 |
| Robertson | VR | 2/3/97 | Legislative Affairs | 622-1910 |
| Bowman | JB | 1/27/97 | Asst. Gen. Counsel (Bkg.) | 622-1964 |
| Carro | [illegible] | 2/3/97 | Assoc. Gen. Counsel | 622-1146 |
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SPECIAL INSTRUCTIONS

☐ Review Officer ______ Date ______ ☐ Executive Secretary ______ Date ______

# CONTRACT WITH AMERICA

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

94-138209

September 26, 1994

INFORMATION

**MEMORANDUM FOR SECRETARY BENTSEN**
**UNDER SECRETARY NEWMAN**

From: Alicia Munnell
Economic Policy

Subject: REPUBLICAN CONTRACT WITH AMERICA

**Summary:**

Attached are Q&A's on the "contract with America" to be announced by House Republicans tomorrow.

**Discussion:**

Tomorrow Republican Representatives and candidates are scheduled to announce their "contract with America": specific pieces of legislation that will become their legislative agenda in the first 100 days of the next Congressional session, and that they commit to passing should the Republicans gain a working majority in the House of Representatives.

At present, we are not certain what exact proposals the House Republicans will put forward. However, we anticipate that the "contract" will include:

- a line-item veto
- a restructuring of House committees
- increased defense spending
- a balanced-budget amendment
- a capital gains tax cut
- a tax cut for two-earner couples
- a tax credit for children
- an IRA proposal

An initial analysis by Gene Sperling estimates a five-year $800 billion budget shortfall in the Republican proposals, the overwhelming bulk of which is due to the inclusion of a balanced-budget amendment.

Leon Panetta, Robert Rubin, and Laura Tyson have spent some time today briefing journalists; according to one report, they "chastised Republicans for coming up with a series of...proposals [tax cuts and a balanced-budget amendment] without specifying how they would pay for them."

Attachments

Edward S. Knight

**CONTRACT WITH AMERICA: OVERVIEW**

Question: The Republican House members and candidates today announced their "contract with America." Do you think their proposals are good economic policy? Do you think that this contract will help them win more seats in the Congress?

Answer: There are a lot of individual pieces in the "contract." But let me address the package as a whole:

- I think that it is unwise, either from the standpoint of good economic policy or of political advantage, to make promises without detailing how they are going to be paid for. I do not think that voters take seriously promises of tax cuts without identified spending cuts to finance them, or promises of balanced budgets without a roadmap showing exactly how the budget will be balanced.

- We have seen lots of proposals to balance the budget and provide tax cuts go awry before.

  - I remember in early 1981 hearing about proposed economic policies that would balance the budget by 1984. But in 1984 the budget deficit was five percent of GDP; we're still cleaning up from that policy mistake.

  - At the end of 1980, the federal government owed $709 billion. At the end of 1992, the government owed $3 trillion. More than 15 cents of every dollar in taxes went just to pay the interest--not to repay the principal--of this debt.

  - We cannot count on "growing out" of our current deficit and balancing the budget without substantial spending cuts. I remember that in 1981 projections of balanced budgets relied on an economy, spurred by supply-side tax cuts, growing at 4.5 percent per year indefinitely. We got the tax cuts, but from 1981 to 1992 the economy grew at a rate of only 2.7 percent per year--hence this large deficit that President Clinton is cutting in half.

- Today, anyone putting forward legislative proposals must specify how they would be paid-for. Our preliminary look--we haven't had a chance to take a hard look at their package--was that the contract proposals were $800 billion short over the next five years. I don't think anyone wants to boost the deficit by $160 billion a year.

## BALANCED-BUDGET AMENDMENT: MACROECONOMIC IMPACT

Question: The Republican House members and candidates today announced their "contract with America," including a promise to pass the balanced-budget amendment. Wouldn't passage of a balanced-budget amendment, at least, be a good thing?

Answer: First, let me draw a distinction: the "contract with America" says that they will pass a balanced-budget amendment; it does not say that they will balance the budget--or even how they would balance the budget.

In the present climate, anyone who presents legislative proposals must specify how they would implement and finance them. Saying that we ought to have a balanced budget is easy. Proposing a policy that will balance the budget is hard--although President Clinton has made a very good start.

## IRA PROPOSAL IN REPUBLICAN "CONTRACT WITH AMERICA"

**Question:**

Why do you not support the "American Dream Savings Account" Super IRA proposal which is part of the Republican "Contract with America", when it is based on the Bentsen-Roth IRA proposals that were included in H.R. 11 which you supported?

**Answer:**

The IRA proposals which I supported were part of a revenue-neutral tax bill, and not part of a fiscally irresponsible set of proposals costing hundreds of billions of dollars without a corresponding set of "pay-fors".

I have always supported the concept of encouraging individuals to save, and I thought IRAs might be one way to do that. But I also believe that the surest way to increase national saving is to reduce the Federal deficit.

DWORIN/XAA
622-0269

## REPRESENTATIVE ARMEY'S FLAT TAX

**Question:**

What do you think about Representative Armey's Flat Tax proposal? Wouldn't it be simpler and fairer than the current income tax system?

**Answer:**

Although Congressman Armey's Flat Tax has a number of apparently attractive features, as proposed it has a number of very serious flaws.

First, although we have not fully examined the proposal, we know that a tax based on rates suggested will not yield the same annual revenue as we currently collect from our Individual and Corporate income tax. There will be a shortfall of over $150 billion, and maybe as much as $200 billion, a year.

Second, the highest-income taxpayers will disproportionately benefit from the shift, both from the lower tax rate and from the elimination of taxation of income from new saving. And if the rate were increased to make the tax revenue neutral, the only group that would pay less would be the highest-income taxpayers.

Third, there are many transition problems that are simply not addressed in Congressman Armey's proposal. For example, those who saved and accumulated wealth with after-tax dollars would incur significant windfall losses, since the business tax only allows deductions for new investment.

DWORIN/XAA
622-0269

# TREASURY CLEARANCE SHEET

NO. ______
Date 9/26/94

MEMORANDUM FOR: ☒ SECRETARY ☐ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
☐ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☒ SPEECH
☐ TESTIMONY ☐ OTHER ______

FROM: Alicia Munnell
THROUGH: ______
SUBJECT: Republican Contract with America

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| Brad De Long | BD | 9/26/94 | Economic Policy | 622-0563 |
| REVIEWERS | | | | |

SPECIAL INSTRUCTIONS

☐ Review Officer ______ Date ______

☐ Executive Secretary ______ Date ______

94-139781

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

November 16, 1994

INFORMATION

MEMORANDUM FOR SECRETARY BENTSEN
DEPUTY SECRETARY NEWMAN

FROM: Leslie B. Samuels LBS
Assistant Secretary (Tax Policy)

Alicia Munnell
Assistant Secretary (Economic Policy)

Alan Cohen ac
Senior Advisor to the Secretary

SUBJECT: Republican "Contract With America" Proposals

**SUMMARY:**

The House Republican "Contract With America" (the Contract) proposes a number of broad-ranging and fundamental changes affecting (among other things) the way the Congress works, the way the Federal Budget is prepared, and the way Federal regulations are promulgated. Specific tax cuts are also proposed. Although many of the problems addressed by the Contract are also of concern to the Administration, and some of the solutions suggested may (with modification) be acceptable to the Administration, taken as a whole the proposals are fiscally irresponsible and very highly skewed towards benefiting wealthy Americans at the expense of the poor. A follow-up memorandum recommending specific Administration responses to the Contract is being prepared.

**DISCUSSION:**

The Contract consists of eight proposals that apply to the way the Congress operates, including a proposal requiring a three-fifths majority vote to pass a tax increase in the House, together with ten bills. The proposed Congressional rule changes will likely be adopted regardless of the Administration's views, but most of the bills, even if enacted by the Congress, would likely not become law without Presidential approval. Constitutional amendments do not require Presidential approval, but they do require 2/3 majority vote for passage in the House and Senate, and approval by 3/4 of the states.

In his memorandum of October 17 (copy attached), Eric Toder had provided you with revenue estimates for all the proposed tax cuts, and an analysis of their overall distributional impact. In this memorandum, we briefly review each of the bills, and provide additional comments on the most important proposals. We also touch upon the issue of "pay-fors."

EXECUTIVE SECRETARIAT

1. **BALANCED-BUDGET AMENDMENT AND LINE-ITEM VETO**

*"The Republicans are proposing a balanced budget/tax limitation amendment and a legislative line-item veto to restore fiscal responsibility to an out-of-control Congress, requiring them to live under the same budget constraints as families and businesses."*

**Balanced Budget Amendment**

The back-up document accompanying the Contract delineates the specifics of their balanced budget amendment proposal. The amendment would require the President to submit, and the Congress to pass, a balanced budget each fiscal year. There are no enforcement mechanisms or sanctions if either of these requirements is not met. These requirements can be waived if a declaration of war is in effect or there is a threat to U.S. national security. There is no provision, however, for a waiver during a recession. The amendment would require a 3/5 vote of the Members in each chamber to raise the debt limit and to raise taxes. Social Security would be included in all budgetary totals, making it susceptible to cuts to achieve balance. The amendment would take effect in 2002 or two years after ratification, whichever is later.

A number of Republicans have said that they will make passage of a balanced budget amendment one of the first priorities in the first one hundred days. Last year the Balanced Budget Amendment to the Constitution received 63 votes in the Senate, four short of the two-thirds needed for passage. In the House, the Amendment received 271 votes, 12 short of the two-thirds needed for passage. Of course, by itself, passage of a balanced budget amendment does nothing to cut spending or raise revenue to balance the budget.

The Republicans in the House strongly favor a 3/5 voting requirement for Congress to raise taxes. Senator Gramm, however, is quoted as saying that the votes are not there in the Senate to pass this requirement. Indeed, last year, Senator Simon, a chief architect of a balanced budget amendment in the Senate, said he would vote against it if the 3/5 required vote for tax increases was included.

The press has also reported that Senator Dole and Congressman Gingrich have agreed to take Social Security out of budget totals. Mr. Dole and Mr. Gingrich may seek to exclude Social Security from the Balanced Budget Amendment calculations. Since Social Security is currently running a surplus, this would increase the deficit reduction needed to balance the budget in the near-term. It would also exclude the use of cuts in Social Security for meeting that goal. However, after the baby-boomers begin to retire, Social Security will be in deficit. Excluding it from totals in those years would look very much like a gimmick.

In addition to these broad problems, the proposal has several serious technical problems. First, under the Amendment, the economy's "automatic stabilizers" will not be allowed to operate, and the budget will not automatically swing into deficit during recession. If federal spending is cut in a recession, the recession will be deeper, and the Federal Reserve's task more difficult. This can be corrected by requiring that the President submit, and the Congress pass, a balanced full-employment budget --a budget based on the assumption that the economy does not fall short of its productive capacity.

Second, the key enforcement mechanism in the proposed amendment may well turn out to be the three-fifths vote requirement for raising the debt limit, because the balanced budget amendment provides no sanctions if the budget is in deficit. Budgets, however, are only estimates, and economic and technical assumptions for the forthcoming fiscal year are only assumptions. Therefore, a budget which is estimated to be in balance may in actuality run a deficit. Thus, the debt limit may have to be raised even if the Congress thought they had achieved a balanced budget. The amendment in the Contract would impose a 3/5 voting requirement to do so. It is hard enough to get a majority vote to raise the debt ceiling, let alone a 3/5 vote. Moreover, requiring a 3/5 vote will give great leverage to individual Members of Congress, who could use that leverage to ransom other legislative changes with which a majority does not agree. This problem, if one desired, can be corrected by requiring only a majority vote in both houses to raise the debt limit.

Third, the requirement of a three-fifths majority for tax increases may bind almost all pieces of legislation if it applies not to the net sum of a tax bill but to all individual elements. It is difficult to think of any tax reform that does not increase someone's taxes. A three-fifths majority for tax increases may turn 263 into the number of votes needed for working control of the House on tax legislation. Moreover, if a balanced budget requirement is imposed, a three-fifth's vote for tax increases removes, for the most part, one of the two tools available to achieve balance.

Fourth, a balanced-budget amendment would make it difficult to borrow to fund long-term government investments -- and there are times when the fairest way to fund long-term investments is through borrowing.

**Line-Item Veto**

The Contract includes a proposal for a legislative line-item veto. Under this proposal, the President could rescind any discretionary budget appropriation, in whole or in part, and send it back to the Congress within twenty calendar days. To overturn this rescission, the Congress would have to pass a law within twenty days of receipt of the President's rescission message. If the President vetoed this new law, the Congress would have to override his vote. This would require a 2/3 majority vote in each chamber.

**In addition to** discretionary budget authority, under the Republican plan, the President could also rescind targeted tax breaks. A targeted tax break is defined in the proposed statute as follows: "any provision which has the practical effect of providing a benefit in the form of a differential treatment to a particular taxpayer or class of taxpayers, whether or not such provision is limited by its terms to a particular taxpayer or class of taxpayers. Such term does not include any benefit provided to a class of taxpayers distinguished on the basis of general demographic conditions such as income, number of dependents, or marital status."

There are obviously several problems which will face the Contract's version of the line-item veto. First, this form of the line-item veto is a very strict one because a rescission can only be overturned with two-thirds votes in each chamber. To be enacted, the Contract's version must overcome a potential filibuster in the Senate. It is not clear whether this measure could survive a filibuster in the Senate.

This proposal is different than the expedited rescission proposal that passed the House last year. Under this bill, the President would also send rescission measures back to the Congress and each chamber would be required to vote on it. **However, if <u>either</u> chamber rejected the rescission by a majority vote, it would be killed.**

A second potential problem with the Republican proposal is its decision to include targeted tax breaks as candidates for rescissions. The definition of a targeted tax break is very vague. It is also not clear whether a majority of Members of the Senate or House would be willing to give the President this type of rescission authority.

Finally, Mr. Gingrich has said that if the line-item veto passes, it should begin in President Clinton's term. Whether other Republicans would go along with this effective date is unclear.

## 2. THE TAKING BACK OUR STREETS ACT

> *"This Republican proposal includes stronger truth-in-sentencing, 'good faith' exclusionary rule exemptions, and effective death penalty provisions. The proposal also would cut social spending from this year's Crime bill to fund*

*prison constructions and additional law enforcement 'to keep people secure in their neighborhoods and kids safe in their schools'."*

**The Crime Bill**

The Omnibus Crime Control Act of 1994, signed into law by President Clinton a little over two months ago, seeks to achieve some of the goals set by the Republicans in the Taking Back Our Streets Act. The Clinton Administration's Crime Act allocates $7.9 billion for new prison construction (the Republican contract authorizes $10.5 billion) and $8.8 billion for new police officers. The Crime Act also includes the "three strikes and you're out" provision, applies the death penalty to over fifty new crimes, and increases penalties for repeat federal sex offenders.

Since some of the Republican proposals are similar to these provisions, they could be acceptable. However, any repeal of the Brady Bill or other related legislation would be problematic. The debate over this Republican proposal is likely to mirror the summer-long debate over the Crime bill.

**3. THE PERSONAL RESPONSIBILITY ACT**

*"The Republicans wish to discourage illegitimacy and teen pregnancy by prohibiting welfare to minor mothers, denying increased AFDC for additional children conceived on welfare (the family cap), cutting spending for welfare programs, and requiring AFDC recipients to work after two years on welfare."*

**Welfare Reform**

The Administration bill has provisions similar to, but more moderate, than each of the Republican proposals. Instead of prohibiting welfare to minor mothers, the Administration bill would require them to live at home. Instead of denying AFDC for additional children conceived on welfare the Administration bill would give states the option to deny these benefits. And the Administration bill combines a two-year limit with work requirements.

Most of the Republican welfare-reform ideas are potentially acceptable. Tougher work requirements and a family cap were both considered seriously by the Welfare Reform Working Group. However, denying AFDC to minor mothers would greatly impair the social safety net and may result in a large increase in homelessness, particularly in center cities and poor rural areas.

The Contract envisions paying for expensive work requirements (about $10 billion in 5 years). This may be funded by a significant cut in other spending especially AFDC, which could shift costs onto the states and private charitable organizations. Changing AFDC into a discretionary program would eliminate the government guarantee to provide for poor children.

**4. THE FAMILY REINFORCEMENT ACT**

> *"The Republicans support stronger child support enforcement, tax incentives for adoption, strengthening the rights of parents in their children's education, stronger child pornography laws, and an elderly dependent care tax credit to reinforce the central role of families in American society."*

**Stronger Child Support and Pornography Laws**

Child support enforcement and stronger child pornography laws are proposals the Administration can support if properly crafted. The Administration child support enforcement section of welfare reform has been supported by both Republicans and Democrats.

**Tax Incentives for Adoption**

The Tax Reform Act of 1986 repealed a deduction of up to $1,500 for the expenses of adopting a child with special needs and replaced it with an outlay program with several components. States are required to reimburse families for costs associated with the process of adopting special needs children. The Federal government shares 50 percent of the first $2,000 of such costs. Some special needs adoptees are eligible for continuing Federal-State assistance under Title IV-E of the Social Security Act. This assistance includes Medicaid. Other adoptees may be eligible for continuing assistance under state-only programs.

The proposal would provide a deduction of up to $5,000, which would be phased out for taxpayers with taxable incomes exceeding $60,000. The allowance of a deduction is an inappropriate means of providing assistance for special need adoptions, which should be under the budgetary responsibility of agencies with responsibility for, and knowledge about, special needs adoptions.

agree

**Credit for Elderly Dependents**

A taxpayer is entitled to an exemption of $2,450 (for 1994 and indexed thereafter) for each dependent claimed. Generally, an elderly person may be claimed as dependent of another taxpayer if that taxpayer provides more than half of the support of the elderly dependent and the elderly dependent has income of under $2,450, apart from nontaxable income such as Social Security benefits.

The proposal will provide a refundable $500 tax credit to taxpayers who provides care in their home for a disabled parent or grandparent. However, taxpayers caring for elderly dependents (and the dependents themselves) are entitled to significant tax benefits under current law. In fact, their total tax benefits, including the exemption of Social Security and Medicare benefits, generally exceed the tax benefits for non-elderly dependents. This proposal would increase the already more favorable treatment of the elderly.

**5. THE AMERICAN DREAM RESTORATION ACT**

> *"The Contract proposes a nonrefundable $500 per child tax credit, partial repeal of the marriage tax penalty, and creation of a back-loaded IRA (the American Dream Savings Account) to provide middle class tax relief."*

**Child Tax Credit**

This proposal provides a $500 non-refundable tax credit per child under 18 years of age to families with annual gross income (AGI) of less than $200,000. The credit is indexed for inflation. This proposal is estimated to cost about $85 billion over the FY 1995-99 Budget period. It is the most expensive proposal over that period, averaging about $21 billion per year (it is first effective in January 1996), but unlike some of the other tax proposals noted in this memorandum, its cost does not increase very rapidly beyond the Budget period.

The proposal is a very generous middle- and upper-middle income tax cut that is targeted to families with children. However, because the proposed tax credit is non-refundable, it only benefits families that would otherwise have a tax liability. Thus, for example, it would not benefit families receiving an EITC refund.

**Back-Loaded IRAs**

The proposal allows individuals (regardless of income) to contribute up to $2,000 a year into an "American Dream Savings Account" (ADSA), but the contributions are not tax deductible. Rather, ASDA earnings are not taxed, and all withdrawals are exempt from tax (and penalty-free) if the investor is older than 59 1/2, upon disability or death, or if used for purchase of a first home, higher education expenses, or medical expenses, including purchase of long-term care insurance. Current IRA holders could transfer the funds in their IRA without penalty into the ADSA, but would have to pay income tax on the amounts withdrawn. This proposal is estimated to be approximately revenue neutral over the FY 1995-99 Budget period (because the ADSA is back-loaded and because of the roll-over feature), but will lose significant revenues in post-1999 years as accounts grow and earn tax-free status. Under the Senate 10 year budget rule, this out-year revenue loss will require offsets.

All tax-favored investment vehicles are likely to stimulate some additional saving, but the amount of induced saving is uncertain, and not likely to be as great for a back-loaded ADSA as for a front-loaded IRA. The proposal benefits mainly high-income families (low-income families are not even taking full advantage of current law IRAs to which they may contribute).

**Partial Repeal of the "Marriage Penalty"**

The Contract specifies that a tax credit shall be allowed to all taxpayers filing a joint return whose tax liability is in excess of the tax to which they would be subject if they were not married, and that the credit allowed shall not exceed this excess (or "marriage penalty"). It further states that the total revenue cost of the credit allowed all such taxpayers shall not exceed $2 billion per year (which is less than the total "marriage penalty" for all taxpayers). It does not indicate how marriage penalty is to be calculated (the answer can depend on how items of income and deductions are shared, and the rate schedules allowed to be used by each spouse), nor how the $2 billion is to be allocated to qualified taxpayers. Based on the specified annual revenue loss, the FY 1995-99 Budget period cost of this proposal is $7 billion.

Because the tax unit is the family, and because of the rate schedules and other features of our income tax (such as personal exemptions, standard deductions, the EITC, etc.), families in which both spouses are earning comparable incomes are subject to a marriage penalty, whereas families in which one spouse earns much less than the other tend to benefit from a "marriage bonus".

Between 1982 and 1986, a deduction was allowed for 10 percent of the wages of the lower earning spouse (to a maximum of $30,000 of wages). This "two-earner deduction" was repealed in the Tax Reform Act of 1986, because it rather imperfectly dealt with the marriage penalty, and because it was felt that the lower marginal tax rates offset the adverse effects of a "marriage penalty" on the work incentives of either spouse. Repeal of the deduction was "scored" as raising about $27 billion over the FY 1987-91 period (based on the 1986 Act's lower rates).

**6. THE NATIONAL SECURITY RESTORATION ACT**

> *"The Contract proposes that U.S. troops no longer serve under United Nations command. It also promotes the 'restoration of the essential parts of our national security funding to strengthen our national defense and maintain our credibility around the world'."*

## 7. THE SENIOR CITIZENS FAIRNESS ACT

> *"The Republicans wish to raise the social security earnings limit which currently forces seniors out of the work force, repeal the 1993 tax hikes on social security benefits and provide tax incentives for private long-term care insurance to let Older Americans keep more of what they have earned over the years."*

**Raising Social Security Earnings Limit**

The proposal would gradually raise the earnings threshold to $30,000 by the year 2000. Advocates of proposals to increase the earnings test threshold often argue that the proposal would increase the labor supply of the elderly. But most retired workers between the ages of 65 and 69 would not benefit from this proposal, and would probably not reenter the work force. Of the 8 million persons in this age group who are covered by social security, 6 million did not work at any time in 1989. Their decision to retire was based on many factors in addition to the social security earnings test. Such factors included their health, preferences for leisure, savings, pension income, the size of social security benefits, and employers' demand for elderly workers. For these same reasons, they are unlikely to seek employment once retired, even if the earnings test were repealed.

Among those who currently work, many would not increase their work effort in response to change in the earnings test. Either they currently earn far less than the exempt amount (and thus could now earn more without penalty), or they earn too much to receive benefits even if the earnings test threshold were increased. Another problem with substantially raising the limit (or repealing) the earnings test is the short-term budgetary cost. In the long-run, an increase in the exempt earnings limitation could be accommodated with the scheduled increases in delayed retirement credits.

**Reduce Taxation of Social Security Benefits**

The rationale for last year's expansion of the taxation of Social Security benefits was to make their tax treatment closer to that of private pensions. The increase, which affected only about 13 percent of taxpayers receiving Social Security benefits, was estimated to raise $24.5 over the FY 1994-98 period. The proposal to repeal the 1993 increase would reduce income to the HI Trust Fund, which under OBRA 93 is the beneficiary of the increased taxation of Social Security benefits.

**Subsidies For Long Term Health Care**

The proposal, which would allow tax-free withdraws from IRAs, 401(k) plans, and other qualified pension plans to purchase long-term care insurance, and allows accelerated death benefits and long-term care benefits to be paid from life insurance policies without specifying parameters under which such amounts can deplete the policies' funds. The proposal allows tax deductions for long-term care premiums, tax-free long-term insurance as a tax-free benefit, similar to provisions included in the Administration's Health Security Act. In addition, the proposal would permit the tax-free exchange of a life insurance or annuity policy for a long-term insurance policy.

**8. THE JOB CREATION AND WAGE ENHANCEMENT ACT**

> *"This proposal calls for small business incentives, capital gains cut and indexation, neutral cost recovery, risk assessment/cost-benefit analysis, strengthening the Regulatory Flexibility Act and unfunded mandate reform to create jobs and raise worker wages."*

**50 Percent Capital Gains Exclusion and Prospective Indexing**

The proposal allows individuals to exclude 50 percent of their net long-term capital gains income. In addition, individuals can deduct any capital loss with respect to the sale or exchange of a principal residence, and indexes prospectively the basis of capital assets. This proposal is estimated to cost about $31 billion over the FY 1995-99 Budget period, but because of indexing, the post-1999 revenue losses will grow rapidly.

A capital gains exclusion would reduce the "lock-in" effect, allowing investors to more efficiently balance their investment portfolio. It may also stimulate increased savings. In addition, by indexing basis, taxpayers are less likely to be taxed on inflationary gains.

However, widening the gap between regular income and capital gains income increases the incentive to convert ordinary income to capital gains income through tax shelter activity. The proposal primarily benefits high-income taxpayers. Indexing the basis of capital assets would add much complexity to the Code. Both proposals would encourage gaming of the system.

**Neutral Cost Recovery System**

The proposal allows taxpayers to claim a depreciation allowance which increases each year, such that the totality of all the allowances claimed exceeds the cost of the asset. The system, which adjusts each year's depreciation for inflation plus a 3.5 percent real rate of interest, is designed to allow taxpayers writeoffs whose present value is just equal to the cost of the asset (i.e., to be economically equivalent to full "expensing"). The proposal also replaces the 200 percent declining balance depreciation method currently allowed for personal property with less than a 15 year recovery period with the less rapid 150 percent declining balance method. In this fashion, the proposal actually raises about $25 billion over the FY 1995-99 Budget period, but because the depreciation allowances increase over time, the revenue cost in future years is very large (in the tens of billions of dollars).

The proposal favors capital intensive industries over labor intensive industries, and unless the revenue loss is addressed, the impact of the resulting increase in Federal debt on interest rates (as well as some capitalization of the tax benefits in the price of depreciable assets) may significantly offset the positive effects of the reduction in the tax component of the cost of capital. The proposal also provides significant opportunity for tax sheltering labor income (especially for higher-income individuals).

**Risk Assessment/ Cost Benefit Analysis**

This proposal requires cost-benefit or risk assessment analysis of major agency regulations relating to human health, safety, or the environment, and limits on unfunded mandates on state and local governments. Under current law, agencies must submit to OMB a Regulatory Impact Analysis (cost-benefit analysis) for regulations imposing costs greater than $100 million. Under current practice, however, agencies have not taken this requirement seriously, and regulatory review has lapsed. The proposal would strengthen the requirement to provide analytical justification for proposed regulations. Some forms of the proposal would extend the requirement for cost- or risk-analysis to other agency actions. In addition, the proposal would limit regulatory requirements that could be imposed on state and local governments, such as for additional sewer and water treatment, municipal solid waste, etc.

Current agency practice has come under fire from many sides (not just business) for writing regulations that impose large costs while offering few measurable benefits, for example under Superfund. The proposal is consistent with recent suggestions from economists and public policy analysts of all political persuasions, and is consistent with the position generally taken by the economic agencies in interagency discussions.

Republican Congressional staff is generally well-informed on these issues, and on the staff level, has submitted rational and well crafted changes in current agency practice. It remains to be seen, however, whether the political actors will feel bound by the generally reasonable proposals composed so far by their staffs.

**9. THE COMMON SENSE LEGAL REFORM ACT**

*"With the aim of reducing unnecessary costs of doing business, this proposal would reform product liability laws, limit punitive damages, and impose the English Rule (loser pays) on tort suits."*

**Tort Reform**

Our tort system costs far more than the approaches used in other countries to protect consumers and compensate victims. This needlessly raises the cost of doing business, raises prices to consumers, and removes useful products and services from the market. The President has spoken about the issue, and is on the record as supporting reform of product liability laws as a way to encourage economic growth while protecting the consumer.

Limits on punitive damages would relieve juries of some of the discretion they now enjoy in setting punitive damage awards, reducing the uncertainty to business. The English Rule would make it more difficult to bring litigation and thus reduce the number of suits. While few deny the benefits of product liability reform, legal and economic analysts continue to debate the merits of limiting punitive damages and imposing the English rule.

Depending on details of the Republican proposal -- which have not yet been released -- it could be, on balance, either beneficial or harmful.

support it,

**10. THE CITIZEN LEGISLATURE ACT**

*A first-ever vote on term limits to replace career politicians with citizen legislators.*

* * *

**Paying For The Contract With "Macroeconomic Feedback Effects"**

The Contract does not include "pay-fors" to finance the approximately $120 billion cost over the FY 1995-99 Budget period of the proposed tax cuts, let alone the much larger out-year costs. Spending cuts may take care of some of the cost, but will be difficult to achieve. One way the House Republicans may seek to deal with this problem is through revision of the "scoring" conventions used by the Joint Committee on Taxation (which are also used by Treasury). Although these conventions do take into account taxpayer response at the microeconomic level, such as allowing for shifts in the mix of investments held by different investors, or shifts in the mix of goods purchased, they assume that key macroeconomic variables, such as future rates of growth in real GDP or future unemployment rates, remain unchanged.

However, the use of revenue estimates that allow for "macroeconomic feedback" effects (i.e., that assume that the key macroeconomic variables will change) may be required for Congressional scoring, with the thought that such effects would allow tax cuts to "pay for themselves". (A consistent approach, which might not be suggested, would also require that the adverse macroeconomic effects of spending cuts also be taken into account.)

One of the reasons current and past Administrations have accepted the convention of ignoring "macroeconomic feedback" effects is the great uncertainty regarding the magnitude of these effects, and the ability of different analysts to obtain vastly different estimates. For example, in their letter to you on GATT funding, Congressmen Gingrich and Saxton provided estimates of the "macroeconomic feedback" effects on revenues resulting from the GATT tariff cuts ranging from $300 million to $115 billion over the Budget period. For this reason, if improperly used, inclusion of "macroeconomic feedback" effects has the potential to seriously damage the fiscal constraints imposed by the Congressional Budget Act. It could effectively repeal the pay-as-you-go rules. Moreover, since Treasury would continue to omit "macroeconomic feedback effects" from its revenue estimates, a procedure which we also believe is consistent with OMB's interpretation of the Budget Enforcement Act, bills passed by the Congress may be subject to sequestration under that Act.

Attachment

DEPARTMENT OF THE TREASURY
WASHINGTON

October 17, 1994

**ACTION**

MEMORANDUM FOR SECRETARY BENTSEN
DEPUTY SECRETARY NEWMAN

FROM: ERIC J. TODER Eric Toder
DEPUTY ASSISTANT SECRETARY (TAX ANALYSIS)

SUBJECT: Estimates of House Republican Tax Proposals

The Office of Tax Analysis (OTA) has prepared estimates of the revenue and distributional effects of the proposals in the House Republican "Contract with America." The attached paper briefly summarizes these estimates.

Recommendation. That Treasury make this analysis available to the White House, but refrain from direct participation in the political debate.

Approved ✓ FMB

Disapproved ____

Other ____

Let's Discuss ____

Attachment

cc: Samuels
Munnell
Levy
Robertson
Cohen
Beerbower
Dworin
Platt
Nunns

## House Republican Contract with America: Revenue and Distributional Estimates

The attached tables present estimates of revenue effects and changes in the distribution of the tax burden by income group from the legislative proposals in the House Republican "Contract with America." Table 1 presents the 5-year revenue effects; Table 2 presents the distributional effects.

The proposals would increase revenue by about $2.4 billion in Fiscal Year 1995 and reduce revenue by $120.1 billion over the 1995-99 period. In the 5-year budget estimating period, the largest revenue losses would come from two proposals -- a $500 per child tax credit for families with adjusted gross income less than $200,000 ($85.0 billion) and a 50% capital gains exclusion with indexing for gains after January 1, 1995 ($30.9 billion).

Two of the proposals would lose substantial revenue after 1999 even though they increase revenue in the 5-year budget period, while one proposal would lose much more revenue after 1999 than in 1995-99. The proposal for a "neutral" cost recovery system (NCRS) would increase revenue by $25.4 billion in 1995-99 by reducing depreciation deductions in the first few years of an asset's life, but would reduce revenue by about $2.6 billion in 1999 and much more in subsequent years by allowing business firms ultimately to deduct much more than 100 percent of the purchase price of assets. The proposal to allow taxpayers to establish "back-loaded" Individual Retirement Accounts (IRAs) would raise $0.2 billion between 1995 and 1999 because of the revenue pickup from taxpayers who pay a one time tax (in four annual installments) when they convert existing IRAs to the new back-loaded IRAs. The proposal reduces revenue by $0.1 billion in 1999, however, and the revenue loss will increase rapidly after 1999 when the conversion from front-loaded to back-loaded IRAs is completed.

The capital gains proposal loses revenue every year, but the 5-year estimate understates its long-run cost because the revenue loss every year increases more than proportionately with the economy. The loss from indexation is initially small because indexing only applies to prospective gains, but then increases rapidly as relatively more gains receive the benefit of indexing.

The proposals would reduce tax burdens for taxpayers in all income groups, but taxpayers in the highest income groups would receive the largest benefits both absolutely and as a percentage of after-tax income. Taxpayers with income over $100,000 would receive over half the benefits of the tax cuts. In the long run, the proposal would reduce tax burdens as a percentage of after-tax income by 2.3 percent on average, but by 3.9 percent for taxpayers with income over $200,000 and by less than 1.9 percent in all income groups less than $75,000.

Because some of the tax cuts reduce the present value of tax burdens much more than they reduce tax payments in the short-run, the total annual tax benefit shown in Table 2 ($110 billion per year) is much larger than the average annual tax reduction in Table 1 (about $24 billion). The attached note explains the difference between the revenue and distributional estimates.

Table 1

## CONTRACT WITH AMERICA - REPUBLICAN REVENUE PROPOSALS

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| Proposal | 1995 | 1996 | 1997 | 1998 | 1999 | 1995-99 |
|---|---|---|---|---|---|---|
| | | | Fiscal years ($ billions) | | | |
| 1 Refundable $5,000 tax credit for adoption expenses | 0.0 | -0.0 | -0.2 | -0.3 | -0.3 | -0.8 |
| 2 Refundable $500 tax credit for eldercare expenses | 0.0 | -0.1 | -0.3 | -0.3 | -0.3 | -0.9 |
| 3 $500 per child tax credit for families with AGI < $200,000 | 0.0 | -11.7 | -23.4 | -24.5 | -25.4 | -85.0 |
| 4 Reduce marriage penalty | 0.0 | -1.0 | -2.0 | -2.0 | -2.0 | -7.0 |
| 5 Establish back-loaded IRA */ | 0.0 | 0.1 | 0.2 | 0.0 | -0.1 | 0.2 |
| 6 Phase-in repeal of new SS thresholds (85%) enacted in 1993 | 0.0 | -0.5 | -1.9 | -3.2 | -4.1 | -9.8 |
| 7 Long-term care tax incentives | | | | | | |
| a Long-term care insurance | 0.0 | -0.3 | -0.9 | -1.0 | -1.1 | -3.3 |
| b Allow tax-free payment of accelerated death benefits under life insurance policies | 0.0 | -0.0 | -0.0 | -0.0 | -0.0 | -0.1 |
| 8 50% exclusion for indexed capital gains */ | -0.2 | -1.7 | -5.4 | -10.3 | -13.3 | -30.9 |
| 9 Neutral cost recovery */ | 2.7 | 8.1 | 10.7 | 6.6 | -2.6 | 25.4 |
| 10 Small business incentives | | | | | | |
| a Raise section 179 expensing limit from $17,500 to $25,000 | 0.0 | -0.7 | -1.1 | -0.8 | -0.6 | -3.3 |
| b Clarify home-office deduction | -0.0 | -0.1 | -0.1 | -0.1 | -0.1 | -0.4 |
| c Increase estate tax exemption from $600,000 to $750,000 | 0.0 | 0.0 | -1.1 | -1.4 | -1.8 | -4.3 |
| | 2.4 | -7.9 | -25.6 | -37.3 | -51.7 | -120.1 |

Department of the Treasury
Office of Tax Analysis

*/ Large revenue losses outside the FY 1995 - 1999 budget window.

Table 2

PRELIMINARY

# Tax Proposals in House Republican "Contract with America" (1)

(1994 Income Levels)

| Family Economic Income Class (4) (000) | Federal Taxes Under Current Law (2) Amount ($B) | As a Percent of Pre-Tax Income (%) | As a Percent of After-Tax Income (%) | Change in Federal Taxes (3) Amount ($B) | As a Percent of Pre-Tax Income (%) | As a Percent of After-Tax Income (%) | Total Federal Taxes After Change Amount ($B) | As a Percent of Pre-Tax Income (%) | As a Percent of After-Tax Income (%) |
|---|---|---|---|---|---|---|---|---|---|
| 0 - 10 | 6.4 | 7.5 | 8.1 | -0.4 | -0.5 | -0.5 | 6.0 | 7.0 | 7.6 |
| 10 - 20 | 25.8 | 9.4 | 10.3 | -1.9 | -0.7 | -0.8 | 23.9 | 8.7 | 9.6 |
| 20 - 30 | 54.7 | 13.8 | 16.0 | -4.0 | -1.0 | -1.2 | 50.8 | 12.8 | 14.8 |
| 30 - 50 | 152.3 | 17.3 | 20.9 | -12.6 | -1.4 | -1.7 | 139.7 | 15.9 | 19.2 |
| 50 - 75 | 204.1 | 19.1 | 23.6 | -16.4 | -1.5 | -1.9 | 187.7 | 17.6 | 21.7 |
| 75 - 100 | 175.2 | 20.5 | 25.8 | -15.3 | -1.8 | -2.3 | 159.9 | 18.7 | 23.5 |
| 100 - 200 | 244.5 | 21.3 | 27.1 | -24.2 | -2.1 | -2.7 | 220.3 | 19.2 | 24.4 |
| 200 & over | 275.0 | 23.3 | 30.3 | -35.3 | -3.0 | -3.9 | 239.8 | 20.3 | 26.4 |
| Total (5) | 1,139.8 | 19.5 | 24.2 | -110.4 | -1.9 | -2.3 | 1,029.3 | 17.6 | 21.8 |

Department of the Treasury
Office of Tax Analysis

October 16, 1994

(1) This table distributes the estimated change in tax burdens due to the tax provisions in the House Republican "Contract with America" as specified in the legislative language released September 27, 1994. The effect of the proposed change in the estate tax exemption is excluded.

(2) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total comsumption expenditures. Taxes due to provisions that expire prior to the end of the Budget period are excluded.

(3) The change in Federal taxes is estimated at 1994 income levels but assuming fully phased in (1999) law and long-run (1999) behavior. The effect of the backloaded IRA proposal is measured as the present value of tax savings on one year's contributions. The effect of the neutral cost recovery proposal is measured as the present value of the tax savings from one year's investment. The effect of the prospective capital gains indexing proposal is the fully phased in tax savings, multiplied by the ratio of the sum of the present values of prospective indexing over 20 years to the sum of the present values of fully phased in indexing over 20 years, holding realizations constant. The effect on tax burdens of the proposed capital gains exclusion and prospective indexing are based on the level of capital gains realizations under current law. The incidence assumptions for tax changes is the same as for current law taxes (see footnote 2).

(4) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and underreported income; IRA and Keogh deductions; nontaxable transfer payments, such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent reliable data allow. Inflationary losses of lenders are subtracted and of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family, rather than on a tax return basis. The [illegible] incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.

## House Republican "Contract with America": Comparison of Revenue and Distributional Estimates for Tax Proposals

Three of the tax proposals in the House Republican "Contract with America" provide substantially greater tax benefits in future years than is indicated by the revenue estimates for the five-year budget period. These three proposals are: (1) the allowance of backloaded IRAs for all taxpayers; (2) prospective indexation of capital gains for inflation; and (3) the neutral cost recovery system.

For the backloaded IRA proposal, the difference between future tax benefits for taxpayers and the revenue loss during the five-year budget period is due in part to the inclusion in the proposal of a provision that would allow taxpayers a rollover of existing IRA balances into a new backloaded IRA. The amount rolled over, to the extent not previously taxed, would be subject to income tax (payable over four years), which would generate sufficient revenues over the budget period to make the proposal a net revenue gainer. However, the (present value of) revenues collected on the rollovers would, under current law, have been paid in future years, so the revenues from this provision only represent a speedup in collections (with some loss in the present value of revenues because of the allowance of payments over four years). In addition, the revenue loss from the tax exemption of earnings on each year's contributions to the new IRAs grows over time, so it is much larger outside the budget period. To represent properly the benefit to taxpayers from the continuing tax exemption of earnings on IRA contributions, the distributional estimates measure the benefit as the present value of the tax savings on one year's contributions. For this calculation, each taxpayer who contributes to a new backloaded IRA is assumed to remain in the same tax bracket and to begin withdrawals as an annuity over his or her expected remaining lifetime at age 65. For contributions in one year at 1994 income levels, and taking account of contributions that would otherwise be placed in nontaxable investments, the present value of the tax savings is $17.8 billion.

The proposed prospective indexation of capital gains phases in over time, so it is not fully effective until the longest vintage of capital gains is fully indexed. To represent properly the phasing in of the benefit of prospective indexation, the distributional estimates measure the benefit as the value of the fully phased in tax savings, multiplied by the ratio of the sum of the present values of prospective indexing over 20 years (virtually the longest capital gain vintage) to the sum of the present values of fully phased in indexing over 20 years, holding realizations constant. At 1994 levels of realizations under current law, the resulting present value is $7.2 billion.

The neutral cost recovery proposal includes a provision to replace the current law double (200 percent) declining balance recovery method with 150 percent declining balance. This provision raises sufficient revenue in the budget period to make the proposal a net revenue gainer. Over time, the proposal <u>loses</u> substantial revenue because firms eventually may deduct much more than the dollar value of investments in machinery and structures. The neutral cost recovery system provides, in present value terms, the equivalent of expensing of investment. To represent properly the benefit to taxpayers of the proposal, the distributional estimates measure the benefit as the present value of the tax savings from expensing (compared to using current law cost recovery schedules) on one year's investment. At 1994 levels of investment, this present value is $45.3 billion.

Including the present value measures for the IRA, capital gains indexing, and neutral cost recovery proposals, and the one-year losses from the other tax proposals (which are all ongoing annual losses), the distributional table shows a change in annual tax benefits of $110.4 billion at 1994 income levels from the "Contract with America" tax provisions.[1] In contrast, the revenue loss from the proposals over the five-year budget period is not much more, $120.1 billion. The large difference, as explained above, is due to provisions in the "Contract" that speed up tax collections into the budget period, and the growth of tax benefits over time inherent in several of the proposals in the "Contract".

[1] The distributional table excludes the effect of the estate tax proposal, which would increase the exemption level.

# TREASURY CLEARANCE SHEET

NO. 94-139 T&I

Date 11/16/94

MEMORANDUM FOR: ☒ SECRETARY ☒ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
☐ ACTION ☐ BRIEFING ☒ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER ____________

FROM: Leslie B. Samuels, Alicia Munnell, Alan Cohen

THROUGH: ____________

SUBJECT: Republican "Contract with America" Proposals

REVIEW OFFICES (Check when office clears)

- ☐ Under Secretary for Finance
  - ☐ Domestic Finance
  - ☐ Economic Policy
  - ☐ Fiscal
    - ☐ FMS
    - ☐ Public Debt
- ☐ Under Secretary for International Affairs
  - ☐ International Affairs
- ☐ Enforcement
  - ☐ ATF
  - ☐ Customs
  - ☐ FLETC
  - ☐ Secret Service
- ☐ General Counsel
- ☐ Inspector General
- ☐ IRS
- ☐ Legislative Affairs
- ☐ Management
- ☐ OCC
- ☐ Policy Management
  - ☐ Scheduling
- ☐ Public Affairs/Liaison
- ☐ Tax Policy
- ☐ Treasurer
  - ☐ E & P
  - ☐ Mint
  - ☐ Savings Bonds
- ☐ Other ____________

| NAME (Please Type) | INITIAL | DATE | OFFICE | TEL. NO. |
|---|---|---|---|---|
| INITIATOR(S) | | | | |
| Lowell Dworin | | | Tax Policy (Tax Analysis) | 622-0269 |
| REVIEWERS | | | | |

SPECIAL INSTRUCTIONS

☐ Review Officer Date ☐ Executive Secretary Date

DO F 80-02.1 (04/89)

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

**INFORMATION**

MEMORANDUM FOR SECRETARY BENTSEN
DEPUTY SECRETARY NEWMAN

FROM: Alicia H. Munnell

SUBJECT: Contract With America Welfare Reform Bill

**Summary**

The Republican welfare bill specified in the Contract With America is likely to pass the House. However, its illegitimacy, legal alien, and entitlement cap provisions raise important questions. Because of the President's public commitment to welfare reform, it would be very difficult for the President to veto any welfare reform bill. It is imperative that the Administration take immediate action to produce a more sensible welfare reform bill. One possible solution is the Medicaid for AFDC swap proposed by Senator Kassebaum.

**Discussion**

According to Ron Haskins, a Republican staffer who will be influential on welfare reform, House Republicans are planning a very short timetable for welfare reform. Their plan is to begin five days of full committee hearings on January 5, mark the bill, then have two days of debate on the House floor before the final vote. The timetable for the Senate is less sure, but their will be pressure to follow the House lead and act quickly.

The Contract With America (CWA) bill has several provisions that would result in tremendous harm to the poor without counterbalancing benefits. First, it would prohibit AFDC payments for children born out-of-wedlock to women under 18 with a state option to go to 21. Legal aliens would be ineligible for most means-tested benefits including AFDC, Medicaid (except emergency), and SSI. And the CWA bill would require aggregate AFDC, SSI, and Housing assistance funding to stay constant in real terms.

While these provisions will almost certainly harm the poor, there is scant evidence they will achieve policy goals. Studies indicate that welfare does contribute to a small increase in out-of-wedlock births, but is outweighed by other factors. Therefore, cutting AFDC for out-of-wedlock births to minor mothers will not significantly decrease illegitimacy (especially since the majority of women who have children out-of-wedlock do not go on AFDC). Legal aliens, excluding refugees, are actually somewhat less likely to go on welfare than citizens. It is questionable whether eliminating welfare payments would discourage the immigrants that are likely to qualify for benefits. Instead, it is likely to result in increased extreme poverty and homelessness among recent immigrants. Finally, capping AFDC, SSI, and Housing Assistance would effectively eliminate the social safety net since these benefits would no longer be guaranteed to qualified applicants.

It would be an unmitigated disaster if a bill with these provisions arrived on the President's desk. The President cannot veto a welfare reform bill without losing his New Democrat credentials. On the other hand, it would be difficult to interpret the illegitimacy provisions in the CWA welfare reform bill as anything less than an attack on African-Americans. And Hispanics would interpret the legal alien provisions as a personal attack even harsher than Proposition 187.

The passage of the CWA bill is not a foregone conclusion. The Senate is less likely to pass an extremely punitive welfare bill. Senators Kassebaum, Packwood, and Dole are fairly moderate on these issues and Senator Moynihan will retain some influence. Further, it is unclear whether, if the issues are made clear, the public will support such harsh punitive actions. Finally, the Republicans will be held politically accountable if they do not pass a welfare reform bill through both Houses of Congress. Therefore, the longer the Administration can delay passage of the bill the more willing Republicans will be to compromise.

Given the specter of a Gingrich et. al. welfare reform, the Administration should carefully consider the kind of swap option proposed by Senator Kassebaum. She argues that the Federal government should give states responsibility for the three primary welfare programs -- AFDC, Food Stamps and WIC. In return, the Federal government would assume primary responsibility for Medicaid. The general features of this proposal were originally developed by the staff of the National Association of State Budget Officers. Subsequently, it was the core element of the Reagan Administration's "Federalism Initiative" and has been considered in a variety of schemes to sort out intergovernmental responsibilities.

?

While the devil is in the details, such a swap has much to recommend it. It responds to the reality that the best ideas for welfare reform are being worked out at the state level and it is likely that different approaches are appropriate for different states. Further, given a choice between a Gingrich welfare reform and those of Bill Weld or Pete Wilson, I would certainly opt for the governors' approaches.

The swap also provides a powerful tool to slow down the Republican juggernaut. It will help expand the wedge between those Republicans who hate government and want to beat on the poor and those who believe programs can be humane and efficient if they are devolved to the state and local level. Given the fiscal implications for states, virtually every governor, including the Republicans, would enthusiastically support a sensibly structured swap. The swap might be even more attractive if it were expanded by turning back to the states virtually every housing program and combining most training programs in a block grant so that states are provided the necessary tools to address welfare reform.