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Mr. Chairman, I am pleased to have this opportunity to appear before the Committee as you consider the extremely important task of reducing the budget deficits now looming ahead. The First Concurrent Budget Resolution for Fiscal Year 1984 (H. Con. Res. 91), passed on June 23, calls for substantial tax increases and expenditure cuts during the next three years. In particular, the resolution specifies revenue increases of $12 billion in fiscal year 1984, $15 billion in 1985, and $46 billion in 1986. In the absence of revenue increases, deficits are projected to remain in the $180 billion to $200 billion range.

There are many ways of raising revenues in response to deficit-reduction needs of this dimension: across-the-board tax rate increases, increases in excise taxes, a continuation of the base-broadening approach exemplified by last year's Tax Equity and Fiscal Responsibility Tax Act (TEFRA), or a combination of these approaches.

I will first mention major changes for raising revenues that could provide a significant portion of the tax increases sought and then I will discuss excise tax increases and tax changes that would broaden the individual and corporation income tax bases, resulting in increases that could be combined to raise the revenues sought.

ACROSS-THE-BOARD TAX RATE INCREASES

Discussion is proceeding in this Committee and elsewhere about a basic restructuring of the tax system. Particular changes under discussion include a

substantial broadening of the individual income tax base combined with a general lowering and reduction in the range of rates applied to this base; integration of the corporate and individual income taxes; and a partial or complete replacement of our present income tax system with a consumption tax or value-added tax. However, fundamental restructuring takes time. The question at hand is how best to respond to the consensus expressed in the budget resolution that revenues should be raised substantially over the next three years.

Capping the Income Tax Reductions

Since the third round of the individual income tax rate reductions is scheduled to be carried out by changes in withholding rates beginning this Friday, the scope of possible revenue increases from altering these changes is greatly reduced. For example, a cap on this rate reduction of $720 dollars per return would raise between $6 billion and $8 billion per year over the 1984-1986 period.

Contingency Taxes

As part of its budget plan for fiscal year 1983, the Administration has proposed a 5 percent individual income tax surcharge and a $5 per barrel oil excise tax, to go into effect in 1986 for three years if, by 1985, certain specified conditions are met. CBO estimates that these temporary taxes would raise almost $40 billion in 1986, about half from the income tax surcharges and half from the oil excise tax. Part or all of these increases could be moved forward to reduce deficits sooner.

Delay of Indexing

An automatic rise (indexation) in the zero bracket amount, personal exemption, and tax rate brackets, provided in the Economic Recovery Tax Act of 1981 (ERTA), is scheduled to go into effect in calendar year 1985. The rescinding of indexing or its delay beyond 1986 would increase revenues by about $6 billion in 1985 and $17 billion in 1986.

Indexing has considerable appeal as a device to prevent the unlegislated increases in real individual income tax liabilities that result solely from the effects of inflation on the tax system (commonly called "bracket creep"). If the federal government is considered likely to be short of tax revenues in 1985 and thereafter, however, the revenue gain from repealing indexing might seem desirable both in its timing and its sensitivity to economic conditions.

A possible drawback to the repeal or postponement of indexing is that it would have different effects on taxpayers at the low and high ends of the income spectrum. Compared with indexation of the exemptions and the tax rate brackets, the three-year tax rate cuts under ERTA were more generous to upper-income taxpayers and less generous to those with lower incomes. If indexing was repealed, one might argue that taxpayers with lower incomes would continue to be less than fully compensated for the bracket creep caused by inflation since the late 1970s.

Indexing can also be justified as a way of continuing the pressure for discipline in federal spending and tax policy. It assures that real individual income tax revenues increase at roughly the rate of growth in real incomes, thus requiring that spending increases be similarly limited if future deficits are not to increase. It also limits the opportunities for increases in tax expenditures and other special-purpose tax provisions, and imposes pressure to reduce those that now exist.

EXCISE TAX INCREASES

Federal revenues could also be increased through selective changes in excise taxes, or through the enactment of new excises. New or increased excise taxes would put the burden of narrowing the deficit on consumption, rather than work or saving; this would tend to reinforce our long-term push toward more rapid growth of output and productivity. On the other hand, increased excise tax collections cannot be so finely targeted on taxpayer groups according to their ability to pay, and so the perceived fairness of the tax system might suffer.

New or increased excise taxes on energy are high on some lists of suggested revenue raisers. Increasing the price of energy to consumers would encourage conservation. Improvements in the energy efficiency of our capital stock, and continued investments in home insulation and more fuel-efficient appliances and autos would pay dividends for years to come, as well as reduce our nation's long-run vulnerability to a sudden interruption of fuel imports. The current lower-than-

expected energy prices may provide an environment in which increases in energy taxes might be more tolerable.

Possible new taxes on energy would include an oil import fee, a windfall profit tax on decontrolled natural gas, and a general energy excise tax (see Table 1). An oil import fee would increase directly the cost of imported oil, thereby conferring a relative advantage on competing sources of energy — including domestic oil, gas, and coal. Domestic energy production and prices and the profits of domestic energy producers would increase, while foreign suppliers would likely have to absorb part of the tax to compete. The increased cost of energy would add somewhat to inflation and unemployment. Each $1 per barrel of import fee would raise about $2 billion per year in revenues, both directly and through higher windfall profit taxes, but the reduced employment and increased inflation would cost the federal government about 25 percent as much in increased outlays and reduced revenues from other taxes.

Price controls on natural gas are widely held to have caused shortages and misallocations. Immediate and full decontrol of natural gas would go a long way toward eliminating those inefficiencies, but it would also result in windfalls for the owners of supplies of low-cost gas. Those windfall profits could be taxed in the same fashion as under the oil windfall profit tax. Such a tax could raise from $2 billion to $5 billion in 1984, but if the tax was limited only to the profits from the acceleration of decontrol before the scheduled limited decontrol on January 1, 1985, revenues would drop sharply after the first year. An alternative would be a simple excise tax

TABLE 1. ESTIMATED REVENUE GAINS FROM NEW OR INCREASED EXCISE TAXES (By fiscal year, in billions of dollars)

Options	1984	1985	1986	Cumulative Three-Year Increase
Impose Oil Import Fee ($2 per barrel)	3	4	4	12
Impose Broad-Based Tax on Domestic Energy (5 percent of value)	11	17	19	47
Impose Tax on Domestic and Imported Oil ($2 per barrel)	6	9	9	23
Impose Excise Tax on Natural Gas (30 cents per 1,000 cubic feet)	2	3	3	8
Increase Gasoline Excise Tax (5 cents per gallon)	3	4	4	11
Extend Doubling of Cigarette Excise Tax Beyond 1985[a,b]	--	--	2	2
Continue 3 Percent Excise Tax on Telephone Service Beyond 1985[a,c]	--	--	1	1
Double Excise Taxes on Alcohol[a,d]	2	4	4	10

SOURCES: Congressional Budget Office, Reducing the Deficit: Spending and Revenue Options (February 1983), pp. 253 and 258.

NOTE: Details may not add to totals because of rounding.

a. The revenue effects are net of income tax offsets. Excise tax increases lower income tax revenues because they can be deductible business expenses and because, unless monetary policy is fully accommodating, they lower taxable incomes throughout the economy. Taking both of these effects into account, and assuming an economy-wide marginal tax rate of 25 percent, results in a net revenue effect that is 75 percent of the gross effect.

b. The doubling of the cigarette excise tax expires October 1, 1985, under current law. The extension beyond 1985 assumes no break in tax collections.

c. The telephone excise terminates December 31, 1985, under current law.

d. The effective date is January 1, 1984.

on natural gas; such a tax would raise about $1 billion per year for every 10 cents on each 1,000 cubic feet. Such a tax would discourage the use of natural gas, however, which might or might not be in keeping with national energy policy, and it would also burden homeowners hard hit by rising heating bills.

A general tax on all energy sources could be formulated in several ways; it could be a tax on each unit of production (tons of coal, barrels of oil, cubic feet of gas), or on the value or price of the energy produced (ad valorem tax), or on the heat content of the fuel (generally measured in British thermal units, or Btu). A 5 percent-of-value tax on all U.S. energy consumption would raise $15 billion to $20 billion per year in revenues.

An existing energy excise tax that could be increased is that on gasoline. Each one-cent increase in the federal excise tax on gasoline raises about $1.1 billion in revenues, though offsetting income tax reductions would reduce the net revenue increase by about 25 percent. While the gasoline excise tax increase would be administratively easier than creating a new tax, it would repeat the increased burden of the recent increase and impinge somewhat on a revenue source heavily used by the states. It would also have differing regional impacts.

Other excise taxes could also be increased. The Tax Equity and Fiscal Responsibility Act increased the 8-cents-per-pack tax on cigarettes to 16 cents per pack through September 30, 1985; extending that increase would yield revenues of about

$1.7 billion per year. The 16-cents-per-pack tax represents about 18 percent of the current cost per pack, still less than the 37 percent of the cost per pack that the 8 cent excise represented in 1951 when it was last raised prior to TEFRA.

The TEFRA increase in the telephone service excise tax from 1 to 3 percent for calendar years 1983-1985 could be extended. The revenue yield would be $2 billion to $3 billion per fiscal year.

Federal excise taxes on alcohol have not been increased since 1951. Doubling those excises would follow the pattern of the tobacco excises set in TEFRA. Distilled spirits are currently taxed at $10.50 per gallon; doubling that tax would raise about $2.7 billion per year. Doubling the excises on beer and wine combined would raise about $1.3 billion per year. At present, beer and wine are both taxed significantly more lightly than distilled spirits as a percentage of retail price, so differential treatment might be called for.

POSSIBLE BASE-BROADENING OPTIONS

The Congress could also raise revenues by eliminating or reducing several tax expenditure provisions. This base-broadening approach was used last summer in TEFRA. Broadening the tax base in this way can make the economy more efficient, by reducing the federal government's role in determining the allocation of resources and increasing the influence of the free market. It can also make the tax system

more fair, by treating incomes from different sources more alike. Below is a list of possible options for base-broadening; a much more extensive list can be found in CBO's February 1983 report on reducing the deficit.

Repeal Percentage Depletion Allowance for Oil and Gas. Independent oil and gas producers are allowed to use percentage depletion instead of cost depletion to recover the costs of discovery and development of oil and gas wells. Eliminating percentage depletion would increase federal revenues by $0.9 billion in fiscal year 1984 and by about $4.5 billion in fiscal years 1984-1986 (see Table 2). The provision was intended to encourage domestic energy production by relatively small-scale producers, but the sharp rises in oil and gas prices in recent years may provide sufficient incentive to potential producers.

Repeal Expensing of Intangible Drilling Costs for Oil and Gas. Taxpayers engaged in oil and gas drilling may deduct the amount they spend on intangible drilling costs in the year the expenditure is made, instead of amortizing the amount over the life of the well. While TEFRA cut back this provision somewhat, repealing expensing entirely would increase federal revenues by $2.6 billion in fiscal year 1984 and by about $11 billion in fiscal years 1984-1986. Proponents of repeal argue that high oil and gas prices as well as the other tax incentives available to the industry provide sufficient encouragement; opponents want to retain the provision in order to help promote a more independent national energy supply.

TABLE 2. ESTIMATED REVENUE GAINS FROM BROADENING THE TAX BASE (By fiscal year, in billions of dollars)

Options	1984	1985	1986	Cumulative Three-Year Increase
Repeal Percentage Depletion Allowance for Oil and Gas	1	2	2	4
Repeal Expensing of Intangible Drilling Costs for Oil and Gas	3	4	4	11
Limit Nonbusiness, Noninvestment Interest Deductions to $10,000	1	2	2	4
Lengthen the Building Depreciation Period to 20 Years	*	2	4	6
Repeal Net Interest Exclusion	--	1	3	4
Require Full Basis Adjustment for the Investment Tax Credit	*	1	2	4
Tax Nonstatutory Fringe Benefits	1	1	1	3
Limit Charitable Deductions for Nonitemizers to $100	--	0	2	2
Tax Some Employer-Paid Health Insurance				
Income tax	3	5	6	14
Payroll tax	1	1	2	4
Freeze Estate and Gift Credit at Exemption Equivalent of $275,000	--	1	1	2
Eliminate Deductibility of State and Local Sales Taxes	1	6	6	13

SOURCES: Congressional Budget Office, Reducing the Deficit: Spending and Revenue Options (February 1983), pp. 250-51.

NOTE: Details may not add to totals because of rounding.

* Less than $0.5 billion.

Limit Consumer and Mortgage Interest Deductions to $10,000. Limiting all consumer and mortgage interest deductions to $10,000, paralleling the limit on investment interest deductions, would affect one percent of all taxpayers and would raise $0.6 billion in fiscal year 1984 and about $4 billion in fiscal years 1984-1986. The proposal would limit deductions of all interest payments on home mortgages, auto loans, installment purchases, credit card carryovers, and other consumption borrowing.

Lengthen the Building Depreciation Period to 20 Years. Since the enactment of ERTA, both new and newly purchased buildings can be depreciated over 15 years using the 175 percent declining balance method. Lengthening the tax life for structures from 15 to 20 years would raise $0.4 billion in fiscal year 1984 and about $6 billion in fiscal years 1984-1986. While a longer period might introduce some distortion of investment allocation, it would more closely approximate a structure's useful life.

Repeal Net Interest Exclusion. A tax exclusion of up to $450 of net interest income will be available to individuals starting in 1985 (up to $900 for joint returns). Repeal of the exclusion would raise about $4 billion in fiscal years 1985-1986. The provision was enacted to reduce taxes on savings, but saving could also be encouraged — at a further revenue gain — by restricting existing tax incentives for consumer borrowing.

Require Full Basis Adjustment for the Investment Tax Credit. To reduce the overlap of benefits from accelerated depreciation and the investment tax credit, in TEFRA, the Congress limited the depreciable basis of an asset to its price minus 50 percent of the eligible investment credit. A full basis adjustment would restrict depreciation to a firm's net cost of the asset — 90 percent in the case of the regular investment credit. If applied to investments in machinery and equipment, this proposal would increase federal revenues by $0.3 billion in fiscal year 1984 and by about $4 billion in fiscal years 1984-1986.

Tax Nonstatutory Fringe Benefits. If the Congress permitted the Internal Revenue Service to issue regulations governing the taxation of most fringe benefits (including, for example, private use of a company car, reduced-price meals, and discounts on employers' products), the revenue gain would be $0.6 billion in fiscal year 1984 and about $3 billion in fiscal years 1984-1986. The present exemption encourages employees to bargain for nonwage forms of compensation; this shrinks the tax base and misallocates resources. Taxing certain fringe benefits, however, could be complicated and costly.

Tax Some Employer-Paid Health Insurance. Employees do not pay income taxes or payroll taxes on income received in the form of employer-paid health care coverage. One proposal to limit the present exclusion treats amounts exceeding $160 a month for families and $65 a month for individuals as taxable income. This would increase income tax revenues by $2.7 billion in fiscal year 1984 and by about $14

billion in fiscal years 1984-1986; it would increase payroll tax revenues by $0.8 billion in fiscal 1984 and by about $4 billion in fiscal years 1984-1986. Many observers feel that the exclusion encourages overuse of health care services, thereby driving up health care costs.

Eliminate Deductibility of State and Local Sales Taxes. Eliminating the itemized deduction for state and local sales taxes would increase federal revenues by $0.9 billion in fiscal year 1984 and by about $13 billion in fiscal years 1984-1986. While sale taxes reduce taxpayers' net income, they are the kind of small, uniform, and predictable expense that is implicitly taken into account when the zero bracket amount, personal exemptions, and general tax rates are established.