5. TAX EXPENDITURES

Tax expenditures are revenue losses due to preferential provisions of the Federal tax laws, such as special exclusions, exemptions, deductions, credits, deferrals, or tax rates. They are alternatives to other policy instruments, such as spending or regulatory programs, as means of achieving Federal policy goals. Tax expenditures are created for a variety of reasons, including to encourage certain activities, to improve fairness, to ease compliance with and administration of the tax system, and to reduce certain tax-induced distortions. The Congressional Budget Act of 1974 (Public Law 93–344) requires that a list of tax expenditures be included in the budget.

The largest tax expenditures tend to be associated with the individual income tax. For example, tax preferences are provided for employer contributions for medical insurance, pension contributions and earnings, mortgage interest payments on owner-occupied homes, capital gains transferred at death, and payments of State and local individual income taxes. Tax expenditures under the corporate income tax tend to be related to the rate of cost recovery for various investments; as is discussed below, the extent to which these provisions are classified as tax expenditures varies according to the conceptual baseline used. Charitable contributions and credits for State death taxes are the largest tax expenditures under the unified transfer (i.e., estate and gift) tax.

Because of potential interactions among provisions, this chapter does not present a grand total revenue loss estimate for tax expenditures. Moreover, past tax changes entailing broad elimination of tax expenditures were generally accompanied by changes in tax rates or other basic provisions, so that the net effects on Federal revenues were considerably (if not totally) offset. Nevertheless, in aggregate, tax expenditures have revenue impacts of hundreds of billions of dollars, and are some of the most important ways in which the Federal Government affects economic decisions and social welfare.

While the significant economic impact is self-evident for large provisions, smaller tax expenditures can be important for certain sectors or types of taxpayers. As is discussed later in this chapter, the Administration is developing a framework for analyzing and reporting the economic and other effects of tax expenditures, so that they can be better compared with policy alternatives. Tax expenditures are also discussed in Section VI of the *Budget*, which considers the Federal Government's spending, regulatory, and tax policies across functional areas.

Tax expenditures relating to the individual and corporate income taxes are considered first in this chapter. They are estimated for fiscal years 1996–2002 using three methods of accounting: revenue loss, outlay equivalent, and present value. The present value approach provides estimates of the revenue losses for tax expenditures that involve deferrals of tax payments into the future or have similar long-term effects. Tax expenditures relating to the unified transfer tax are considered in a section at the end of the chapter.

TAX EXPENDITURES IN THE INCOME TAX

Tax Expenditure Estimates

The Treasury Department prepared all tax expenditure estimates presented here based upon tax law enacted as of December 31, 1996. The analysis includes new tax expenditures which were enacted this year in the Health Insurance Protection and Accountability Act and the Small Business Job Protection Act of 1996. Expired or repealed provisions are not listed if their revenue effects result only from taxpayer activity occurring before fiscal year 1996.

The total revenue loss estimates for tax expenditures for fiscal years 1996–2002 are displayed by the budget's functional categories in table 5–1. Descriptions of the specific tax expenditure provisions follow the tables of estimates and discussion of general features of the tax expenditure concept.

As in prior years, two baseline concepts—the normal tax baseline and the reference tax law baseline—are used to identify tax expenditures. For the most part, the two concepts coincide. However, items treated as tax expenditures under the normal tax baseline, but not the reference tax law baseline, are indicated by the designation "normal tax method" in the tables. The revenue losses for these items are zero using the reference tax rules. The alternative baseline concepts are discussed in detail following the estimates.

Table 5–2 reports the respective portions of the total revenue losses that arise under the individual and corporate income taxes. Listing revenue loss estimates under the individual and corporate headings does not imply that these categories of filers benefit from the special tax provisions in proportion to the respective tax expenditure amounts shown. Rather, these breakdowns show the specific tax accounts through which the various provisions are cleared. The ultimate beneficiaries of corporate tax expenditures, for example, could be stockholders, employees, customers, or others, depending on the circumstances.

Table 5–3 ranks the major tax expenditures by fiscal year 1998 revenue loss. This table merges several individual entries provided in table 5–1; for example, table 5–3 contains one merged entry for charitable contributions instead of the three separate entries found in table 5–1.

Interpreting Tax Expenditure Estimates

Tax expenditure revenue loss estimates do not necessarily equal the increase in Federal revenues (or the reduction in budget deficits) that would result from repealing the special provisions, for the following reasons:

- *Eliminating a tax expenditure may have incentive effects that alter economic behavior.* These incentives can affect the resulting magnitudes of the formerly subsidized activity or of other tax preferences or Government programs. For example, if deductibility of mortgage interest were limited, some taxpayers would hold smaller mortgages, with a concomitantly smaller effect on the budget than if no such limits were in force.
- *Tax expenditures are interdependent even without incentive effects.* Repeal of a tax expenditure provision can increase or decrease the revenue losses associated with other provisions. For example, even if behavior does not change, repeal of an itemized deduction could increase the revenue losses from other deductions because some taxpayers would be moved into higher tax brackets. Alternatively, repeal of an itemized deduction could lower the revenue loss from other deductions if taxpayers are led to claim the standard deduction instead of itemizing. Similarly, if two provisions were repealed simultaneously, the increase in tax liability could be greater or less than the sum of the two separate tax expenditures, since each is estimated assuming that the other remains in force. In addition, the estimates reported in Table 5–1 are the totals of individual and corporate income tax revenue losses reported in Table 5–2 and do not reflect any possible interactions between the individual and corporate income tax receipts. For this reason, the figures in Table 5–1 (as well as those in Table 5–5, which are also based on summing individual and corporate estimates) should be regarded as approximations.
- *Revenues raised by changes to tax expenditures are sensitive to timing effects and effective dates.* Changes in some provisions would yield their full potential revenue gains relatively quickly, whereas changes to other provisions would only gradually yield their full revenue potential, as certain deductions or exemptions would likely be grandfathered.
- *The annual value of tax expenditures for tax deferrals is reported on a cash basis in all tables except table 5–4.* Cash-based estimates reflect the difference between taxes deferred in the current year and incoming revenues that are received due to deferrals of taxes from prior years. While such estimates are useful as a measure of cash flows into the Government, they do not always accurately reflect the true economic cost of these provisions. For example, for a provision where activity levels have changed, so that incoming tax receipts from past deferrals are greater than deferred receipts from new activity, the cash-basis tax expenditure estimate can be negative, despite the fact that in present-value terms current deferrals do have a real cost to the Government. Alternatively, in the case of a newly enacted deferral provision, a cash-based estimate can overstate the real cost to the Government because the newly deferred taxes will ultimately be received. Present-value estimates, which are a useful supplement to the cash-basis estimates for provisions involving deferrals, are discussed below.
- *Repeal of some provisions could affect overall levels of income and rates of economic growth.* In principle, repeal of major tax provisions may have some impact on the budget economic assumptions. In general, however, most changes in particular provisions are unlikely to have significant macroeconomic effects.

Present-Value Estimates

Discounted present-value estimates of revenue losses are presented in table 5–4 for certain provisions that involve tax deferrals or other long-term revenue effects. These estimates complement the cash-based tax expenditure estimates presented in the other tables.

The present-value estimates represent the revenue losses, net of future tax payments, that follow from activities undertaken during calendar year 1997 which cause the deferrals or other long-term revenue effects. For instance, a pension contribution in 1997 would cause a deferral of tax payments on wages in 1997 and on pension earnings on this contribution (e.g., interest) in later years. In some future year, however, the 1997 pension contribution and accrued earnings will be paid out and taxes will be due; these receipts are included in the present-value estimate. In general, this conceptual approach is similar to the one used for reporting the budgetary effects of credit programs, where direct loans and guarantees in a given year affect future cash flows.

TABLE 5–1. TOTAL REVENUE LOSS ESTIMATES FOR TAX EXPENDITURES IN THE INCOME TAX

(In millions of dollars)

Provision	Total Revenue Loss							
	1996	1997	1998	1999	2000	2001	2002	1998–2002
National defense:								
Exclusion of benefits and allowances to armed forces personnel	2,060	2,080	2,095	2,120	2,140	2,160	2,180	10,695
International affairs:								
Exclusion of income earned abroad by United States citizens	1,520	1,680	1,865	2,065	2,290	2,545	2,825	11,590
Exclusion of income of foreign sales corporations	1,500	1,600	1,700	1,800	1,900	2,000	2,100	9,500
Inventory property sales source rules exception	1,400	1,500	1,600	1,700	1,800	1,900	2,000	9,000
Deferral of income from controlled foreign corporations (normal tax method)	2,100	2,200	2,400	2,600	2,800	3,000	3,200	14,000
General science, space, and technology:								
Expensing of research and experimentation expenditures (normal tax method)	40	195	430	580	685	740	765	3,200
Credit for increasing research activities	805	685	1,045	250	105	40	5	1,445
Energy:								
Expensing of exploration and development costs, fuels	–210	–130	–40	20	100	75	80	235
Excess of percentage over cost depletion, fuels	1,125	1,145	1,170	1,190	1,205	1,225	1,255	6,045
Alternative fuel production credit	570	600	485	565	535	505	485	2,575
Exception from passive loss limitation for working interests in oil and gas properties	50	50	55	55	60	60	65	295
Capital gains treatment of royalties on coal	15	15	15	20	20	20	20	95
Exclusion of interest on State and local IDBs for energy facilities	315	315	315	315	310	310	310	1,560
Enhanced oil recovery credit	80	85	90	100	105	105	110	510
New technology credit	30	35	40	40	40	45	45	210
Alcohol fuel credit [1]	10	10	10	10	10	10	10	50
Tax credit and deduction for clean-fuel burning vehicles and properties	65	65	75	80	85	90	95	425
Exclusion from income of conservation subsidies provided by public utilities	150	65	15	30	35	45	45	170
Natural resources and environment:								
Expensing of exploration and development costs, nonfuel minerals	35	35	35	35	35	35	35	175
Excess of percentage over cost depletion, nonfuel minerals	285	295	300	305	315	320	325	1,565
Capital gains treatment of iron ore	....	....	....	....	....	....	....	....
Special rules for mining reclamation reserves	50	50	50	50	50	50	50	250
Exclusion of interest on State and local IDBs for pollution control and sewage and waste disposal facilities	700	690	675	655	640	600	545	3,115
Capital gains treatment of certain timber income	15	15	15	20	20	20	20	95
Expensing of multiperiod timber growing costs	395	415	440	460	485	505	525	2,415
Investment credit and seven-year amortization for reforestation expenditures	45	50	50	50	50	50	50	250
Tax incentives for preservation of historic structures	125	120	115	115	110	105	105	550
Agriculture:								
Expensing of certain capital outlays	65	65	65	70	70	70	70	345
Expensing of certain multiperiod production costs	80	80	80	85	85	85	85	420
Treatment of loans forgiven solvent farmers as if insolvent	10	10	10	10	10	10	10	50
Capital gains treatment of certain income	165	170	175	180	185	190	195	925
Commerce and housing:								
Financial institutions and insurance:								
Exemption of credit union income	660	700	745	790	835	885	940	4,195
Excess bad debt reserves of financial institutions	90	70	40	15	5	....	....	60
Deferral on income on life insurance and annuity contracts	10,525	11,210	11,940	12,715	13,540	14,420	15,360	67,975
Special alternative tax on small property and casualty insurance companies	5	5	5	5	5	5	5	25
Tax exemption of certain insurance companies	240	245	255	260	280	295	310	1,400
Small life insurance company deduction	110	115	120	130	135	140	145	670
Housing:								
Exclusion of interest on owner-occupied mortgage subsidy bonds	1,765	1,755	1,735	1,715	1,690	1,665	1,640	8,445
Exclusion of interest on State and local debt for rental housing	755	760	755	760	765	760	750	3,790
Deductibility of mortgage interest on owner-occupied homes	47,525	49,820	52,115	54,440	56,830	59,345	62,060	284,790
Deductibility of State and local property tax on owner-occupied homes	15,900	16,670	17,435	18,215	19,015	19,855	20,765	95,285
Deferral of income from post 1987 installment sales	955	975	995	1,015	1,035	1,055	1,075	5,175
Deferral of capital gains on home sales	14,410	14,845	15,290	15,745	16,220	16,705	17,205	81,165
Exclusion of capital gains on home sales for persons age 55 and over	5,225	5,230	5,095	5,515	5,295	5,810	5,495	27,210
Exception from passive loss rules for $25,000 of rental loss	3,950	3,700	3,470	3,260	3,065	2,885	2,715	15,395
Credit for low-income housing investments	2,600	2,840	3,270	3,500	3,595	3,445	3,325	17,135
Accelerated depreciation on rental housing (normal tax method)	1,190	1,350	1,555	1,955	2,335	2,240	2,310	10,395
Commerce:								
Cancellation of indebtedness	70	40	15	....	–10	–5	–5	–5
Permanent exceptions from imputed interest rules	150	155	155	160	160	160	165	800
Capital gains (other than agriculture, timber, iron ore, and coal) (normal tax method)	7,990	8,230	8,480	8,730	8,995	9,265	9,540	45,010
Capital gains exclusion of small corporation stock	....	....	5	20	40	70	95	230
Step-up basis of capital gains at death	29,530	30,715	31,945	33,225	34,555	35,940	37,375	173,040
Carryover basis of capital gains on gifts	140	150	160	170	180	190	200	900
Ordinary income treatment of loss from small business corporation stock sale	35	35	35	35	40	40	40	190

TABLE 5–1. TOTAL REVENUE LOSS ESTIMATES FOR TAX EXPENDITURES IN THE INCOME TAX—Continued

(In millions of dollars)

Provision	Total Revenue Loss							
	1996	1997	1998	1999	2000	2001	2002	1998–2002
Accelerated depreciation of buildings other than rental housing (normal tax method)	6,800	5,800	4,660	3,420	2,385	1,640	1,085	13,190
Accelerated depreciation of machinery and equipment (normal tax method)	25,430	27,280	29,285	32,500	35,730	38,325	40,125	175,965
Expensing of certain small investments (normal tax method)	1,440	1,065	900	890	850	700	560	3,900
Amortization of start-up costs (normal tax method)	195	200	205	210	215	220	225	1,075
Graduated corporation income tax rate (normal tax method)	4,435	4,695	4,940	5,125	5,455	5,720	5,925	27,165
Exclusion of interest on small issue IDBs	275	265	260	255	250	250	240	1,255
Treatment of Alaska Native Corporations	20	15	10	5	5	5	....	25
Transportation:								
Deferral of tax on shipping companies	20	20	20	20	20	20	20	100
Exclusion of reimbursed employee parking expenses	1,250	1,285	1,315	1,350	1,385	1,425	1,470	6,945
Exclusion for employer-provided transit passes	50	60	70	85	100	115	130	500
Community and regional development:								
Investment credit for rehabilitation of structures (other than historic)	80	80	70	70	70	65	65	340
Exclusion of interest on IDBs for airports, docks, and sports and convention facilities	1,980	1,975	1,970	1,915	1,865	1,810	1,760	9,320
Exemption of certain mutuals' and cooperatives' income	60	60	60	65	65	65	70	325
Empowerment zones	530	585	640	670	700	700	530	3,240
Education, training, employment, and social services:								
Education:								
Exclusion of scholarship and fellowship income (normal tax method)	835	845	850	860	870	875	885	4,340
Exclusion of interest on State and local student loan bonds	305	290	280	265	260	250	250	1,305
Exclusion of interest on State and local debt for private nonprofit educational facilities	955	930	895	860	830	800	775	4,160
Exclusion of interest on savings bonds transferred to educational institutions	5	10	10	15	15	15	20	75
Parental personal exemption for students age 19 or over	820	845	885	930	985	1,045	1,090	4,935
Deductibility of charitable contributions (education)	1,865	1,960	2,060	2,165	2,270	2,385	2,500	11,380
Exclusion of employer provided educational assistance	20	575	20	....	....	....	....	20
Training, employment, and social services:								
Work opportunity tax credit	....	120	150	85	30	10	....	275
Exclusion of employer provided child care	775	830	890	955	1,025	1,100	1,180	5,150
Adoption assistance	....	10	200	320	355	370	365	1,610
Exclusion of employee meals and lodging (other than military)	570	600	630	665	700	735	775	3,505
Credit for child and dependent care expenses	2,580	2,705	2,840	2,985	3,130	3,290	3,455	15,700
Credit for disabled access expenditures	80	85	85	85	90	90	90	440
Expensing of costs of removing certain architectural barriers to the handicapped	20	20	20	20	20	20	20	100
Deductibility of charitable contributions, other than education and health	16,045	16,845	17,680	18,560	19,480	20,445	21,455	97,620
Exclusion of certain foster care payments	30	35	35	35	40	40	45	195
Exclusion of parsonage allowances	295	315	335	360	380	410	435	1,920
Health:								
Exclusion of employer contributions for medical insurance premiums and medical care	64,450	70,460	75,750	81,285	86,900	92,815	98,995	435,745
Medical savings accounts	....	10	100	190	195	195	200	880
Deductibility of medical expenses	3,675	4,060	4,535	4,895	5,270	5,670	6,100	26,470
Exclusion of interest on State and local debt for private nonprofit health facilities	2,135	2,080	2,005	1,930	1,855	1,790	1,745	9,325
Deductibility of charitable contributions (health)	2,360	2,480	2,600	2,735	2,870	3,005	3,155	14,365
Tax credit for orphan drug research	5	20	10	....	....	....	....	10
Special Blue Cross/Blue Shield deduction	120	135	95	150	165	200	250	860
Income security:								
Exclusion of railroad retirement system benefits	440	440	450	450	455	455	465	2,275
Exclusion of workmen's compensation benefits	4,695	4,970	5,305	5,550	5,855	6,220	6,660	29,590
Exclusion of public assistance benefits (normal tax method)	500	515	550	575	600	625	655	3,005
Exclusion of special benefits for disabled coal miners	90	90	85	80	75	75	70	385
Exclusion of military disability pensions	130	130	130	130	130	130	130	650
Net exclusion of pension contributions and earnings:								
Employer plans	55,410	55,810	56,245	56,665	57,085	57,510	57,940	285,445
Individual Retirement Accounts	8,025	8,345	8,600	8,880	9,125	9,340	9,520	45,465
Keogh plans	3,030	3,200	3,325	3,500	3,680	3,875	4,080	18,460
Exclusion of employer provided death benefits	35	35	35	40	40	45	45	205
Exclusion of other employee benefits:								
Premiums on group term life insurance	2,495	2,615	2,745	2,880	3,020	3,170	3,325	15,140
Premiums on accident and disability insurance	155	165	175	185	195	205	215	975
Income of trusts to finance supplementary unemployment benefits	20	20	20	20	20	20	20	100
Special ESOP rules	905	735	720	740	760	790	820	3,830
Additional deduction for the blind	25	25	25	30	30	30	30	145
Additional deduction for the elderly	1,470	1,485	1,495	1,500	1,510	1,515	1,515	7,535
Tax credit for the elderly and disabled	45	50	50	50	50	50	50	250
Deductibility of casualty losses	460	485	510	535	560	590	620	2,815
Earned income credit [2]	5,097	5,653	5,814	6,112	6,319	6,621	6,859	31,725

TABLE 5–1. TOTAL REVENUE LOSS ESTIMATES FOR TAX EXPENDITURES IN THE INCOME TAX—Continued

(In millions of dollars)

Provision	Total Revenue Loss							
	1996	1997	1998	1999	2000	2001	2002	1998–2002
Social Security:								
Exclusion of social security benefits:								
OASI benefits for retired workers	17,005	17,810	18,495	19,290	20,190	20,875	21,495	100,345
Disability insurance benefits	2,090	2,375	2,615	2,820	3,045	3,290	3,545	15,315
Benefits for dependents and survivors	3,795	3,985	4,175	4,355	4,530	4,710	4,895	22,665
Veterans benefits and services:								
Exclusion of veterans disability compensation	2,615	2,770	2,930	3,100	3,280	3,470	3,675	16,455
Exclusion of veterans pensions	70	70	70	70	75	80	85	380
Exclusion of GI bill benefits	50	60	70	80	90	95	100	435
Exclusion of interest on State and local debt for veterans housing	40	40	35	35	35	35	35	175
General purpose fiscal assistance:								
Exclusion of interest on public purpose State and local debt	15,720	15,800	15,735	15,595	15,445	15,300	15,170	77,245
Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	28,265	29,630	30,995	32,375	33,800	35,290	36,910	169,370
Tax credit for corporations receiving income from doing business in U.S. possessions	2,760	2,700	2,770	2,800	2,885	2,970	3,060	14,485
Interest:								
Deferral of interest on savings bonds	1,300	1,290	1,285	1,270	1,215	1,170	1,155	6,095
Addendum—Aid to State and local governments:								
Deductibility of:								
Property taxes on owner-occupied homes	15,900	16,670	17,435	18,215	19,015	19,855	20,765	95,285
Nonbusiness State and local taxes other than on owner-occupied homes	28,265	29,630	30,995	32,375	33,800	35,290	36,910	169,370
Exclusion of interest on:								
Public purpose State and local debt	15,720	15,800	15,735	15,595	15,445	15,300	15,170	77,245
IDBs for certain energy facilities	315	315	315	315	310	310	310	1,560
IDBs for pollution control and sewage and waste disposal facilities	700	690	675	655	640	600	545	3,115
Small-issue IDBs	275	265	260	255	250	250	240	1,255
Owner-occupied mortgage revenue bonds	1,765	1,755	1,735	1,715	1,690	1,665	1,640	8,445
State and local debt for rental housing	755	760	755	760	765	760	750	3,790
IDBs for airports, docks, and sports and convention facilities	1,980	1,975	1,970	1,915	1,865	1,810	1,760	9,320
State and local student loan bonds	305	290	280	265	260	250	250	1,305
State and local debt for private nonprofit educational facilities	955	930	895	860	830	800	775	4,160
State and local debt for private nonprofit health facilities	2,135	2,080	2,005	1,930	1,855	1,790	1,745	9,325
State and local debt for veterans housing	40	40	35	35	35	35	35	175

[1] In addition alcohol fuels results in a reduction in excise tax receipts (in millions of dollars) as follows: 1996 $670; 1997 $670; 1998 $700; 1999 $740; 2000 $770; 2001 $800; and 2002 $840.

[2] The figures in the table indicate the effect of the earned income tax credit on receipts. The effect on outlays (in millions of dollars) is as follows: 1996 $19,159; 1997 $21,163; 1998 $21,983; 1999 $22,864; 2000 $23,818; 2001 $24,634; and 2002 $25,518.

Note: Provisions with estimates denoted ''normal tax method'' have no revenue loss under the reference tax law method.

All estimates have been rounded to the nearest $5 million.

Figures in table 5–1 are the arithmetic sums of corporate and individual income tax revenue loss estimates from table 5–2, and do not reflect possible interactions across these two taxes.

TABLE 5–2. CORPORATE AND INDIVIDUAL INCOME TAX REVENUE LOSS ESTIMATES FOR TAX EXPENDITURES

(In millions of dollars)

Provision	Revenue Loss													
	Corporations							Individuals						
	1996	1997	1998	1999	2000	2001	2002	1996	1997	1998	1999	2000	2001	2002
National defense:														
Exclusion of benefits and allowances to armed forces personnel	—	—	—	—	—	—	—	2,060	2,080	2,095	2,120	2,140	2,160	2,180
International affairs:														
Exclusion of income earned abroad by United States citizens	—	—	—	—	—	—	—	1,520	1,680	1,865	2,065	2,290	2,545	2,825
Exclusion of income of foreign sales corporations	1,500	1,600	1,700	1,800	1,900	2,000	2,100	—	—	—	—	—	—	—
Inventory property sales source rules exception	1,400	1,500	1,600	1,700	1,800	1,900	2,000	—	—	—	—	—	—	—
Deferral of income from controlled foreign corporations (normal tax method)	2,100	2,200	2,400	2,600	2,800	3,000	3,200	—	—	—	—	—	—	—
General science, space, and technology:														
Expensing of research and experimentation expenditures (normal tax method)	40	190	420	570	670	725	750	....	5	10	10	15	15	15
Credit for increasing research activities	790	670	1,035	250	105	40	5	15	15	10	....	....	....	....
Energy:														
Expensing of exploration and development costs, fuels	–155	–95	–30	15	80	55	60	–55	–35	–10	5	20	20	20
Excess of percentage over cost depletion, fuels	845	860	875	890	905	920	940	280	285	295	300	300	305	315
Alternative fuel production credit	535	565	450	535	505	475	455	35	35	35	30	30	30	30
Exception from passive loss limitation for working interests in oil and gas properties	—	—	—	—	—	—	—	50	50	55	55	60	60	65
Capital gains treatment of royalties on coal	—	—	—	—	—	—	—	15	15	15	20	20	20	20
Exclusion of interest on State and local IDBs for energy facilities	125	125	125	125	125	125	125	190	190	190	190	185	185	185
Enhanced oil recovery credit	75	80	85	90	95	95	100	5	5	5	10	10	10	10
New technology credit	30	35	40	40	40	45	45	....	....	....	....	....	....	....
Alcohol fuel credit [1]	5	5	5	5	5	5	5	5	5	5	5	5	5	5
Tax credit and deduction for clean-fuel burning vehicles and properties	55	55	60	60	60	65	70	10	10	15	20	25	25	25
Exclusion from income of conservation subsidies provided by public utilities	100	10	–45	–35	–30	–25	–25	50	55	60	65	65	70	70
Natural resources and environment:														
Expensing of exploration and development costs, nonfuel minerals	25	25	25	25	25	25	25	10	10	10	10	10	10	10
Excess of percentage over cost depletion, nonfuel minerals	215	220	225	230	235	240	245	70	75	75	75	80	80	80
Capital gains treatment of iron ore	—	—	—	—	—	—	—	....	....	....	....	....	....	....
Special rules for mining reclamation reserves	45	45	45	45	45	45	45	5	5	5	5	5	5	5
Exclusion of interest on State and local IDBs for pollution control and sewage and waste disposal facilities	280	275	270	260	255	235	215	420	415	405	395	385	365	330
Capital gains treatment of certain timber income	—	—	—	—	—	—	—	15	15	15	20	20	20	20
Expensing of multiperiod timber growing costs	225	235	250	260	275	285	295	170	180	190	200	210	220	230
Investment credit and seven-year amortization for reforestation expenditures	20	20	20	20	20	20	20	25	30	30	30	30	30	30
Tax incentives for preservation of historic structures	25	25	25	25	20	20	20	100	95	90	90	90	85	85
Agriculture:														
Expensing of certain capital outlays	10	10	10	10	10	10	10	55	55	55	60	60	60	60
Expensing of certain multiperiod production costs	10	10	10	10	10	10	10	70	70	70	75	75	75	75
Treatment of loans forgiven solvent farmers as if insolvent	—	—	—	—	—	—	—	10	10	10	10	10	10	10
Capital gains treatment of certain income	—	—	—	—	—	—	—	165	170	175	180	185	190	195
Commerce and housing:														
Financial institutions and insurance:														
Exemption of credit union income	660	700	745	790	835	885	940	—	—	—	—	—	—	—
Excess bad debt reserves of financial institutions	90	70	40	15	5	....	....	—	—	—	—	—	—	—
Deferral on income on life insurance and annuity contracts	325	345	370	395	420	445	475	10,200	10,865	11,570	12,320	13,120	13,975	14,885
Special alternative tax on small property and casualty insurance companies	5	5	5	5	5	5	5	—	—	—	—	—	—	—
Tax exemption of certain insurance companies	240	245	255	260	280	295	310	—	—	—	—	—	—	—
Small life insurance company deduction	110	115	120	130	135	140	145	—	—	—	—	—	—	—
Housing:														
Exclusion of interest on owner-occupied mortgage subsidy bonds	705	700	690	685	675	665	655	1,060	1,055	1,045	1,030	1,015	1,000	985
Exclusion of interest on State and local debt for rental housing	300	305	300	305	305	305	300	455	455	455	455	460	455	450
Deductibility of mortgage interest on owner-occupied homes	—	—	—	—	—	—	—	47,525	49,820	52,115	54,440	56,830	59,345	62,060
Deductibility of State and local property tax on owner-occupied homes	—	—	—	—	—	—	—	15,900	16,670	17,435	18,215	19,015	19,855	20,765
Deferral of income from post 1987 installment sales	245	250	255	260	265	270	275	710	725	740	755	770	785	800
Deferral of capital gains on home sales	—	—	—	—	—	—	—	14,410	14,845	15,290	15,745	16,220	16,705	17,205
Exclusion of capital gains on home sales for persons age 55 and over	—	—	—	—	—	—	—	5,225	5,230	5,095	5,515	5,295	5,810	5,495
Exception from passive loss rules for $25,000 of rental loss	—	—	—	—	—	—	—	3,950	3,700	3,470	3,260	3,065	2,885	2,715
Credit for low-income housing investments	520	570	655	700	720	690	665	2,080	2,270	2,615	2,800	2,875	2,755	2,660
Accelerated depreciation on rental housing (normal tax method)	750	855	1,005	1,340	1,650	1,500	1,515	440	495	550	615	685	740	795
Commerce:														
Cancellation of indebtedness	—	—	—	—	—	—	—	70	40	15	....	–10	–5	–5

TABLE 5–2. CORPORATE AND INDIVIDUAL INCOME TAX REVENUE LOSS ESTIMATES FOR TAX EXPENDITURES—Continued

(In millions of dollars)

Provision	Revenue Loss													
	Corporations							Individuals						
	1996	1997	1998	1999	2000	2001	2002	1996	1997	1998	1999	2000	2001	2002
Permanent exceptions from imputed interest rules	—	—	—	—	—	—	—	150	155	155	160	160	160	165
Capital gains (other than agriculture, timber, iron ore, and coal) (normal tax method)	—	—	—	—	—	—	—	7,990	8,230	8,480	8,730	8,995	9,265	9,540
Capital gains exclusion of small corporation stock	—	—	—	—	—	—	—	....	....	5	20	40	70	95
Step-up basis of capital gains at death	—	—	—	—	—	—	—	29,530	30,715	31,945	33,225	34,555	35,940	37,375
Carryover basis of capital gains on gifts	—	—	—	—	—	—	—	140	150	160	170	180	190	200
Ordinary income treatment of loss from small business corporation stock sale	—	—	—	—	—	—	—	35	35	35	35	40	40	40
Accelerated depreciation of buildings other than rental housing (normal tax method)	4,780	4,070	3,260	2,385	1,695	1,185	800	2,020	1,730	1,400	1,035	690	455	285
Accelerated depreciation of machinery and equipment (normal tax method)	20,195	21,510	23,055	25,510	27,980	29,625	31,080	5,235	5,770	6,230	6,990	7,750	8,700	9,045
Expensing of certain small investments (normal tax method)	875	655	575	580	560	470	385	565	410	325	310	290	230	175
Amortization of start-up costs (normal tax method)	90	95	95	100	100	105	105	105	105	110	110	115	115	120
Graduated corporation income tax rate (normal tax method)	4,435	4,695	4,940	5,125	5,455	5,720	5,925	—	—	—	—	—	—	—
Exclusion of interest on small issue IDBs	110	105	105	100	100	100	95	165	160	155	155	150	150	145
Treatment of Alaska Native Corporations	20	15	10	5	5	5	....	—	—	—	—	—	—	—
Transportation:														
Deferral of tax on shipping companies	20	20	20	20	20	20	20	—	—	—	—	—	—	—
Exclusion of reimbursed employee parking expenses	—	—	—	—	—	—	—	1,250	1,285	1,315	1,350	1,385	1,425	1,470
Exclusion for employer-provided transit passes	—	—	—	—	—	—	—	50	60	70	85	100	115	130
Community and regional development:														
Investment credit for rehabilitation of structures (other than historic)	15	15	15	15	15	15	15	65	65	55	55	55	50	50
Exclusion of interest on IDBs for airports, docks, and sports and convention facilities	790	790	785	760	740	720	700	1,190	1,185	1,185	1,155	1,125	1,090	1,060
Exemption of certain mutuals' and cooperatives' income	60	60	60	65	65	65	70	—	—	—	—	—	—	—
Empowerment zones	500	550	600	625	650	650	490	30	35	40	45	50	50	40
Education, training, employment, and social services:														
Education:														
Exclusion of scholarship and fellowship income (normal tax method)	—	—	—	—	—	—	—	835	845	850	860	870	875	885
Exclusion of interest on State and local student loan bonds	120	115	110	105	105	100	100	185	175	170	160	155	150	150
Exclusion of interest on State and local debt for private nonprofit educational facilities	380	370	355	340	330	320	310	575	560	540	520	500	480	465
Exclusion of interest on savings bonds transferred to educational institutions	—	—	—	—	—	—	—	5	10	10	15	15	15	20
Parental personal exemption for students age 19 or over	—	—	—	—	—	—	—	820	845	885	930	985	1,045	1,090
Deductibility of charitable contributions (education)	180	190	200	210	220	230	240	1,685	1,770	1,860	1,955	2,050	2,155	2,260
Exclusion of employer provided educational assistance	—	—	—	—	—	—	—	20	575	20	....	....	....	....
Training, employment, and social services:														
Work opportunity tax credit	....	100	130	70	25	10	....	....	20	20	15	5	....	....
Exclusion of employer provided child care	—	—	—	—	—	—	—	775	830	890	955	1,025	1,100	1,180
Adoption assistance	—	—	—	—	—	—	—	....	10	200	320	355	370	365
Exclusion of employee meals and lodging (other than military)	—	—	—	—	—	—	—	570	600	630	665	700	735	775
Credit for child and dependent care expenses	—	—	—	—	—	—	—	2,580	2,705	2,840	2,985	3,130	3,290	3,455
Credit for disabled access expenditures	50	50	50	50	55	55	55	30	35	35	35	35	35	35
Expensing of costs of removing certain architectural barriers to the handicapped	15	15	15	15	15	15	15	5	5	5	5	5	5	5
Deductibility of charitable contributions, other than education and health	670	700	730	760	790	820	850	15,375	16,145	16,950	17,800	18,690	19,625	20,605
Exclusion of certain foster care payments	—	—	—	—	—	—	—	30	35	35	35	40	40	45
Exclusion of parsonage allowances	—	—	—	—	—	—	—	295	315	335	360	380	410	435
Health:														
Exclusion of employer contributions for medical insurance premiums and medical care	—	—	—	—	—	—	—	64,450	70,460	75,750	81,285	86,900	92,815	98,995
Medical savings accounts	—	—	—	—	—	—	—	....	10	100	190	195	195	200
Deductibility of medical expenses	—	—	—	—	—	—	—	3,675	4,060	4,535	4,895	5,270	5,670	6,100
Exclusion of interest on State and local debt for private nonprofit health facilities	850	825	795	765	735	710	695	1,285	1,255	1,210	1,165	1,120	1,080	1,050
Deductibility of charitable contributions (health)	640	675	705	745	780	810	850	1,720	1,805	1,895	1,990	2,090	2,195	2,305
Tax credit for orphan drug research	5	20	10	....	....	....	....	—	—	—	—	—	—	—
Special Blue Cross/Blue Shield deduction	120	135	95	150	165	200	250	—	—	—	—	—	—	—
Income security:														
Exclusion of railroad retirement system benefits	—	—	—	—	—	—	—	440	440	450	450	455	455	465
Exclusion of workmen's compensation benefits	—	—	—	—	—	—	—	4,695	4,970	5,305	5,550	5,855	6,220	6,660
Exclusion of public assistance benefits (normal tax method)	—	—	—	—	—	—	—	500	515	550	575	600	625	655

TABLE 5–2. CORPORATE AND INDIVIDUAL INCOME TAX REVENUE LOSS ESTIMATES FOR TAX EXPENDITURES—Continued

(In millions of dollars)

Provision	Revenue Loss													
	Corporations							Individuals						
	1996	1997	1998	1999	2000	2001	2002	1996	1997	1998	1999	2000	2001	2002
Exclusion of special benefits for disabled coal miners	—	—	—	—	—	—	—	90	90	85	80	75	75	70
Exclusion of military disability pensions	—	—	—	—	—	—	—	130	130	130	130	130	130	130
Net exclusion of pension contributions and earnings:														
Employer plans	—	—	—	—	—	—	—	55,410	55,810	56,245	56,665	57,085	57,510	57,940
Individual Retirement Accounts	—	—	—	—	—	—	—	8,025	8,345	8,600	8,880	9,125	9,340	9,520
Keogh plans	—	—	—	—	—	—	—	3,030	3,200	3,325	3,500	3,680	3,875	4,080
Exclusion of employer provided death benefits	—	—	—	—	—	—	—	35	35	35	40	40	45	45
Exclusion of other employee benefits:														
Premiums on group term life insurance	—	—	—	—	—	—	—	2,495	2,615	2,745	2,880	3,020	3,170	3,325
Premiums on accident and disability insurance	—	—	—	—	—	—	—	155	165	175	185	195	205	215
Income of trusts to finance supplementary unemployment benefits	—	—	—	—	—	—	—	20	20	20	20	20	20	20
Special ESOP rules	845	675	660	680	700	730	760	60	60	60	60	60	60	60
Additional deduction for the blind	—	—	—	—	—	—	—	25	25	25	30	30	30	30
Additional deduction for the elderly	—	—	—	—	—	—	—	1,470	1,485	1,495	1,500	1,510	1,515	1,515
Tax credit for the elderly and disabled	—	—	—	—	—	—	—	45	50	50	50	50	50	50
Deductibility of casualty losses	—	—	—	—	—	—	—	460	485	510	535	560	590	620
Earned income credit [2]	—	—	—	—	—	—	—	5,097	5,653	5,814	6,112	6,319	6,621	6,859
Social Security:														
Exclusion of social security benefits:														
OASI benefits for retired workers	—	—	—	—	—	—	—	17,005	17,810	18,495	19,290	20,190	20,875	21,495
Disability insurance benefits	—	—	—	—	—	—	—	2,090	2,375	2,615	2,820	3,045	3,290	3,545
Benefits for dependents and survivors	—	—	—	—	—	—	—	3,795	3,985	4,175	4,355	4,530	4,710	4,895
Veterans benefits and services:														
Exclusion of veterans disability compensation	—	—	—	—	—	—	—	2,615	2,770	2,930	3,100	3,280	3,470	3,675
Exclusion of veterans pensions	—	—	—	—	—	—	—	70	70	70	70	75	80	85
Exclusion of GI bill benefits	—	—	—	—	—	—	—	50	60	70	80	90	95	100
Exclusion of interest on State and local debt for veterans housing	15	15	15	15	15	15	15	25	25	20	20	20	20	20
General purpose fiscal assistance:														
Exclusion of interest on public purpose State and local debt	6,290	6,310	6,280	6,220	6,160	6,105	6,055	9,430	9,490	9,455	9,375	9,285	9,195	9,115
Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	—	—	—	—	—	—	—	28,265	29,630	30,995	32,375	33,800	35,290	36,910
Tax credit for corporations receiving income from doing business in U.S. possessions	2,760	2,700	2,770	2,800	2,885	2,970	3,060	—	—	—	—	—	—	—
Interest:														
Deferral of interest on savings bonds	—	—	—	—	—	—	—	1,300	1,290	1,285	1,270	1,215	1,170	1,155
Addendum—Aid to State and local governments:														
Deductibility of:														
Property taxes on owner-occupied homes	—	—	—	—	—	—	—	15,900	16,670	17,435	18,215	19,015	19,855	20,765
Nonbusiness State and local taxes other than on owner-occupied homes	—	—	—	—	—	—	—	28,265	29,630	30,995	32,375	33,800	35,290	36,910
Exclusion of interest on:														
Public purpose State and local debt	6,290	6,310	6,280	6,220	6,160	6,105	6,055	9,430	9,490	9,455	9,375	9,285	9,195	9,115
IDBs for certain energy facilities	125	125	125	125	125	125	125	190	190	190	190	185	185	185
IDBs for pollution control and sewage and waste disposal facilities	280	275	270	260	255	235	215	420	415	405	395	385	365	330
Small-issue IDBs	110	105	105	100	100	100	95	165	160	155	155	150	150	145
Owner-occupied mortgage revenue bonds	705	700	690	685	675	665	655	1,060	1,055	1,045	1,030	1,015	1,000	985
State and local debt for rental housing	300	305	300	305	305	305	300	455	455	455	455	460	455	450
IDBs for airports, docks, and sports and convention facilities	790	790	785	760	740	720	700	1,190	1,185	1,185	1,155	1,125	1,090	1,060
State and local student loan bonds	120	115	110	105	105	100	100	185	175	170	160	155	150	150
State and local debt for private nonprofit educational facilities	380	370	355	340	330	320	310	575	560	540	520	500	480	465
State and local debt for private nonprofit health facilities	850	825	795	765	735	710	695	1,285	1,255	1,210	1,165	1,120	1,080	1,050
State and local debt for veterans housing	15	15	15	15	15	15	15	25	25	20	20	20	20	20

[1] In addition alcohol fuels results in a reduction in excise tax receipts (in millions of dollars) as follows: 1996 $670; 1997 $670; 1998 $700; 1999 $740; 2000 $770; 2001 $800; and 2002 $840.

[2] The figures in the table indicate the effect of the earned income tax credit on receipts. The effect on outlays (in millions of dollars) is as follows: 1996 $19,159; 1997 $21,163; 1998 $21,983; 1999 $22,864; 2000 $23,818; 2001 $24,634; and 2002 $25,518.

Note: Provisions with estimates denoted ''normal tax method'' have no revenue loss under the reference tax law method.

All estimates have been rounded to the nearest $5 million.

TABLE 5–3. MAJOR TAX EXPENDITURES IN THE INCOME TAX, RANKED BY TOTAL 1998 REVENUE LOSS

(In millions of dollars)

Provision	1998	1998–2002
Exclusion of employer contributions for medical insurance premiums and medical care	75,750	435,745
Net exclusion of employer pension-plan contributions and earnings	56,245	285,445
Deductibility of mortgage interest on owner-occupied homes	52,115	284,790
Step-up basis of capital gains at death	31,945	173,040
Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	30,995	169,370
Accelerated depreciation of machinery and equipment (normal tax method)	29,285	175,965
Deductibility of charitable contributions	22,340	123,365
Exclusion of OASI benefits for retired workers	18,495	100,345
Deductibility of State and local property tax on owner-occupied homes	17,435	95,285
Exclusion of interest on public purpose State and local debt	15,735	77,245
Deferral of capital gains on home sales	15,290	81,165
Deferral on income on life insurance and annuity contracts	11,940	67,975
Exclusion of interest on State and local debt for various non-public purposes	8,925	42,450
Net exclusion of Individual Retirement Account contributions and earnings	8,600	45,465
Capital gains (other than agriculture, timber, iron ore, and coal) (normal tax method)	8,480	45,010
Earned income credit [1]	5,814	31,725
Exclusion of workmen's compensation benefits	5,305	29,590
Exclusion of capital gains on home sales for persons age 55 and over	5,095	27,210
Graduated corporation income tax rate (normal tax method)	4,940	27,165
Accelerated depreciation of buildings other than rental housing (normal tax method)	4,660	13,190
Deductibility of medical expenses	4,535	26,470
Exclusion of Social Security benefits for dependents and survivors	4,175	22,665
Exception from passive loss rules for $25,000 of rental loss	3,470	15,395
Net exclusion of Keogh plan contributions and earnings	3,325	18,460
Credit for low-income housing investments	3,270	17,135
Exclusion of veterans disability compensation	2,930	16,455
Credit for child and dependent care expenses	2,840	15,700
Tax credit for corporations receiving income from doing business in U.S. possessions	2,770	14,485
Exclusion of employer-provided premiums on group term life insurance	2,745	15,140
Exclusion of Social Security disability insurance benefits	2,615	15,315
Deferral of income from controlled foreign corporations (normal tax method)	2,400	14,000
Exclusion of benefits and allowances to armed forces personnel	2,095	10,695
Exclusion of interest on State and local debt for private nonprofit health facilities	2,005	9,325
Exclusion of income earned abroad by United States citizens	1,865	11,590
Exclusion of income of foreign sales corporations	1,700	9,500
Inventory property sales source rules exception	1,600	9,000
Accelerated depreciation on rental housing (normal tax method)	1,555	10,395
Additional deduction for the elderly	1,495	7,535
Exclusion of reimbursed employee parking expenses	1,315	6,945
Deferral of interest on savings bonds	1,285	6,095
Excess of percentage over cost depletion (fuels)	1,170	6,045
Credit for increasing research activities	1,045	1,445
Deferral of income from post 1987 installment sales	995	5,175
Expensing of certain small investments (normal tax method)	900	3,900
Exclusion of employer provided child care	890	5,150
Parental personal exemption for students age 19 or over	885	4,935
Exclusion of scholarship and fellowship income (normal tax method)	850	4,340
Exemption of credit union income	745	4,195
Special ESOP rules	720	3,830
Empowerment zones	640	3,240
Exclusion of employee meals and lodging (other than military)	630	3,505
Exclusion of public assistance benefits (normal tax method)	550	3,005
Deductibility of casualty losses	510	2,815
Alternative fuel production credit	485	2,575
Exclusion of railroad retirement system benefits	450	2,275
Expensing of multiperiod timber growing costs	440	2,415
Expensing of research and experimentation expenditures (normal tax method)	430	3,200
Exclusion of parsonage allowances	335	1,920
Excess of percentage over cost depletion, nonfuel minerals	300	1,565
Exclusion of interest on small issue IDBs	260	1,255
Tax exemption of certain insurance companies	255	1,400
Amortization of start-up costs (normal tax method)	205	1,075
Adoption assistance	200	1,610
Capital gains treatment of certain income	175	925
Exclusion of employer-provided premiums on accident and disability insurance	175	975
Carryover basis of capital gains on gifts	160	900
Permanent exceptions from imputed interest rules	155	800
Work opportunity tax credit	150	275
Exclusion of military disability pensions	130	650

TABLE 5–3. MAJOR TAX EXPENDITURES IN THE INCOME TAX, RANKED BY TOTAL 1998 REVENUE LOSS—Continued

(In millions of dollars)

Provision	1998	1998–2002
Small life insurance company deduction	120	670
Tax incentives for preservation of historic structures	115	550
Medical savings accounts	100	880
Special Blue Cross/Blue Shield deduction	95	860
Enhanced oil recovery credit	90	510
Credit for disabled access expenditures	85	440
Exclusion of special benefits for disabled coal miners	85	385
Expensing of certain multiperiod production costs	80	420
Tax credit and deduction for clean-fuel burning vehicles and properties	75	425
Exclusion for employer-provided transit passes	70	500
Investment credit for rehabilitation of structures (other than historic)	70	340
Exclusion of veterans pensions	70	380
Exclusion of GI bill benefits	70	435
Expensing of certain capital outlays	65	345
Exemption of certain mutuals' and cooperatives' income	60	325
Exception from passive loss limitation for working interests in oil and gas properties	55	295
Tax credit for the elderly and disabled	50	250
Special rules for mining reclamation reserves	50	250
Investment credit and seven-year amortization for reforestation expenditures	50	250
Excess bad debt reserves of financial institutions	40	60
New technology credit	40	210
Exclusion of employer provided death benefits	35	205
Ordinary income treatment of loss from small business corporation stock sale	35	190
Exclusion of certain foster care payments	35	195
Expensing of exploration and development costs, nonfuel minerals	35	175
Additional deduction for the blind	25	145
Exclusion of employer provided educational assistance	20	20
Deferral of tax on shipping companies	20	100
Exclusion of income of trusts to finance supplementary unemployment benefits	20	100
Expensing of costs of removing certain architectural barriers to the handicapped	20	100
Exclusion from income of conservation subsidies provided by public utilities	15	170
Cancellation of indebtedness	15	–5
Capital gains treatment of royalties on coal	15	95
Capital gains treatment of certain timber income	15	95
Treatment of Alaska Native Corporations	10	25
Treatment of loans forgiven solvent farmers as if insolvent	10	50
Tax credit for orphan drug research	10	10
Exclusion of interest on savings bonds transferred to educational institutions	10	75
Alcohol fuel credit [2]	10	50
Capital gains exclusion of small corporation stock	5	230
Special alternative tax on small property and casualty insurance companies	5	25
Capital gains treatment of iron ore	....	....
Expensing of exploration and development costs (fuels)	–40	235

[1] The figures in the table indicate the effect of the earned income tax credit on receipts. The effect on outlays (in millions of dollars) is as follows: 1996 $19,159; 1997 $21,163; 1998 $21,983; 1999 $22,864; 2000 $23,818; 2001 $24,634; and 2002 $25,518.

[2] In addition alcohol fuels results in a reduction in excise tax receipts (in millions of dollars) as follows: 1996 $670; 1997 $670; 1998 $700; 1999 $740; 2000 $770; 2001 $800; and 2002 $840.

Note: Provisions with estimates denoted ''normal tax method'' have no revenue loss under the reference tax law method.

All estimates have been rounded to the nearest $5 million.

Figures in table 5–3 are the arithmetic sums of corporate and individual income tax revenue loss estimates from table 5-2, and do not reflect possible interactions across these two taxes.

TABLE 5–4. PRESENT VALUE OF SELECTED TAX EXPENDITURES FOR ACTIVITY IN CALENDAR YEAR 1997

(In millions of dollars)

Provision	Present Value of Revenue Loss
Deferral of income from controlled foreign corporations (normal tax method)	2,150
Expensing of research and experimentation expenditures (normal tax method)	1,610
Expensing of exploration and development costs—fuels	205
Expensing of exploration and development costs—nonfuels	60
Expensing of multiperiod timber growing costs	140
Expensing of certain multiperiod production costs—agriculture	85
Expensing of certain capital outlays—agriculture	70
Deferral of income on life insurance and annuity contracts	18,700
Deferral of capital gains on home sales	14,630
Credit for low-income housing investments	3,150
Accelerated depreciation of rental housing (normal tax method)	2,025
Accelerated depreciation of buildings other than rental housing (normal tax method)	420
Accelerated depreciation of machinery and equipment (normal tax method)	29,830
Expensing of certain small investments (normal tax method)	1,050
Amortization of start-up costs (normal tax method)	170
Deferral of tax on shipping companies	10
Exclusion of pension contributions and earnings—employer plans	54,060
Exclusion of IRA contributions and earnings	2,175
Exclusions of contribution and earnings for Keogh plans	3,220
Exclusion of interest on State and local public-purpose bonds	17,535
Exclusion of interest on State and local non-public purpose bonds	8,925
Deferral of interest on U.S. savings bonds	210

Note: Provisions with estimates denoted "normal tax method" have no revenue loss under the reference tax law method.

Outlay Equivalents

The concept of "outlay equivalents" complements "revenue losses" as a measure of the budget effect of tax expenditures. It is the amount of outlay that would be required to provide the taxpayer the same after-tax income as would be received through the tax preference. The outlay equivalent measure allows a comparison of the cost of the tax expenditure with that of a direct Federal outlay. Outlay equivalents are reported in table 5–5.

The measure is larger than the revenue loss estimate when the tax expenditure is judged to function as a Government payment for service. This occurs because an outlay program would increase the taxpayer's pre-tax income. For some tax expenditures, however, the revenue loss equals the outlay equivalent measure. This occurs when the tax expenditure is judged to function like a price reduction or tax deferral that does not directly enter the taxpayer's pre-tax income.[1]

[1] Budget outlay figures generally reflect the pre-tax price of the resources. In some instances, however, Government purchases or subsidies are exempted from tax by a special tax provision. When this occurs, the outlay figure understates the resource cost of the program and is, therefore, not comparable with other outlay amounts. For example, the outlays for certain military personnel allowances are not taxed. If this form of compensation were treated as part of the employee's taxable income, the Defense Department would have to make larger cash payments to its military personnel to leave them as well off after tax as they are now. The tax subsidy must be added to the tax-exempt budget outlay to make this element of national defense expenditures comparable with other outlays.

TABLE 5–5. OUTLAY EQUIVALENT ESTIMATES FOR TAX EXPENDITURES IN THE INCOME TAX

(In millions of dollars)

Provision	Outlay Equivalents							
	1996	1997	1998	1999	2000	2001	2002	1998–2002
National defense:								
Exclusion of benefits and allowances to armed forces personnel	2,405	2,425	2,445	2,470	2,495	2,520	2,545	12,475
International affairs:								
Exclusion of income earned abroad by United States citizens	2,025	2,240	2,485	2,755	3,055	3,390	3,770	15,455
Exclusion of income of foreign sales corporations	2,310	2,460	2,615	2,770	2,925	3,075	3,230	14,615
Inventory property sales source rules exception	2,155	2,310	2,460	2,615	2,770	2,925	3,075	13,845
Deferral of income from controlled foreign corporations (normal tax method)	2,100	2,200	2,400	2,600	2,800	3,000	3,200	14,000
General science, space, and technology:								
Expensing of research and experimentation expenditures (normal tax method)	40	195	430	580	685	740	765	3,200
Credit for increasing research activities	1,245	1,055	1,610	380	160	60	10	2,220
Energy:								
Expensing of exploration and development costs, fuels	–210	–130	–40	20	100	75	80	235
Excess of percentage over cost depletion, fuels	1,580	1,620	1,640	1,675	2,705	1,730	1,765	8,515
Alternative fuel production credit	800	795	845	795	755	715	685	3,795
Exception from passive loss limitation for working interests in oil and gas properties	50	50	55	55	60	60	65	295
Capital gains treatment of royalties on coal	20	20	20	25	25	25	25	120
Exclusion of interest on State and local IDBs for energy facilities	420	420	415	415	410	405	400	2,045
New technology credit	40	50	55	60	60	60	65	300
Alcohol fuel credit [1]	10	10	10	10	10	10	10	50
Tax credit and deduction for clean-fuel burning vehicles and properties	90	95	105	110	120	125	130	590
Exclusion from income of conservation subsidies provided by public utilities	210	95	25	40	55	60	65	245
Natural resources and environment:								
Expensing of exploration and development costs, nonfuel minerals	35	35	35	35	35	35	35	175
Excess of percentage over cost depletion, nonfuel minerals	405	415	425	435	440	455	460	2,215
Capital gains treatment of iron ore	....	....	....	....	....	....	....	....
Special rules for mining reclamation reserves	50	50	50	50	50	50	50	250
Exclusion of interest on State and local IDBs for pollution control and sewage and waste disposal facilities	925	900	870	845	815	755	675	3,960
Capital gains treatment of certain timber income	20	20	20	25	25	25	25	120
Expensing of multiperiod timber growing costs	395	415	440	460	485	505	525	2,415
Investment credit and seven-year amortization for reforestation expenditures	65	65	75	75	75	75	75	375
Tax incentives for preservation of historic structures	125	120	115	115	110	105	105	550
Agriculture:								
Expensing of certain capital outlays	65	65	65	70	70	70	70	345
Expensing of certain multiperiod production costs	80	80	80	85	85	85	85	420
Treatment of loans forgiven solvent farmers as if insolvent	10	10	10	10	10	10	10	50
Capital gains treatment of certain income	220	225	235	240	245	255	260	1,235
Commerce and housing:								
Financial institutions and insurance:								
Exemption of credit union income	840	895	945	1,005	1,065	1,130	1,200	5,345
Excess bad debt reserves of financial institutions	90	70	40	15	5	....	....	60
Deferral on income on life insurance and annuity contracts	10,525	11,210	11,940	12,715	13,540	14,420	15,360	67,975
Special alternative tax on small property and casualty insurance companies	5	5	5	5	5	5	5	25
Tax exemption of certain insurance companies	315	320	335	340	370	390	405	1,840
Small life insurance company deduction	145	150	160	170	175	185	190	880
Housing:								
Exclusion of interest on owner-occupied mortgage subsidy bonds	2,305	2,265	2,230	2,190	2,150	2,110	2,070	10,750
Exclusion of interest on State and local debt for rental housing	990	985	980	985	990	980	970	4,905
Deductibility of mortgage interest on owner-occupied homes	47,525	49,820	52,115	54,440	56,830	59,345	62,060	284,790
Deductibility of State and local property tax on owner-occupied homes	15,900	16,670	17,435	18,215	19,015	19,855	20,765	95,285
Deferral of income from post 1987 installment sales	955	975	995	1,015	1,035	1,055	1,075	5,175
Deferral of capital gains on home sales	14,410	14,845	15,290	15,745	16,220	16,705	17,205	81,165
Exclusion of capital gains on home sales for persons age 55 and over	6,965	6,975	6,795	7,355	7,060	7,745	7,325	36,280
Exception from passive loss rules for $25,000 of rental loss	3,950	3,700	3,470	3,260	3,065	2,885	2,715	15,395
Credit for low-income housing investments	2,660	2,945	3,270	3,500	3,595	3,445	3,325	17,135
Accelerated depreciation on rental housing (normal tax method)	1,190	1,350	1,560	1,955	2,340	2,240	2,310	10,405
Commerce:								
Cancellation of indebtedness	70	40	15	....	–10	–5	–5	–5
Permanent exceptions from imputed interest rules	150	155	155	160	160	160	165	800
Capital gains (other than agriculture, timber, iron ore, and coal)	10,655	10,975	11,295	11,640	11,995	12,355	12,720	60,005
Capital gains exclusion of small corporation stock	....	....	5	25	55	95	125	305
Step-up basis of capital gains at death	39,375	40,955	42,595	44,300	46,075	47,920	49,835	230,725
Carryover basis of capital gains on gifts	140	150	160	170	180	190	200	900
Ordinary income treatment of loss from small business corporation stock sale	45	45	50	50	55	55	55	265
Accelerated depreciation of buildings other than rental housing (normal tax method)	6,800	5,795	4,655	3,420	2,380	1,640	1,085	13,180
Accelerated depreciation of machinery and equipment (normal tax method)	25,430	27,280	29,285	32,500	35,730	38,320	40,125	175,960

TABLE 5–5. OUTLAY EQUIVALENT ESTIMATES FOR TAX EXPENDITURES IN THE INCOME TAX—Continued

(In millions of dollars)

Provision	Outlay Equivalents							
	1996	1997	1998	1999	2000	2001	2002	1998–2002
Expensing of certain small investments (normal tax method)	1,435	1,065	900	890	845	700	560	3,895
Amortization of start-up costs (normal tax method)	195	200	205	210	215	220	225	1,075
Graduated corporation income tax rate (normal tax method)	5,995	6,345	6,675	6,925	7,370	7,730	8,005	36,705
Exclusion of interest on small issue IDBs	335	310	300	290	285	275	270	1,420
Treatment of Alaska Native Corporations	20	15	10	5	5	5	....	25
Transportation:								
Deferral of tax on shipping companies	20	20	20	20	20	20	20	100
Exclusion of reimbursed employee parking expenses	1,625	1,670	1,715	1,755	1,805	1,855	1,910	9,040
Exclusion for employer-provided transit passes	65	80	100	115	135	155	180	685
Community and regional development:								
Investment credit for rehabilitation of structures (other than historic)	80	80	70	70	70	65	65	340
Exclusion of interest on IDBs for airports, docks, and sports and convention facilities	2,570	2,550	2,525	2,445	2,360	2,280	2,200	11,810
Exemption of certain mutuals' and cooperatives' income	60	60	60	65	65	65	70	325
Empowerment zones	530	585	640	670	700	700	530	3,240
Education, training, employment, and social services:								
Education:								
Exclusion of scholarship and fellowship income (normal tax method)	915	925	935	945	955	965	980	4,780
Exclusion of interest on State and local student loan bonds	380	360	335	320	305	295	290	1,545
Exclusion of interest on State and local debt for private nonprofit educational facilities	1,225	1,175	1,120	1,065	1,015	970	935	5,105
Exclusion of interest on savings bonds transferred to educational institutions	5	10	10	15	15	15	20	75
Parental personal exemption for students age 19 or over	910	935	980	1,030	1,090	1,155	1,205	5,460
Deductibility of charitable contributions (education)	2,480	2,605	2,730	2,870	3,000	3,155	3,295	15,050
Exclusion of employer provided educational assistance	25	710	25	....	....	....	....	25
Training, employment, and social services:								
Work opportunity tax credit	....	120	150	85	30	10	....	275
Exclusion of employer provided child care	1,035	1,105	1,185	1,275	1,365	1,465	1,575	6,865
Adoption assistance	....	10	240	385	430	450	435	1,940
Exclusion of employee meals and lodging (other than military)	695	730	770	810	855	900	950	4,285
Credit for child and dependent care expenses	3,440	3,605	3,785	3,980	4,175	4,385	4,605	20,930
Credit for disabled access expenditures	105	115	115	115	120	120	120	590
Expensing of costs of removing certain architectural barriers to the handicapped	20	20	20	20	20	20	20	100
Deductibility of charitable contributions, other than education and health	27,365	28,740	30,185	31,735	33,305	34,965	36,365	166,555
Exclusion of certain foster care payments	40	40	45	45	50	50	55	245
Exclusion of parsonage allowances	365	390	415	440	470	505	540	2,370
Health:								
Exclusion of employer contributions for medical insurance premiums and medical care	82,200	90,035	96,950	104,220	111,490	119,100	127,045	558,805
Medical savings accounts	....	10	110	205	210	210	220	955
Deductibility of medical expenses	3,675	4,060	4,535	4,895	5,270	5,670	6,100	26,470
Exclusion of interest on State and local debt for private nonprofit health facilities	2,740	2,630	2,510	2,390	2,275	2,175	2,095	11,445
Deductibility of charitable contributions (health)	3,175	3,325	3,585	3,655	3,825	4,005	4,195	19,265
Tax credit for orphan drug research	5	30	15	....	....	....	....	15
Special Blue Cross/Blue Shield deduction	155	175	125	200	220	260	330	1,135
Income security:								
Exclusion of railroad retirement system benefits	440	440	450	450	455	455	465	2,275
Exclusion of workmen's compensation benefits	4,695	4,970	5,305	5,550	5,855	6,220	6,660	29,590
Exclusion of public assistance benefits (normal tax method)	500	515	550	575	600	625	655	3,005
Exclusion of special benefits for disabled coal miners	90	90	85	80	75	75	70	385
Exclusion of military disability pensions	130	130	130	130	130	130	130	650
Net exclusion of pension contributions and earnings:								
Employer plans	72,195	77,045	77,625	78,175	78,760	79,350	79,950	314,510
Individual Retirement Accounts	11,110	11,615	12,045	12,515	12,950	13,370	13,755	64,635
Keogh plans	3,990	4,215	4,380	4,610	4,850	5,105	5,375	24,320
Exclusion of employer provided death benefits	45	50	50	55	55	60	65	285
Exclusion of other employee benefits:								
Premiums on group term life insurance	3,280	3,440	3,610	3,790	3,975	4,170	4,375	19,920
Premiums on accident and disability insurance	200	210	225	235	250	260	275	1,245
Income of trusts to finance supplementary unemployment benefits	20	20	20	20	20	20	20	100
Special ESOP rules	1,255	1,020	1,000	1,030	1,055	1,095	1,140	5,320
Additional deduction for the blind	30	30	35	35	35	35	40	180
Additional deduction for the elderly	1,780	1,795	1,805	1,815	1,825	1,830	1,830	9,105
Tax credit for the elderly and disabled	60	60	60	60	60	60	60	300
Deductibility of casualty losses	600	630	660	695	730	765	805	3,655
Earned income credit [2]	5,663	6,281	6,460	6,792	7,021	7,357	7,621	35,251

TABLE 5–5. OUTLAY EQUIVALENT ESTIMATES FOR TAX EXPENDITURES IN THE INCOME TAX—Continued
(In millions of dollars)

Provision	Outlay Equivalents							
	1996	1997	1998	1999	2000	2001	2002	1998–2002
Social Security:								
Exclusion of social security benefits:								
OASI benefits for retired workers	17,005	17,810	18,495	19,290	20,190	20,875	21,495	100,345
Disability insurance benefits	2,090	2,375	2,615	2,820	3,045	3,290	3,545	15,315
Benefits for dependents and survivors	3,795	3,985	4,175	4,355	4,530	4,710	4,895	22,665
Veterans benefits and services:								
Exclusion of veterans disability compensation	2,615	2,770	2,930	3,100	3,280	3,470	3,675	16,455
Exclusion of veterans pensions	70	70	70	70	75	80	85	380
Exclusion of GI bill benefits	50	60	70	80	90	95	100	435
Exclusion of interest on State and local debt for veterans housing	50	45	45	45	40	40	40	210
General purpose fiscal assistance:								
Exclusion of interest on public purpose State and local debt	19,840	19,700	19,490	19,225	18,950	18,675	18,420	94,760
Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	28,265	29,630	30,995	32,375	33,800	35,290	36,910	169,370
Tax credit for corporations receiving income from doing business in U.S. possessions	3,940	3,860	3,960	4,000	4,120	4,245	4,370	20,695
Interest:								
Deferral of interest on savings bonds	1,300	1,290	1,285	1,270	1,215	1,170	1,155	6,095
Addendum—Aid to State and local governments:								
Deductibility of:								
Property taxes on owner-occupied homes	15,900	16,670	17,435	18,215	19,015	19,855	20,765	95,285
Nonbusiness State and local taxes other than on owner-occupied homes	28,265	29,630	30,995	32,375	33,800	35,290	36,910	169,370
Exclusion of interest on:								
Public purpose State and local debt	19,840	19,700	19,490	19,225	18,950	18,675	18,420	94,760
IDBs for certain energy facilities	420	420	415	415	410	405	400	2,045
IDBs for pollution control and sewage and waste disposal facilities	925	900	870	845	815	755	675	3,960
Small-issue IDBs	335	310	300	290	285	275	270	1,420
Owner-occupied mortgage revenue bonds	2,305	2,265	2,230	2,190	2,150	2,110	2,070	10,750
State and local debt for rental housing	990	985	980	985	990	980	970	4,905
IDBs for airports, docks, and sports and convention facilities	2,570	2,550	2,525	2,445	2,360	2,280	2,200	11,810
State and local student loan bonds	380	360	335	320	305	295	290	1,545
State and local debt for private nonprofit educational facilities	1,225	1,175	1,120	1,065	1,015	970	935	5,105
State and local debt for private nonprofit health facilities	2,740	2,630	2,510	2,390	2,275	2,175	2,095	11,445
State and local debt for veterans housing	50	45	45	45	40	40	40	210

[1] In addition, alcohol fuels results in a reduction in excise tax receipts (in millions of dollars) as follows: 1996 $670; 1997 $670; 1998 $700; 1999 $740; 2000 $770; 2001 $800; and 2002 $840.
[2] The figures in the table indicate the effect of the earned income tax credit on receipts. The effect on outlays (in millions of dollars) is as follows: 1996 $19,159; 1997 $21,163; 1998 $21,983; 1999 $22,864; 2000 $23,818; 2001 $24,634; and 2002 $25,518.
Note: Provisions with estimates denoted ''normal tax method'' have outlay equivalents of zero under the reference tax law method.
All estimates have been rounded to the nearest $5 million.

Tax Expenditure Baselines

A tax expenditure is a preferential exception to the baseline provisions of the tax structure. The 1974 Congressional Budget Act does not, however, specify the baseline provisions of the tax law. Deciding whether provisions are preferential exceptions, therefore, is a matter of judgement. As in prior years, this year's tax expenditure estimates are presented using two baselines: the normal tax baseline, which is used by the Joint Committee on Taxation, and the reference tax law baseline, which has been used by the Administration since 1983.

The normal tax baseline is patterned on a comprehensive income tax, which defines income as the sum of consumption and the change in net wealth in a given period of time. The normal tax baseline allows personal exemptions, a standard deduction, and deductions of the expenses incurred in earning income. It is not limited to a particular structure of tax rates, or by a specific definition of the taxpaying unit.

The reference tax law baseline is also patterned on a comprehensive income tax, but in practice is closer to existing law. Reference law tax expenditures are limited to special exceptions in the tax code that serve programmatic functions. These functions correspond to specific budget categories such as national defense, agriculture, or health care. While tax expenditures under the reference law baseline are generally tax expenditures under the normal tax baseline, the reverse is not always true.

Both the normal and reference tax baselines allow several major departures from a pure comprehensive income tax. For example:

- *Income is taxable when realized in exchange.* Thus, neither the deferral of tax on unrealized capital gains nor the tax exclusion of imputed income (such as the rental value of owner-occupied housing or farmers' consumption of their own produce) is regarded as a tax expenditure. Both accrued and imputed income would be taxed under a comprehensive income tax.
- *There is a separate corporation income tax.* Under a comprehensive income tax corporate income would be taxed only once—at the shareholder

level, whether or not distributed in the form of dividends.

- *Values of assets and debt are not adjusted for inflation.* A comprehensive income tax would adjust the cost basis of capital assets and debt for changes in the price level during the time the assets or debt are held. Thus, under a comprehensive income tax baseline the failure to take account of inflation in measuring depreciation, capital gains, and interest income would be regarded as a negative tax expenditure (i.e., a tax penalty), and failure to take account of inflation in measuring interest costs would be regarded as a positive tax expenditure (i.e., a tax subsidy).

While the reference law and normal tax baselines are generally similar, areas of difference include:

- *Tax rates.* The separate schedules applying to the various taxpaying units are included in the reference law baseline. Thus, corporate tax rates below the maximum statutory rate do not give rise to a tax expenditure. The normal tax baseline is similar, except that it specifies the current maximum rate as the baseline for the corporate income tax. The lower tax rates applied to the first $10 million of corporate income are thus regarded as a tax expenditure. Similarly, under the reference law baseline, preferential tax rates for capital gains generally do not yield a tax expenditure; only capital gains treatment of otherwise "ordinary income," such as that from coal and iron ore royalties and the sale of timber and certain agricultural products, is considered a tax expenditure. The alternative minimum tax is treated as part of the baseline rate structure under both the reference and normal tax methods.
- *Income subject to the tax.* Income subject to tax is defined as gross income less the costs of earning that income. The Federal income tax defines gross income to include: (1) consideration received in the exchange of goods and services, including labor services or property; and (2) the taxpayer's share of gross or net income earned and/or reported by another entity (such as a partnership). Under the reference tax rules, therefore, gross income does not include gifts—defined as receipts of money or property that are not consideration in an exchange—or most transfer payments, which can be thought of as gifts from the Government.[2] The normal tax baseline also excludes gifts between individuals from gross income. Under the normal tax baseline, however, all cash transfer payments from the Government to private individuals are counted in gross income, and exemptions of such transfers from tax are identified as tax expenditures. The costs of earning income are generally deductible in determining taxable income under both the reference and normal tax baselines.[3]
- *Capital recovery.* Under the reference tax law baseline no tax expenditures arise from accelerated depreciation. Under the normal tax baseline, the depreciation allowance for machinery and equipment is determined using straight-line depreciation over tax lives equal to mid-values of the asset depreciation range (a depreciation system in effect from 1971 through 1980). The normal tax baseline for real property is computed using 40-year straight-line depreciation.
- *Treatment of foreign income.* Both the normal and reference tax baselines allow a tax credit for foreign income taxes paid (up to the amount of U.S. income taxes that would otherwise be due), which prevents double taxation of income earned abroad. Under the normal tax method, however, controlled foreign corporations (CFCs) are not regarded as entities separate from their controlling U.S. shareholders. Thus, the deferral of tax on income received by CFCs is regarded as a tax expenditure under this method. In contrast, except for tax haven activities, the reference law baseline follows current law in treating CFCs as separate taxable entities whose income is not subject to U.S. tax until distributed to U.S. taxpayers. Under this baseline, deferral of tax on CFC income is not a tax expenditure because U.S. taxpayers generally are not taxed on accrued, but unrealized, income.

In addition to these areas of difference, the Joint Committee on Taxation considers a somewhat broader set of tax expenditures under its normal tax baseline than is considered here.

Performance Measures and the Economic Effects of Tax Expenditures

Under the Government Performance and Results Act of 1993 (GPRA), Federal agencies, in conjunction with the Office of Management and Budget, are directed to develop strategic plans for their functions and programs, with specific performance measures and performance goals. Consistent with this effort, OMB and the Department of the Treasury have started to develop a framework for evaluating the performance and economic effects of tax expenditures. This framework is expected to evolve based on additional work within the Executive branch and consultation with Congressional units, including the Joint Committee on Taxation and the General Accounting Office. Initial work is summarized below and will be updated in the Administration's May 1997 report on GPRA implementation.

Tax expenditures have a variety of objectives and effects. These include encouraging certain types of activities (e.g., saving for retirement or investing in certain sectors); increasing certain types of after-tax income (e.g., favorable tax treatment of social security

[2] Gross income does, however, include transfer payments associated with past employment, such as social security benefits.

[3] In the cases of individuals who hold "passive" equity interests in businesses, however, the pro rata shares of sales and expense deductions reportable in a year are limited. A passive business activity is defined to be one in which the holder of the interest, usually a partnership interest, does not actively perform managerial or other participatory functions. The taxpayer may generally report no larger deductions for a year than will reduce taxable income from such activities to zero. Deductions in excess of the limitation may be taken in subsequent years, or when the interest is liquidated.

income); reducing private compliance costs and government administrative costs (e.g., favorable treatment of certain employer-provided fringe benefits); and promoting tax neutrality (e.g., accelerated depreciation in the presence of inflation). Some of these objectives are well suited to quantitative measurement, while others are less suited. Also, many tax expenditures, including those cited above, may have more than one objective. As just one example, favorable treatment of employer-provided pensions might be argued to have aspects of most, or even all, of the goals mentioned above. In addition, the economic effects of particular provisions can extend beyond their intended objectives (e.g., a provision intended to promote an activity or raise certain incomes may have positive or negative effects on tax neutrality).

Performance measurement is generally concerned with inputs, outputs, and outcomes. In the case of tax expenditures, the principal input is likely to be the tax revenue loss. Outputs are quantitative or qualitative measures of goods and services, or changes in income and investment, directly produced by these inputs. Outcomes, in turn, represent the changes in the economy, society, or environment that are the ultimate goals of programs.

Thus, for a provision that reduces taxes on investment in a certain activity, an increase in the amount of investment would likely be a key output. The resulting production from that investment, and, in turn, the associated improvements in national income, welfare, or security, could be the outcomes of interest. For other provisions, such as those designed to address a potential inequity or unintended consequence in the tax code, an important performance measure might be how they change effective tax rates (the discounted present-value of taxes owed on new investments or incremental earnings) or excess burden (an economic measure of the distortions caused by taxes). Distributional effects on incomes may be an important concern for certain provisions.

Estimation of these performance indicators and economic effects may be pursued via economic modeling and use of tax data. It is anticipated that OMB, Treasury, and other agencies will work together, as appropriate, on determining a set of useful measures and in developing quantitative and other estimates of provisions' impacts.

The discussion below considers the types of measures that might be useful for some major programmatic groups of tax expenditures. The discussion is intended to be illustrative, and not all encompassing.

One major set of tax expenditures benefits retirement savings, through employer-provided pensions, individual retirement accounts, Keogh plans and other instruments, such as annuities. These provisions might be evaluated in terms of their effects on boosting retirement incomes and private savings. In considering the provisions' distributional effects, it may be of interest to consider beneficiaries' incomes while retired and over their entire lifetimes.

Individuals also benefit from favorable treatment of employer-provided health insurance. Measures of these benefits could include increased coverage and the distribution of this coverage across different income groups. In principle, the effects of insurance coverage on final outcome measures of actual health (e.g., infant mortality, days of work lost due to illness, or life expectancy) or intermediate outcomes (e.g., use of preventative health care) could also be investigated.

Other provisions principally have income distribution, rather than incentive, effects. For example, tax-favored treatment of social security benefits provides increased incomes to eligible groups; the distribution of these increased incomes may be a useful performance measure. The earned-income tax credit, in contrast, should probably be evaluated both for its effects on labor force participation and its distributional properties.

Housing investment also benefits from tax expenditures, including the mortgage interest deduction and preferential treatment of capital gains on housing. Measures of the effectiveness of these provisions could include consideration of their effects on increasing the extent of home ownership and the quality of housing. The effects of the capital gains provisions in terms of offsetting inflationary gains are also likely to be relevant. Deductibility of State and local property taxes assists with making housing more affordable as well as easing the cost of providing community services through these taxes. Provisions that are intended to promote investment in rental housing could be evaluated for their effects on making rental housing more available and affordable.

A series of tax expenditures reduces the cost of investment, both in specific activities—such as research and experimentation, extractive industries, and certain financial activities—and more generally, through accelerated depreciation for plant and equipment. These provisions can be evaluated along a number of dimensions. For example, in addition to considering revenue effects, it is can be useful to consider the extent of the incentive delivered by measuring the provisions' effects on the cost of capital (the interest rate which investments must yield to cover their pretax tax costs) and effective tax rates. Another set of measures would reflect the impact of these provisions on the amounts of corresponding forms of investment—such as research spending, exploration activity, or equipment. A third group of measures would, in turn, consider the provisions' effects on production from these investments—such as numbers or value of patents, energy production and reserves, and industrial production. Other measures could consider objectives which are less directly attributable but still are ultimate goals, such as assisting the U.S. technological base, energy security, or economic growth.

The above illustrative discussion, while broad, is nevertheless incomplete, both for the provisions mentioned and the many that are not explicitly cited. Developing a framework which is appropriately comprehensive, accurate, and flexible to reflect the objectives and effects of the wide range of tax expenditures will be a significant challenge. It is expected that this framework will evolve and improve over the next several years and that quantitative estimates will be made to the extent possible. Such estimates could then be compared with the costs of the provisions and with the costs and benefits of other means of achieving the same performance goals.

Other Considerations

The tax expenditure analysis could be extended beyond the income and transfer taxes to include payroll and excise taxes. The exclusion of certain forms of compensation from the wage base, for instance, reduces payroll taxes, as well as income taxes. Payroll tax exclusions are complex to analyze, however, because they also affect social insurance benefits. Certain targeted excise tax provisions might also be considered tax expenditures. In this case challenges include determining an appropriate baseline.

Descriptions of Income Tax Provisions

Descriptions of the individual and corporate income tax expenditures reported upon in this chapter follow.

National Defense

Benefits and allowances to armed forces personnel.—The housing and meals provided military personnel, either in cash or in kind, as well as certain amounts of pay related to combat service are excluded from income subject to tax.

International Affairs

Income earned abroad.—A U.S. citizen or resident alien who resides in a foreign country or who stays in one or more foreign countries for a minimum of 11 out of the past 12 months may exclude $70,000 per year of foreign-earned income. Eligible taxpayers also may exclude or deduct reasonable housing costs in excess of one-sixth of the salary of a civil servant at grade GS –14, step 1. These provisions do not apply to Federal employees working abroad; however, the tax expenditure estimate does reflect certain allowances that are excluded from their taxable income.

Income of Foreign Sales Corporations.—The Foreign Sales Corporation (FSC) provisions exempt from tax a portion of U.S. exporters' foreign trading income to reflect the FSC's sales functions as foreign corporations. These provisions conform to the General Agreement on Tariffs and Trade.

Source rule exceptions.—The worldwide income of U.S. persons is taxable by the United States and a credit for foreign taxes paid is allowed. The amount of foreign taxes that can be credited is limited to the pre-credit U.S. tax on the foreign source income. The treatment of sales of inventory property is a tax expenditure because it permits greater use of foreign tax credits by U.S. exporters by allowing the exporters to attribute a larger portion of their earnings abroad than would be the case if the allocation of earnings was based upon actual economic activity.

Income of U.S.-controlled foreign corporations.—The income of foreign corporations controlled by U.S. shareholders is not subject to U.S. taxation. The income becomes taxable only when the controlling U.S. shareholders receive dividends or other distributions from their foreign stockholding. Under the normal tax method, the currently attributable foreign source pre-tax income from such a controlling interest is subject to U.S. taxation, whether or not distributed. Thus, under the normal tax baseline the excess of controlled foreign corporation income over the amount distributed to a U.S. shareholder gives rise to a tax expenditure in the form of a tax deferral.

General Science, Space, and Technology

Expensing R&E expenditures.—Research and experimentation (R&E) projects can be viewed as investments because their benefits accrue for several years when they are successful. It is difficult, however, to identify whether a specific R&E project is completed and successful and, if it is successful, what its expected life will be. For these reasons, the statutory provision that these expenditures may be expensed is considered part of the reference law. Under the normal tax method, however, the expensing of R&E expenditures is viewed as a tax expenditure. The baseline assumed for the normal tax method is that all R&E expenditures are successful and have an expected life of five years.

R&E credit.—The R&E credit, which had expired on July 1, 1995, was reinstated under the Small Business Job Protection Act of 1996 for 11 months (July 1, 1996 through May 31, 1997). The 1996 Act also provided a special rule for taxpayers that elect an alternative credit regime. The tax credit is 20 percent of qualified research expenditures in excess of a base amount. The base amount is generally determined by multiplying a "fixed-base percentage" (limited to a maximum of .16) by the average amount of the company's gross receipts for the 1984 to 1988 period. Certain start-up companies are assigned a fixed-base percentage of .03 for the first five taxable years, which is gradually phased out in years 6 through 10 and replaced by the firm's actual fixed- base percentage. Under the alternative credit regime, the credit rate is reduced and the taxpayer is assigned a three-tiered fixed-base percentage that is lower than the fixed-base percentage that would otherwise apply. A credit with a separate threshold is provided for a taxpayer's payments to universities for basic research.

Energy

Exploration and development costs.—In the case of successful investments in domestic oil and gas wells, intangible drilling costs, such as wages, the costs of using machinery for grading and drilling, and the cost of unsalvageable materials used in constructing wells, may be expensed rather than amortized over the productive life of the property.

Integrated oil companies may currently deduct only 70 percent of such costs and amortize the remaining 30 percent over five years. The same rule applies to the exploration and development costs of surface stripping and the construction of shafts and tunnels for other fuel minerals.

Percentage depletion.—Independent fuel mineral producers and royalty owners are generally allowed to take percentage depletion deductions rather than cost depletion on limited quantities of output. Under cost depletion, outlays are deducted over the productive life of the property based on the fraction of the resource extracted. Under percentage depletion taxpayers deduct a percentage of gross income from mineral production at rates of 22 percent for uranium, 15 percent for oil, gas and oil shale, and 10 percent for coal. The deduction is limited to 50 percent of net income from the property, except for oil and gas where the deduction can be 100 percent of net property income. Production from geothermal deposits is eligible for percentage depletion at 65 percent of net income, but with no limit on output and no limitation with respect to qualified producers. Unlike depreciation or cost depletion, percentage depletion deductions can exceed the cost of the investment.

Alternative fuel production credit.—A nontaxable credit of $3 per barrel (in 1979 dollars) of oil-equivalent production is provided for several forms of alternative fuels. It is generally available as long as the price of oil stays below $29.50 (in 1979 dollars). The credit generally expires on December 31, 2002.

Oil and gas exception to passive loss limitation.—Although owners of working interests in oil and gas properties are subject to the alternative minimum tax, they are exempted from the "passive income" limitations. This means that the working interest-holder, who manages on behalf of himself and all other owners the development of wells and incurs all the costs of their operation, may aggregate negative taxable income from such interests with his income from all other sources. Thus, he will be relieved of the minimum tax rules limit on tax deferrals.

Capital gains treatment of royalties on coal.—Sales of certain coal under royalty contracts can be treated as capital gains. While the top statutory rate on ordinary income is 39.6 percent, the rates on capital gains are limited to 28 percent.

Tax-exempt bonds for energy facilities.—Certain energy facilities, such as municipal electric and gas utilities, may benefit from tax-exempt financing.

Enhanced oil recovery credit.—A credit is provided equal to 15 percent of the taxpayer's costs for tertiary oil recovery on projects in the United States. Qualifying costs include tertiary injectant expenses, intangible drilling and development costs on a qualified enhanced oil recovery project, and amounts incurred for tangible depreciable property.

New technology credits.—A credit of 10 percent is available for investment in solar and geothermal energy facilities. In addition, a credit of 1.5 cents is provided per kilowatt hour of electricity produced from renewable resources such as wind and biomass. The renewable resources credit applies only to electricity produced by a facility placed in service before July 1, 1999.

Alcohol fuel credit.—Gasohol, a motor fuel composed of at least 10 percent alcohol, is exempt from 5.4 of the 18.4 cents per gallon Federal excise tax on gasoline. Smaller exemptions are allowed for motor fuel with lower alcohol content. There is a corresponding income tax credit for alcohol used as a fuel in applications where the excise tax is not assessed. This credit, equal to a subsidy of 54 cents per gallon for alcohol used as a motor fuel, is intended to encourage substitution of alcohol for petroleum-based gasoline. In addition, small producers of ethanol are eligible for a 10 cent per gallon credit.

Credit and deduction for clean-fuel vehicles and property.—A tax credit of 10 percent is provided for electric vehicles. In addition, a deduction is provided for other clean-fuel burning vehicles as well as refueling property.

Exclusion of utility conservation subsidies.—Subsidies by public utilities for customer expenditures on energy conservation measures are excluded from the gross income of the customer. After December 31, 1996, the exclusion does not apply to subsidies provided to businesses.

Natural Resources and Environment

Exploration and development costs.—As is true for fuel minerals, certain capital outlays associated with exploration and development of nonfuel minerals may be expensed rather than depreciated over the life of the asset.

Percentage depletion.—Most nonfuel mineral extractors also make use of percentage depletion rather than cost depletion, with percentage depletion rates ranging from 22 percent for sulphur down to 5 percent for sand and gravel.

Capital gains treatment of iron ore and of certain timber income.—Iron ore and certain timber sold under a royalty contract can be treated as capital gains.

Mining reclamation reserves.—Taxpayers are allowed to establish reserves to cover certain costs of mine reclamation and of closing solid waste disposal properties. Net increases in reserves may be taken as a deduction against taxable income.

Tax-exempt bonds for pollution control and waste disposal.—Interest on State and local government debt issued to finance private pollution control and waste disposal facilities was excludable from income subject to tax. This authorization was repealed for most pollution control equipment and limits placed on the amount of debt that can be issued for private waste disposal facilities by the Tax Reform Act of 1986.

Expensing multiperiod timber growing costs.—Generally, costs must be capitalized when goods are produced for inventory used in one's own trade or business, or under contract to another party. Timber production, however, was specifically exempted from these multiperiod cost capitalization rules, creating a special benefit derived from this deferral of taxable income.

Credit and seven-year amortization for reforestation.—A special 10 percent investment tax credit is allowed for up to $10,000 invested annually in clearing land and planting trees for the ultimate production of timber. The same amount of forestation investment may also be amortized over a seven-year period. Without this preference, the amount would have to be capitalized and could be recovered (deducted) only when the trees were sold or harvested 20 or more years later. Moreover, the amount of forestation investment that is amortizable is not reduced by any of the investment credit that is allowed.

Historic preservation.—Expenditures to preserve and restore historic structures qualify for a 20 percent investment credit, but the depreciable basis must be reduced by the full amount of the credit taken.

AGRICULTURE

Expensing certain capital outlays.—Farmers, except for certain agricultural corporations and partnerships, are allowed to deduct certain expenditures for feed and fertilizer, as well as for soil and water conservation measures. Expensing is allowed, even though these expenditures are for inventories held beyond the end of the year, or for capital improvements that would otherwise be capitalized.

Expensing multiperiod livestock and crop production costs.—The production of livestock and crops with a production period of less than two years is exempted from the uniform cost capitalization rules. Farmers establishing orchards, constructing farm facilities for their own use, or producing any goods for sale with a production period of two years or more may elect not to capitalize costs. If they do, they must apply straight-line depreciation to all depreciable property they use in farming.

Loans forgiven solvent farmers.—Farmers are granted special tax treatment by being forgiven the tax liability on certain forgiven debt. Normally, the amount of loan forgiveness is accounted for as a gain (income) of the debtor and he must either report the gain, or reduce his recoverable basis in the property to which the loan relates. If the debtor elects to reduce basis and the amount of forgiveness exceeds his basis in the property, the excess forgiveness is taxable. However, in the case of insolvent (bankrupt) debtors, the amount of loan forgiveness never results in an income tax liability.[4] Farmers with forgiven debt are considered insolvent for tax purposes, and thus qualify for income tax forgiveness.

Capital gains treatment of certain income.—Certain agricultural income, such as unharvested crops, can be treated as capital gains.

COMMERCE AND HOUSING

This category includes a number of tax expenditure provisions that also affect economic activity in other functional categories. For example, provisions related to investment, such as accelerated depreciation, could also have been classified under the energy, natural resources and environment, agriculture, or transportation categories.

Credit union income.—The earnings of credit unions not distributed to members as interest or dividends are exempt from income tax.

Bad debt reserves.—Small (less than $500 million in assets) commercial banks, mutual savings banks, and savings and loan associations may deduct additions to bad debt reserves in excess of actually experienced losses. Before January 1, 1996, all thrifts could use either the "experience" method or the "percentage of taxable income" method for determining deductible additions to bad debt reserves.

Deferral of income on life insurance and annuity contracts.—Favorable tax treatment is provided for investment income ("inside buildup") within qualified life insurance and annuity contracts. Investment income earned on qualified life insurance contracts held until death is permanently exempted from Federal income tax. Investment income distributed prior to the death of the insured is tax-deferred, if not tax-exempt. Investment income earned on annuities is treated less favorably than income earned on life insurance contracts, but it benefits from tax deferral without annual contribution or income limits generally applicable to other tax-favored retirement income plans.

Small property and casualty insurance companies.— Insurance companies that have annual net premium incomes of less than $350,000 are exempted from

[4] The insolvent taxpayer's carryover losses and unused credits are extinguished first, and then his basis in assets reduced to no less than amounts still owed creditors. Finally, the remainder of the forgiven debt is excluded from tax.

tax; those with $350,000 to $2,100,000 of net premium incomes may elect to pay tax only on the income earned by their investment portfolio.

Insurance companies owned by exempt organizations.—Generally, the income generated by life and property and casualty insurance companies is subject to tax, albeit by special rules. Insurance operations conducted by such exempt organizations as fraternal societies and voluntary employee benefit associations, however, are exempted from tax.

Mortgage housing bonds.—Interest on all mortgage revenue bonds issued by State and local governments is exempt from taxation. Proceeds are used to finance homes purchased by first-time buyers—with low to moderate incomes—of dwellings with prices under 90 percent of the average area purchase price.

There are limits imposed on the amount of tax-exempt State and local government bonds that could be issued to fund private activity. The volume cap for single-family mortgage revenue bonds and multifamily rental housing bonds is combined with the cap for student loans and industrial development bonds (IDBs). The cap is set at $50 per capita or a minimum of $150 million for each State.

States are authorized to issue mortgage credit certificates (MCCs) in lieu of qualified mortgage revenue bonds because the bonds are relatively inefficient subsidies to first-time home buyers. MCCs entitle home buyers to income tax credits for a specified percentage of interest on qualified mortgage loans. In this way, the entire amount of the subsidy flows directly to the home buyer without being partly diverted to financial middlemen or bondholders. A State cannot issue an aggregate annual amount of MCCs greater than 25 percent of its annual ceiling for qualified mortgage bonds. Because of the relationship between MCCs and qualified mortgage bonds, their estimates are presented as one line item in the tables.

Rental housing bonds.—State and local government issues of IDBs are restricted to multifamily rental housing projects in which 20 percent (15 percent in targeted areas) of the units are reserved for families whose income does not exceed 50 percent of the area's median income; or 40 percent for families with incomes of no more than 60 percent of the area median income. Other tax-exempt bonds for multifamily rental projects are generally issued with the requirement that all tenants must be low or moderate income families. Rental housing bonds are subject to the volume cap discussed in the mortgage housing bond section above.

Interest and taxes on owner-occupied homes.—Owner-occupants of homes may deduct mortgage interest and property taxes on their primary and secondary residences as itemized nonbusiness deductions. The mortgage interest deduction is limited to interest on debt no greater than the owner's basis in the residence and, for debt incurred after October 13, 1987, it is limited to no more than $1 million. Interest on up to $100,000 of other debt secured by a lien on a principal or second residence is also deductible, irrespective of the purpose of borrowing, provided the debt does not exceed the fair market value of the residence. Mortgage interest deductions on personal residences are tax expenditures because the taxpayers are not required to report the value of owner-occupied housing services as gross income.

Real property installment sales.—Dealers in real and personal property, i.e., sellers that regularly hold property for sale or resale, cannot defer taxable income from installment sales until the receipt of the loan repayment. Nondealers, defined as sellers of real property used in their business, are required to pay interest to the Federal Government on deferred taxes attributable to their total installment obligations in excess of $5 million. Only properties with sales prices exceeding $150,000 are includable in the total. The payment of a market rate of interest eliminates the benefit of the tax deferral. The tax exemption for nondealers with total installment obligations of less than $5,000,000 is, therefore, a tax expenditure.

Capital gains on home sales.—When a primary residence is sold, the homeowner can defer paying a capital gains tax on the proceeds by purchasing or constructing a home of value at least equal to that of the prior home (net of sales and qualified fix-up expenses) within two years. This deferral is a tax expenditure.

Capital gains on sales by owners aged 55 or older.—A taxpayer who is 55 years of age or older at the time of the sale of his residence may elect to exclude from tax up to $125,000 of the gain from its sale. This is a once-in-a-lifetime election. In effect, this provision converts some prior deferrals of tax into forgiveness of tax.

Passive loss real estate exemption.—In general, passive losses may not offset income from other sources. Losses up to $25,000 attributable to certain rental real estate activity, however, are exempted from this rule.

Low-income housing investment.—Through 1989, a tax credit for investment in new, substantially rehabilitated, and certain unrehabilitated low-income housing was structured to have a present value of 70 percent of construction or rehabilitation costs incurred and was allowed over 10 years. For Federally subsidized projects and those involving unrehabilitated existing low income housing, the credit was structured to have a present value of 30 percent. Beginning on January 1, 1990, the credit was extended at a present value of 70 percent, including projects financed with other Federal subsidies, but only if substantial rehabilitation was done. Notwithstanding the capital grant character of this subsidy, the investor's recoverable basis is not reduced by the substantial credit allowed.

Accelerated depreciation of real property, machinery and equipment.—As previously noted, the tax depreciation allowance provisions are part of the reference law rules, and thus do not cause tax expenditures under the reference method. Under the normal tax method, however, a 40-year tax life for depreciable real property is the norm. So, the statutory depreciation period in effect from 1987 to 1993 for nonresidential properties of 31.5 years, and the 39-year period for property placed in service after February 25, 1993, give rise to tax expenditures. The statutory depreciation period for residential property is 27.5 years, which also results in tax expenditures. Statutory depreciation of machinery, equipment, and some other property also is somewhat accelerated relative to the normal tax baseline. In addition, tax expenditures arise from pre-1987 tax allowances for real and personal property.

Cancellation of indebtedness.—Individuals are not required to report the cancellation of certain indebtedness as current income. However, if they do not, it would be included as an adjustment in the basis of the underlying property.

Imputed interest rules.—Under reference law rules commonly referred to as original issue discount (OID), both the holder and seller of a financial contract are generally required to report interest earned in the period it accrues, not when the contract payments are made. Moreover, the amount of interest accruable is determined by the actual price paid for the contract, not by the stated or nominal principal and interest stipulated in the contract.[5]

Exceptions to the general rules for accounting for interest expense or income include the following: (a) permission for the mortgagor of his personal residence to treat the discount from the nominal principal of his mortgage loan, commonly called "points," as prepaid interest which is deductible in the year paid, not the year accrued; and (b) sellers of farms and small businesses worth less than $1 million, in exchange for the purchaser's debt obligation, are exempted from the OID rules. This is $750,000 more than the $250,000 exemption that the reference tax law generally allows for such transactions.

Capital gains (other than agriculture, timber, iron ore and coal).—While the top statutory rate on ordinary income is 39.6 percent, the rates on capital gains are limited to 28 percent. This treatment is considered a tax expenditure under the normal tax method but not under the reference law method.

Capital gains exclusion for small business stock.—An exclusion of 50 percent is provided for capital gains from qualified small business stock held by individuals for more than 5 years. A qualified small business is a corporation whose gross assets do not exceed $50 million as of the date of issuance of the stock. Certain activities such as personal services and banking are ineligible for the exclusion.

Step-up in basis of capital gains at death.—Capital gains on assets held at the owner's death are not subject to capital gains taxes. The cost basis of the appreciated assets is adjusted upward to the market value at the owner's date of death. The step-up in the heir's cost basis means that, in effect, the capital gain is forgiven.

Carryover basis of capital gains on gifts.—When a gift is made, the transferred property carries to the donee the donor's basis—the cost that was incurred when the property was first acquired. The carryover of the donor's basis allows a continued deferral of unrealized capital gains.

Ordinary income treatment of losses from sale of small business corporate stock shares.—Up to $100,000 in losses from the sale of such stock may be treated as ordinary losses, and therefore not be subject to the $3,000 annual capital loss write-off limit if the corporation's capitalization is less than $1 million.

Expensing of certain small investments.—In 1996, qualifying investments in tangible property up to $18,500 can be expensed rather than depreciated over time. (The expensing limit increases annually until 2003, when it reaches $25,000). To the extent that qualifying investment during the year exceeds $200,000, the amount eligible for expensing is decreased. In 1996, the amount expensed is completely phased out when qualifying investments exceed $218,500.

Business start-up costs.—When an individual or corporation acquires or otherwise enters into a new business, certain start-up expenses, such as the costs of investigating opportunities and legal services, are normally incurred. The taxpayer may elect to amortize these outlays over 60 months although they are similar to other payments he makes for nondepreciable intangible assets that are not recoverable until the business is sold. Under the normal tax method this gives rise to a tax expenditure, while under the reference method it does not.

Graduated corporation income tax rate schedule.—The schedule is graduated, with rates of 15 percent on the first $50,000 of taxable income, 25 percent on the next $25,000, 34 percent on the next $9.925 million, and a rate of 35 percent on income over $10 million. As compared with a flat 35 percent tax rate, the lower rates provide a $111,000 reduction in tax liability for corporations with taxable incomes of $10 million. This benefit is recaptured in the cases of corporations with taxable incomes exceeding $100,000.

[5] Thus, when a borrower on December 31, 1996, issues a promise to pay $1,000 plus interest at 10 percent on December 30, 1997, for a total repayment of $1,100, and accepts $900 from a lender in exchange for the contract, the rules require that both parties: (a) recognize that $900 is the amount lent, so that the effective loan interest rate is not the nominal 10 percent rate but is 22.2 percent; and (b) both report $200 as interest paid or received in 1996, as the case may be.

This is accomplished by (1) a 5 percent additional tax on corporate incomes in excess of $100,000, but less than $335,000 and (2) a 3 percent additional tax on income over $15 million but less than $18.33 million. At this point the $111,000 is fully recaptured. Since this rate schedule is part of the reference tax law, it does not give rise to a tax expenditure under the reference method. A flat corporation income tax rate is taken as the baseline under the normal tax method; therefore the lower rates do yield a tax expenditure under this concept.

Small issue industrial development bonds.—The interest on small issue industrial development bonds (IDBs) issued by State and local governments to finance private business property is excluded from income subject to tax. Depreciable property financed with small issue IDBs must be depreciated, however, using the straight-line method. The tax exemption of small issue bonds expired in 1986, except for small issue IDBs exclusively issued to finance manufacturing facilities for which the tax exemption is permanent. The annual volume of small issue IDBs is subject to the unified volume cap discussed in the mortgage housing bond section above.

Treatment of Alaskan Native Corporations losses.—Tax law restricts the ability of profitable corporations to reduce their tax liabilities by merging or buying corporations with accumulated net operating losses (NOLs) and as yet unrefunded claims to investment credits. Alaska Native Corporations have a limited exemption (fifteen years after the NOL or credit claim was first experienced) from these restrictions that includes NOLs and credits claimable prior to April 26, 1988.

TRANSPORTATION

Shipping companies that are U.S. flag carriers.—Certain companies that operate U.S. flag vessels receive a deferral of income taxes on that portion of their income used for shipping purposes, primarily construction, modernization and major repairs to ships, and repayment of loans to finance these qualified investments. Once indefinite, the deferral has been limited to 25 years since January 1, 1987.

Exclusion of reimbursed employee parking expenses.—Parking at or near an employer's business premises that is paid for by the employer is excludable from the income of the employee as a working condition fringe benefit. The maximum amount of the parking exclusion is $155 month (in 1993 dollars), indexed in $5 increments. The tax expenditure estimate does not include parking at facilities owned by the employer.

Exclusion of employer-provided transit passes.—Transit passes, tokens, and fare cards provided by an employer to defray an employee's commuting costs are excludable from the employee's income as a de minimis fringe benefit, if the total value of the benefit does not exceed $60 per month (in 1993 dollars), indexed in $5 increments.

COMMUNITY AND REGIONAL DEVELOPMENT

Rehabilitation of structures.—A 10 percent investment tax credit is available for the rehabilitation of buildings that are used for business or productive activities and that were erected before 1936 for other than residential purposes. A full reduction by the amount of the credit is required in the taxpayer's recoverable basis.

Tax-exempt bonds for airports and similar facilities.—Government-owned airports, docks and wharves, as well as high-speed rail facilities that need not be government-owned, may be financed with tax-exempt bonds. These bonds are not covered by a volume cap.

Exemption of certain mutuals' and cooperatives' income.—The incomes of mutual and cooperative telephone and electric companies are exempted from tax if at least 85 percent of their revenues are derived from patron service charges.

Empowerment zones.—Qualifying businesses in designated economically depressed areas can receive tax benefits such as an employer wage credit, increasing expensing of investment in equipment, tax-exempt financing, and accelerated depreciation. In addition, a tax credit for contributions to certain community development corporations can be available.

EDUCATION, TRAINING, EMPLOYMENT, AND SOCIAL SERVICES

Scholarship and fellowship income.—Scholarships and fellowships are excluded from taxable income to the extent they pay for tuition and course-related expenses of the grantee. Similarly, tuition reductions for employees of educational institutions and their families are not included in taxable income. From an economic point of view, scholarships and fellowships are either gifts not conditioned on the performance of services, or they are rebates of educational costs. Thus, under the reference law method, this exclusion is not a tax expenditure because this method does not include either gifts or price reductions in a taxpayer's gross income. Under the normal tax method, however, the exclusion is considered a tax expenditure because under this method gift-like transfers of government funds—and many scholarships are derived directly or indirectly from government funding—are included in gross income.

Tax-exempt bonds for educational purposes.—Interest on State and local government debt issued to finance student loans or the construction of facilities used by private nonprofit educational institutions is excluded from income subject to tax. The aggregate volume of such private activity bonds that each State may issue during any calendar year is limited.

U.S. savings bonds for education.—Interest on U.S. savings bonds, issued after December 31, 1989, may be excluded from tax if the bonds, plus accrued interest, are transferred to an educational institution as payment for educational expenses. The exclusion from tax is phased out for joint returns with adjusted gross incomes of $74,200 to $104,200 and $49,250 to $64,250 for single and head of household returns in 1996.

Dependent students age 19 or older.—Taxpayers can claim personal exemptions for dependent children age 19 or over who receive parental support payments of $1,000 or more per year, are full-time students, and do not claim a personal exemption on their own tax returns. This preferential arrangement usually generates tax savings because the students' marginal tax rates are more often than not lower than their parents' marginal tax rates.

Charitable contributions.—Contributions to charitable, religious, and certain other nonprofit organizations are allowed as an itemized deduction for individuals, generally up to 50 percent of adjusted gross income. Taxpayers who donate capital assets to charitable or educational organizations can deduct the assets' current value without the taxation of any appreciation in value. Corporations can also deduct charitable contributions up to 10 percent of their pre-tax income. Tax expenditures resulting from the deductibility of contributions are shown separately for educational and other institutions. Contributions to health institutions are reported under the health function.

Employer provided benefits.—Many employers provide employee benefits that are not counted in employee income. The employers' costs for these benefits are deductible business expenses. The exclusion from an employee's income of the value of educational assistance, child care, meals and lodging, as well as ministers' housing allowances and the rental value of parsonages are tax expenditures. The exclusion for educational assistance expires in mid-1997. After June 30, 1996, the exclusion does not apply to graduate courses. Health and other insurance benefits are reported under the health and income security functions. Certain parking and transit benefits are reported under the transportation function.

Work opportunity tax credit.—Employers can claim a tax credit for qualified wages paid to individuals who begin work after September 30, 1996 and before October 1, 1997 and who are certified as members of various targeted groups. The amount of the credit that can be claimed is 35 percent of the first $6,000 paid during the first year of employment. Employers must reduce their deduction for wages paid by the amount of the credit claimed. The work opportunity tax credit is similar to the targeted jobs tax credit, which applied to employees hired before January 1, 1995.

Child and dependent care expenses.—A tax credit may be claimed by married couples for child and dependent care expenses incurred when one spouse works full time and the other works at least part time or goes to school. The credit may also be claimed by divorced or separated parents who have custody of children, and by single parents. Expenditures up to a maximum $2,400 for one dependent and $4,800 for two or more dependents are eligible for the credit. The credit is equal to 30 percent of qualified expenditures for taxpayers with incomes of $10,000 or less. The credit is reduced to a minimum of 20 percent by one percentage point for each $2,000 of income between $10,000 and $28,000.

Adoption assistance.—Beginning January 1, 1997, taxpayers can receive a nonrefundable tax credit for qualified adoption expenses. The maximum credit is $5,000 per child ($6,000 for special needs adoptions, except foreign adoptions). The credit is phased-out ratably for taxpayers with modified AGI between $75,000 and $115,000. Unused credits may be carried forward. In lieu of the tax credit, taxpayers may exclude qualified adoption expenses from income, subject to the same maximum amounts and phase-out as the credit. The non-special needs adoption assistance and foreign special needs assistance expire on December 31, 2001.

Disabled access expenditures.—A credit is provided of 50 percent of eligible disabled access expenditures in excess of $250. The credit is limited to $5,000.

Costs of removing architectural barriers to the handicapped.—The investment cost of making any business accessible to persons suffering physical or mental disabilities may be deducted, rather than capitalized as part of the taxpayer's basis in such property and recovered by subsequent depreciation allowances, as is generally required.

Foster care payments.—Foster parents provide a home and care for children who are wards of the State, under contract with the State. Compensation received for this service is explicitly excluded from the gross incomes of foster parents, making the expenses they incur nondeductible. This activity is, in effect, tax-exempt.

HEALTH

Employer paid medical insurance and expenses.—Employee compensation, in the form of payments by employers for health insurance premiums and other medical expenses (including long-term care), is deducted as a business expense by employers, but it is not included in employee gross income. The self-employed also may deduct part of their family health insurance premiums.

Medical savings accounts.—Beginning January 1, 1997, some employees may deduct annual contributions to a medical savings account (MSA); employer contributions to MSAs (except those made through cafeteria plans) for qualified employees are also excluded from income. An employee may contribute to an MSA in a given year only if the employer does not contribute to the MSA in that year. MSAs are only available to self-employed individuals or employees covered under an employer-sponsored high deductible health plan of a small employer. The maximum annual MSA contribution is 75 percent of the deductible under the high deductible plan for family coverage (65 percent for individual coverage). Earnings from MSAs are excluded from taxable income. Distributions from an MSA for medical expenses are not taxable. The number of taxpayers who may benefit annually from MSAs is generally limited to 750,000. No new MSAs may be established after December 31, 2000.

Medical care expenses.—Personal expenditures for medical care (including the costs of prescription drugs) exceeding 7.5 percent of the taxpayer's adjusted gross income are deductible.

Tax-exempt bonds for hospital construction.—Interest earned on State and local government debt issued to finance hospital construction is excluded from income subject to tax.

Charitable contributions to health institutions.—Contributions to nonprofit health institutions are allowed as a deduction for individuals and corporations. Tax expenditures resulting from the deductibility of contributions to other charitable institutions are listed under the education, training, employment, and social services function.

Orphan drugs.—To encourage the development of drugs for the treatment of rare diseases or physical conditions, a tax credit was granted equal to 50 percent of the costs for clinical testing that must be completed before manufacture and distribution are approved by the Food and Drug Administration. Because the drug firm was not required to reduce its deduction for testing expenses (an R&D expenditure) by the amount of this credit, the private cost of clinically testing orphan drugs was reduced substantially. This tax expenditure expires on May 31, 1997.

Blue Cross and Blue Shield.—Although these organizations are not qualified as exempt, they are provided exceptions from otherwise applicable insurance company income tax accounting rules that effectively eliminate their tax liabilities.

INCOME SECURITY

Railroad retirement benefits.—These benefits are not generally subject to the income tax unless the recipient's gross income reaches a certain threshold discussed more fully under the social security function.

Workmen's compensation benefits.—Workmen's compensation provides payments to disabled workers. These benefits, although income to the recipients, are a tax preference because they are not subject to the income tax.

Public assistance benefits.—The exclusion from taxable income of public assistance benefits received by individuals is listed as a tax expenditure under the normal tax method because, under this method, cash transfers from government are included in gross income. In contrast, gifts not conditioned on the performance of services, including transfers from government, are not taxable under the reference law. Therefore, under the reference tax method, the tax exclusion for public assistance benefits is not shown as a tax expenditure.

Special benefits for disabled coal miners.—Disability payments to former coal miners out of the Black Lung Trust Fund, although income to the recipient, are not subject to the income tax.

Military disability pensions.—Most of the military pension income received by current disabled retired veterans is excluded from their income subject to tax.

Pension contributions and earnings.—Certain employer contributions to pension plans, along with individual contributions to individual retirement accounts (IRAs) and amounts set aside by the self-employed, are excluded from adjusted gross income in the year of contribution. The investment income earned by pension funds and other qualifying retirement plans is not taxable when earned, and this deferral is, therefore, also a tax expenditure.

In 1997, $9,500 (indexed) can be excluded from an employee's adjusted gross income under a qualified cash or deferred arrangement with the employer (401(k) plan). An employee's own contribution of no more than $9,500 or the 401(k) limitation (whichever is greater) may be excluded annually from an employee's adjusted gross income when placed in a tax-sheltered annuity (403(b) plan).

In 1996, employees could deduct annual contributions to an IRA of $2,000 (or 100 percent of compensation, if less), or $2,250 on a joint return with only one spouse earning income (beginning January 1, 1997, each spouse may contribute $2,000 to a deductible IRA), if: (a) neither the individual or spouse is an active participant in an employer-provided retirement plan; or (b) their adjusted gross income falls below $40,000 ($25,000 for a single taxpayer). The allowable IRA deduction is phased out between $40,000 and $50,000 for a joint return and $25,000 and $35,000 for a single return. Beyond these income limits, nondeductible contributions to IRAs are available to taxpayers who are active participants in employer-provided retirement plans. Self-employed persons can make deductible contributions to their own retirement (Keogh) plans equal to

25 percent of their income, up to a maximum of $30,000 per year.

Employer provided insurance benefits.—Many employers cover part or all the cost of premiums or payments for: (a) employees' life insurance benefits; (b) accident and disability benefits; (c) death benefits; and (d) supplementary unemployment benefits. The amounts are deductible by the employers and are excluded as well from employees' gross incomes for tax purposes.

Employer Stock Ownership Plan (ESOP) provisions.—A special type of employee benefit plan, organized as a trust, is tax-exempt. Employer-paid contributions (the value of stock issued to the ESOP) are deductible by the employer as part of employee compensation costs. They are not included in the employees' gross income for tax purposes, however, until they are paid out as benefits. The following special income tax provisions for ESOPs are intended to increase ownership of corporations by their employees: (1) annual employer contributions are subject to less restrictive limitations (percentages of employees' cash compensation); (2) ESOPs may borrow to purchase employer stock, guaranteed by their agreement with the employer that the debt will be serviced by his payment (deductible by him) of a portion of wages (excludable by the employees) to service the loan; (3) ESOPs' lenders may exclude half the interest from their gross income (the ESOP interest exclusion expired on June 10, 1996); (4) employees who sell appreciated company stock to the ESOP may defer any taxes due until they withdraw benefits; and (5) dividends paid to ESOP-held stock are deductible by the employer.

Support of the aged and the blind.—Taxpayers who are blind or 65 years of age or older may take an additional $1,000 standard deduction if single, or $800 if married. In addition, individuals who are 65 years of age or older, or who are permanently disabled, can take a tax credit equal to 15 percent of the sum of their earned and retirement income. Qualified income is limited to no more than $2,500 for single individuals or married couples filing a joint return where only one spouse is 65 years of age or older, and up to $3,750 for joint returns where both spouses are 65 years of age or older. These limits are reduced by one-half of the taxpayer's adjusted gross income over $7,500 for single individuals and $10,000 for married couples filing a joint return.

Casualty losses.—Neither the purchase of property nor insurance premiums to protect its value are deductible as costs of earning income; therefore, reimbursement for insured loss of such property is not reportable as a part of gross income. However, a special provision permits relief for taxpayers suffering an uninsured loss. They may deduct casualty and theft losses of more than $100 each, but only to the extent that total losses during the year exceed 10 percent of adjusted gross income.

Earned income credit.—This credit may be claimed by low income workers. For a family with one qualifying child, the credit is 34 percent of the first $6,500 of earned income in 1997. The credit is 40 percent of the first $9,140 of income for a family with two or more qualifying children. When the taxpayer's income exceeds $11,930, the credit is phased out at the rate of 15.98 percent (21.06 percent if two or more qualifying children are present). It is completely phased out at $25,760 of adjusted gross income ($29,290 if two or more qualifying children are present).

The credit may also be claimed by workers who do not have children living with them. Qualifying workers must be at least age 25 and may not be claimed as a dependent on another taxpayer's return. The credit is not available to workers age 65 or older. In 1996, the credit is 7.65 percent of the first $4,340 of earned income. When the taxpayer's income exceeds $5,430, the credit is phased out at the rate of 7.65 percent. It is completely phased out at $9,770 of adjusted gross income.

For workers with or without children, the income level at which the credit's phase-outs begin and the maximum amounts of income on which the credit can be taken are adjusted for inflation. Earned income tax credits in excess of tax liabilities are refundable to individuals, and as such are paid by the Federal Government. This portion of the credit is included in outlays, while the amount that offsets tax liabilities is shown as a tax expenditure.

SOCIAL SECURITY

Old Age and Survivors Insurance (OASI) benefits for retired workers.—Social security benefits that exceed the beneficiary's contributions out of taxed income are deferred employee compensation and the deferral of tax on that compensation is a tax expenditure. These additional retirement benefits are paid for partly by employers' contributions that were not included in employees' taxable compensation. Portions (reaching as much as 85 percent) of recipients' social security and tier 1 railroad retirement benefits are included in the income tax base, however, if the recipient's provisional income exceeds certain base amounts. Provisional income is equal to adjusted gross income plus foreign or U.S. possession income and tax-exempt interest, and one half of social security and tier 1 railroad retirement benefits. The tax expenditure is limited to the portion of the benefits received by taxpayers who are below the base amounts at which 85 percent of the benefits are taxable.

Social Security benefits for the disabled, dependents and survivors.—Benefit payments from the Social Security Trust Fund, for disability and for dependents and survivors, are excluded from the beneficiaries' gross incomes, and thus give rise to tax expenditures.

Veterans Benefits and Services

Veterans benefits.—All compensation due to death or disability and pensions paid by the Veterans Administration are excluded from taxable income.

Tax-exempt mortgage bonds for veterans.—Interest earned on general obligation bonds issued by State and local governments to finance housing for veterans is excluded from taxable income. The issuance of such bonds is limited, however, to five pre-existing State programs and to amounts based upon previous volume levels for the period January 1, 1979 to June 22, 1984. Furthermore, future issues are limited to veterans who served on active duty before 1977.

General Government

Public purpose State and local debt.—Interest on State and local government debt, issued to finance government activities, is excluded from Federal taxation. State and local governments, therefore, can sell debt obligations at a lower interest cost than would be possible if such interest were subject to tax. Only the excluded interest on bonds for public purposes, such as schools, roads, and sewers, is included here.

Nonbusiness State and local taxes excluding home-owner property taxes.—The deductibility of nonbusiness State and local income and personal property taxes gives indirect assistance to these governments by reducing the costs of the services they provide.

Business income earned in U.S. possessions.—Under certain conditions, U.S. corporations receiving income from an active trade or business, or from investments located in a U.S. possession, can claim a special credit against U.S. tax otherwise due.

Interest

U.S. savings bonds.—The interest on U.S. savings bonds is not taxable until the bonds are redeemed, thereby deferring tax liability. The deferral is equivalent to an interest-free loan and, therefore, it is a tax expenditure.

TAX EXPENDITURES IN THE UNIFIED TRANSFER TAX

Exceptions to the general terms of the Federal unified transfer tax favor particular transferees or dispositions of transferors, similar to Federal direct expenditure or loan programs. The transfer tax provisions identified as tax expenditures satisfy the reference law criteria for inclusion in the tax expenditure budget that were described above. There is no generally accepted normal tax baseline for transfer taxes.

Unified Transfer Tax Reference Rules

The reference tax rules for the unified transfer tax from which departures represent tax expenditures include:

- *Definition of the taxpaying unit.* The payment of the tax is the liability of the transferor whether the transfer of cash or property was made by gift or bequest.
- *Definition of the tax base.* The base for the tax is the transferor's cumulative, taxable lifetime gifts made plus the net estate at death. Gifts in the tax base are all annual transfers in excess of $10,000 to any donee except the donor's spouse. Excluded are, however, payments on behalf of family members' educational and medical expenses, as well as the cost of ceremonial gatherings and celebrations that are not in honor of the donor.
- *Property valuation.* In general, property is valued at its fair market value at the time it is transferred. This is not necessarily the case in the valuation of property for transfer tax purposes. Executors of estates are provided the option to value assets at the time of the testator's death or up to six months later.
- *Tax rate schedule.* A single graduated tax rate schedule applies to all taxable transfers. This is reflected in the name of the "unified transfer tax" that has replaced the former separate gift and estate taxes. The tax rates vary from 18 percent on the first $10,000 of aggregate taxable transfers, to 55 percent on amounts exceeding $3 million. A $192,800 lifetime credit is provided against the tax in determining the final amount of transfer taxes that are due and payable. This allows each taxpayer to make a $600,000 tax-free transfer of assets that otherwise would be liable to the unified transfer tax.[6]
- *Time when tax is due and payable.* Donors are required to pay the tax annually as gifts are made. The generation-skipping transfer tax is payable by the donees whenever they accede to the gift. The net estate tax liability is due and payable within nine months after the decedent's death. The Internal Revenue Service may grant an extension of up to 10 years for a reasonable cause. Interest is charged on the unpaid tax liability at a rate equal to the cost of Federal short-term borrowing, plus three percentage points.

[6] An additional tax, at a flat rate of 55 percent, is imposed on lifetime, generation-skipping transfers in excess of $1 million. It is considered a generation-skipping transfer whenever the transferee is at least two generations younger than the transferor, as it would be in the case of transfers to grandchildren or great-grandchildren. The liability of this tax is on the recipients of the transfer.

Tax Expenditures by Function

The estimates of tax expenditures in the Federal unified transfer tax for fiscal years 1996–2002 are displayed by functional category in table 5–6. Outlay equivalent estimates are similar to revenue loss estimates for transfer tax expenditures and, therefore, are not shown separately. A description of the provisions follows.

Natural Resources and Environment

Donations of conservation easements.—Bequests for conservation are excluded from taxable estates. A conservation bequest is the value of property and easements (in perpetuity) to such property the use of which is restricted to any one or more of the following: the public for outdoor recreation; protection of the natural habitats of fish, wildlife, plants, etc.; scenic enjoyment of the public; and preservation of historic land areas and structures. Similar conservation gifts are excluded from the gift tax base and are also deductible from the donor's otherwise taxable income in the year of the gift.

Agriculture

Special use valuation of farms.—Farmland owned and operated by a decedent and/or a member of the family may be valued for estate tax purposes on the basis of its "continued use" as a farm if: the farmland is at least 25 percent of the decedent's gross estate; the entire value of all farm property is at least 50 percent of the gross estate; and family heirs to the farm agree to continue to operate the property as a farm for at least 10 years. Since continued use valuation of farmland is frequently substantially less than the fair market value, the resulting reduction in tax liability serves as a subsidy to the continued operation of family farms.

Tax deferral of closely held farms.—Decedents' estates may use a preferential, extended installment payment period of five to 15 years to discharge estate tax liabilities if the value of the farm properties exceeds 35 percent of the net estates. The interest charged is only 4 percent for the first five years, rather than the standard Federal short-term borrowing rate plus three percentage points, which applies during the last 10 years of the repayment period.

Commerce and Housing Credit

Special use valuation of closely held businesses.—The two estate tax incentives to family farming are also available to the estates of owners of 1995 nonfarm family businesses. If the same three conditions previously described are met, the real property in their estates is eligible for continued use valuation.

Tax deferral of closely held businesses.—Nonfarm family businesses that satisfy the net estate requirements qualify for preferential 15 year deferred estate tax payment. To be eligible for this special provision, the value of stock in closely held corporations must exceed 35 percent of the decedent's gross estate, less debt and funeral expenses.

Education, Training, Employment, and Social Services

Bequests to tax-exempt organizations.—These bequests are deductible from decedent's otherwise taxable lifetime transfers.

TABLE 5–6. REVENUE LOSS ESTIMATES FOR TAX EXPENDITURES IN THE FEDERAL UNIFIED TRANSFER TAX
(In millions of dollars)

Description	Fiscal Years							
	1996	1997	1998	1999	2000	2001	2002	1998–2002
Natural Resources and Environment:								
Deductions for donations of conservation easements	....	....	....	....	....	....	....	....
Agriculture:								
Special use valuation of farm real property	75	80	85	90	95	100	105	475
Tax deferral of closely held farms	10	10	10	15	15	15	15	70
Commerce:								
Special use valuation of real property used in closely held businesses	20	20	25	25	25	25	30	130
Tax deferral of closely held business	60	65	70	75	80	85	90	400
Education, training, employment, and social services:								
Deduction for charitable contributions (education)	940	1,005	1,080	1,155	1,240	1,330	1,430	6,235
Deduction for charitable contributions (other than education and health)	2,765	2,965	3,180	3,415	3,665	3,930	4,220	18,410
Health:								
Deduction for charitable contributions (health)	845	905	975	1,045	1,120	1,205	1,290	5,635
General government:								
Credit for State death taxes	3,235	3,465	3,720	3,990	4,285	4,600	4,935	21,530

Note: All estimates have been rounded to the nearest $5 million.

HEALTH

Bequests to health providers.—Such bequests, that are exempt from the income tax, are deductible from otherwise taxable lifetime transfers of decedents.

GENERAL GOVERNMENT

State and local death taxes.—A credit is allowed for state death taxes against any Federal estate tax that otherwise would be due. The amount of the state death tax credit is determined by a rate schedule that reaches a limit of 16 percent of the taxable estate in excess of $60,000.