18. TAX EXPENDITURES

The Congressional Budget Act of 1974 (Public Law 93–344) requires that a list of "tax expenditures" be included in the budget. Tax expenditures are defined in the law as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of liability." These exceptions may be viewed as alternatives to other policy instruments, such as spending or regulatory programs. Identification and measurement of tax expenditures depends importantly on the baseline tax system against which the actual tax system is compared.

The largest reported tax expenditures tend to be associated with the individual income tax. For example, sizeable deferrals, deductions and exclusions are provided for pension contributions and earnings, employer contributions for medical insurance, capital gains, and payments of State and local individual income and property taxes. Reported tax expenditures under the corporate income tax tend to be related to timing differences in 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.

Each tax expenditure estimate in this chapter was calculated assuming other parts of the tax code remained unchanged. The estimates would be different if all tax expenditures or major groups of tax expenditures were changed simultaneously because of potential interactions among provisions. For that reason, this chapter does not present a grand total for the estimated 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.

Tax expenditures relating to the individual and corporate income taxes are estimated for fiscal years 2003–2009 using three methods of accounting: revenue effects, outlay equivalent, and present value. The present value approach provides estimates of the revenue effects for tax expenditures that generally involve deferrals of tax payments into the future.

The section of the chapter on performance measures and economic effects presents information related to assessment of the effect of tax expenditures on the achievement of program performance goals. This section is a complement to the Government-wide performance plan required by the Government Performance and Results Act of 1993.

The 2004 Budget included a thorough review of important ambiguities in the tax expenditure concept. In particular, this review focused on defining tax expenditures relative to a comprehensive income tax baseline, defining tax expenditures relative to a broad-based consumption tax baseline, and defining negative tax expenditures, i.e., provisions of current law that overtax certain items or activities. This review has been updated and is presented in the Appendix.

TAX EXPENDITURES IN THE INCOME TAX

Tax Expenditure Estimates

All tax expenditure estimates presented here are based upon current tax law enacted as of December 31, 2003. Expired or repealed provisions are not listed if their revenue effects result only from taxpayer activity occurring before fiscal year 2003. Due to the time required to estimate the large number of tax expenditures, the estimates are based on Mid-Session economic assumptions; exceptions are the earned income tax credit and child credit provisions, which involve outlay components and hence are updated to reflect the economic assumptions used elsewhere in the budget.

The total revenue effects for tax expenditures for fiscal years 2003–2009 are displayed according to the budget's functional categories in Table 18–1. Descriptions of the specific tax expenditure provisions follow the tables of estimates and the 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. These baseline concepts are thoroughly discussed in Special Analysis G of the 1985 Budget, where the former is referred to as the pre-1983 method, and the latter the post-1982 method. 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 effects for these items are zero using the reference tax rules. The alternative baseline concepts are discussed in detail following the tables.

Table 18–2 reports the respective portions of the total revenue effects that arise under the individual and corporate income taxes separately. The location of the 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 could be shareholders, employees, customers, or other providers of capital, depending on economic forces.

Table 18–3 ranks the major tax expenditures by the size of their FY 2005–2009 revenue effect.

Interpreting Tax Expenditure Estimates

The estimates shown for individual tax expenditures in Tables 18–1, 18–2, and 18–3 do not necessarily equal the increase in Federal revenues (or the change in the budget balance) that would result from repealing these 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 activity or of other tax provisions or Government programs. For example, if capital gains were taxed at ordinary rates, capital gain realizations would be expected to decline, potentially resulting in a decline in tax receipts. Such behavioral effects are not reflected in the estimates.

Tax expenditures are interdependent even without incentive effects. Repeal of a tax expenditure provision can increase or decrease the tax revenues associated with other provisions. For example, even if behavior does not change, repeal of an itemized deduction could increase the revenue costs from other deductions because some taxpayers would be moved into higher tax brackets. Alternatively, repeal of an itemized deduction could lower the revenue cost 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, because each is estimated assuming that the other remains in force. In addition, the estimates reported in Table 18–1 are the totals of individual and corporate income tax revenue effects reported in Table 18–2 and do not reflect any possible interactions between the individual and corporate income tax receipts. For this reason, the estimates in Table 18–1 (as well as those in Table 18–5, which are also based on summing individual and corporate estimates) should be regarded as approximations.

Present-Value Estimates

The annual value of tax expenditures for tax deferrals is reported on a cash basis in all tables except Table 18–4. 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. Although such estimates are useful as a measure of cash flows into the Government, they do not 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 effect on receipts to the Government because the newly deferred taxes will ultimately be received. Present-value estimates, which are a useful complement to the cash-basis estimates for provisions involving deferrals, are discussed below.

Discounted present-value estimates of revenue effects are presented in Table 18–4 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 effects, net of future tax payments, that follow from activities undertaken during calendar year 2003 which cause the deferrals or other long-term revenue effects. For instance, a pension contribution in 2003 would cause a deferral of tax payments on wages in 2003 and on pension earnings on this contribution (e.g., interest) in later years. In some future year, however, the 2003 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 18–1. ESTIMATES OF TOTAL INCOME TAX EXPENDITURES

(in millions of dollars)

		Total from corporations and individuals							
		2003	2004	2005	2006	2007	2008	2009	2005–09
	National Defense								
1	Exclusion of benefits and allowances to armed forces personnel	2,210	2,240	2,260	2,290	2,310	2,330	2,350	11,540
	International Affairs								
2	Exclusion of income earned abroad by U.S. citizens	2,620	2,680	2,750	2,810	2,940	3,100	3,270	14,870
3	Exclusion of certain allowances for Federal employees abroad	770	800	840	880	920	960	1,010	4,610
4	Extraterritorial income exclusion	5,150	5,510	5,890	6,290	6,730	7,200	7,700	33,810
5	Inventory property sales source rules exception	1,540	1,620	1,700	1,790	1,880	1,980	2,080	9,430
6	Deferral of income from controlled foreign corporations (normal tax method)	7,450	7,900	8,400	8,930	9,550	10,210	10,920	48,010
7	Deferred taxes for financial firms on certain income earned overseas	2,050	2,130	2,190	2,260	960	....	....	5,410
	General Science, Space, and Technology								
8	Expensing of research and experimentation expenditures (normal tax method)	–1,980	–2,350	4,500	8,290	7,110	6,360	5,570	31,830
9	Credit for increasing research activities	4,960	4,400	2,550	1,090	460	150	60	4,310
	Energy								
10	Expensing of exploration and development costs, fuels	210	270	170	80	70	60	40	420
11	Excess of percentage over cost depletion, fuels	640	620	580	590	610	610	610	3,000
12	Alternative fuel production credit	1,280	890	890	890	890	350	....	3,020
13	Exception from passive loss limitation for working interests in oil and gas properties	20	20	20	20	20	20	20	100
14	Capital gains treatment of royalties on coal	100	110	120	120	130	130	140	640
15	Exclusion of interest on energy facility bonds	90	100	110	110	120	130	130	600
16	Enhanced oil recovery credit	400	400	410	420	430	440	450	2,150
17	New technology credit	280	350	370	370	370	370	370	1,850
18	Alcohol fuel credits [1]	30	30	30	30	30	30	30	150
19	Tax credit and deduction for clean-fuel burning vehicles	70	60	10	–20	–70	–60	–70	–210
20	Exclusion from income of conservation subsidies provided by public utilities	80	80	80	80	80	80	80	400
	Natural Resources and Environment								
21	Expensing of exploration and development costs, nonfuel minerals	10	10	10	10	10	10	10	50
22	Excess of percentage over cost depletion, nonfuel minerals	250	250	260	260	270	280	280	1,350
23	Exclusion of interest on bonds for water, sewage, and hazardous waste facilities	450	490	530	570	590	630	650	2,970
24	Capital gains treatment of certain timber income	100	110	120	120	130	130	140	640
25	Expensing of multiperiod timber growing costs	340	340	350	370	380	400	410	1,910
26	Tax incentives for preservation of historic structures	270	290	300	320	330	340	370	1,660
	Agriculture								
27	Expensing of certain capital outlays	120	130	130	130	140	150	160	710
28	Expensing of certain multiperiod production costs	90	90	90	100	100	100	100	490
29	Treatment of loans forgiven for solvent farmers	10	10	10	10	10	10	10	50
30	Capital gains treatment of certain income	1,050	1,100	1,160	1,220	1,280	1,350	1,420	6,430
31	Income averaging for farmers	70	80	80	80	80	90	90	420
32	Deferral of gain on sale of farm refiners	10	10	10	10	20	20	20	80
	Commerce and Housing								
	Financial institutions and insurance:								
33	Exemption of credit union income	1,300	1,360	1,430	1,500	1,570	1,650	1,730	7,880
34	Excess bad debt reserves of financial institutions	40	30	20	20	10	....	....	50
35	Exclusion of interest on life insurance savings	18,900	20,500	22,130	24,010	26,050	28,260	30,660	131,110
36	Special alternative tax on small property and casualty insurance companies	120	120	130	130	140	140	140	680
37	Tax exemption of certain insurance companies owned by tax-exempt organizations	190	210	220	240	250	260	280	1,250
38	Small life insurance company deduction	90	90	90	90	90	90	90	450
	Housing:								
39	Exclusion of interest on owner-occupied mortgage subsidy bonds	910	990	1,080	1,150	1,200	1,280	1,320	6,030
40	Exclusion of interest on rental housing bonds	280	310	350	370	380	400	410	1,910
41	Deductibility of mortgage interest on owner-occupied homes	61,160	62,590	69,740	74,800	78,420	83,030	87,920	393,910
42	Deductibility of State and local property tax on owner-occupied homes	22,090	21,740	19,410	16,110	14,580	13,640	13,110	76,850
43	Deferral of income from post 1987 installment sales	1,080	1,100	1,120	1,140	1,160	1,190	1,200	5,810
44	Capital gains exclusion on home sales	20,260	20,860	21,490	22,140	22,800	23,480	24,190	114,100
45	Exception from passive loss rules for $25,000 of rental loss	5,710	4,570	4,390	4,210	4,020	3,840	3,660	20,120
46	Credit for low-income housing investments	6,210	6,550	6,860	7,180	7,470	7,830	8,210	37,550
47	Accelerated depreciation on rental housing (normal tax method)	1,220	620	–170	–1,110	–2,330	–3,560	–4,900	–12,070
	Commerce:								
48	Cancellation of indebtedness	20	30	30	30	40	40	40	180
49	Exceptions from imputed interest rules	50	50	50	50	50	50	50	250
50	Capital gains (except agriculture, timber, iron ore, and coal) [2]	25,730	27,300	30,190	32,930	36,410	48,930	29,210	177,670
51	Capital gains exclusion of small corporation stock	130	160	210	250	300	350	390	1,500
52	Step-up basis of capital gains at death	14,880	16,280	18,240	20,240	22,240	24,190	26,010	110,920
53	Carryover basis of capital gains on gifts	590	390	450	540	550	580	620	2,740
54	Ordinary income treatment of loss from small business corporation stock sale	40	50	50	50	50	50	50	250
55	Accelerated depreciation of buildings other than rental housing (normal tax method)	–2,290	–3,190	–4,060	–4,690	–6,810	–10,170	–14,430	–40,160

Table 18–1. ESTIMATES OF TOTAL INCOME TAX EXPENDITURES—Continued

(in millions of dollars)

		Total from corporations and individuals							
		2003	2004	2005	2006	2007	2008	2009	2005–09
56	Accelerated depreciation of machinery and equipment (normal tax method)	48,520	46,800	–10,920	–37,940	–31,040	–28,770	–27,590	–136,260
57	Expensing of certain small investments (normal tax method)	1,030	1,590	4,850	1,650	–490	–30	130	6,110
58	Amortization of start-up costs (normal tax method)	110	120	130	150	160	160	160	760
59	Graduated corporation income tax rate (normal tax method)	3,030	3,090	3,910	4,650	4,800	4,890	5,040	23,290
60	Exclusion of interest on small issue bonds	390	430	470	490	520	550	570	2,600
	Transportation								
61	Deferral of tax on shipping companies	20	20	20	20	20	20	20	100
62	Exclusion of reimbursed employee parking expenses	2,130	2,240	2,360	2,490	2,610	2,740	2,880	13,080
63	Exclusion for employer-provided transit passes	320	380	450	520	590	660	730	2,950
	Community and Regional Development								
64	Investment credit for rehabilitation of structures (other than historic)	30	30	30	30	30	30	30	150
65	Exclusion of interest for airport, dock, and similar bonds	770	840	910	970	1,020	1,080	1,110	5,090
66	Exemption of certain mutuals' and cooperatives' income	60	60	70	70	70	70	70	350
67	Empowerment zones, Enterprise communities, and Renewal communities	1,070	1,080	1,120	1,210	1,320	1,470	1,730	6,850
68	New markets tax credit	190	290	430	610	830	870	790	3,530
69	Expensing of environmental remediation costs	80	20	–10	–10	–10	–10	–10	–50
	Education, Training, Employment, and Social Services								
	Education:								
70	Exclusion of scholarship and fellowship income (normal tax method)	1,260	1,260	1,340	1,400	1,410	1,420	1,420	6,990
71	HOPE tax credit	3,290	3,420	3,510	3,290	3,330	3,320	3,310	16,760
72	Lifetime Learning tax credit	1,910	2,250	2,180	2,120	2,320	2,320	2,300	11,240
73	Education Individual Retirement Accounts	70	110	140	190	240	300	370	1,240
74	Deductibility of student-loan interest	730	760	780	800	820	830	840	4,070
75	Deduction for higher education expenses	1,730	1,810	2,580	2,610	....	....	....	5,190
76	State prepaid tuition plans	50	150	320	430	510	590	660	2,510
77	Exclusion of interest on student-loan bonds	260	280	310	320	340	360	380	1,710
78	Exclusion of interest on bonds for private nonprofit educational facilities	780	850	930	990	1,030	1,100	1,130	5,180
79	Credit for holders of zone academy bonds	80	90	110	130	130	140	140	650
80	Exclusion of interest on savings bonds redeemed to finance educational expenses	10	10	10	10	20	20	20	80
81	Parental personal exemption for students age 19 or over	3,140	3,130	2,550	2,000	1,760	1,580	1,430	9,320
82	Deductibility of charitable contributions (education)	3,670	3,390	3,660	4,000	4,230	4,510	4,830	21,230
83	Exclusion of employer-provided educational assistance	500	530	560	590	620	660	690	3,120
84	Special deduction for teacher expenses	140	140	....	....	....	....	....	....
	Training, employment, and social services:								
85	Work opportunity tax credit	430	370	170	70	30	....	....	270
86	Welfare-to-work tax credit	60	60	40	30	20	....	....	90
87	Employer provided child care exclusion	590	620	770	870	920	960	1,010	4,530
88	Employer-provided child care credit	90	130	140	150	160	170	180	800
89	Assistance for adopted foster children	250	290	330	380	430	480	540	2,160
90	Adoption credit and exclusion	220	450	500	540	560	570	580	2,750
91	Exclusion of employee meals and lodging (other than military)	780	810	850	890	930	970	1,000	4,640
92	Child credit [3]	37,970	24,340	29,860	24,810	24,680	24,480	25,430	129,260
93	Credit for child and dependent care expenses	2,720	2,950	2,690	2,210	2,030	1,900	1,780	10,610
94	Credit for disabled access expenditures	50	50	60	60	60	60	60	300
95	Deductibility of charitable contributions, other than education and health	30,020	27,370	29,670	32,550	34,500	36,790	39,410	172,920
96	Exclusion of certain foster care payments	430	430	440	450	460	470	570	2,390
97	Exclusion of parsonage allowances	380	400	420	450	480	510	540	2,400
	Health								
98	Exclusion of employer contributions for medical insurance premiums and medical care	101,920	106,720	112,990	120,940	129,820	139,620	150,300	653,670
99	Deductibility of self-employed medical insurance premiums	2,550	3,740	3,780	4,090	4,370	4,750	5,150	22,140
100	Medical Savings Accounts/Health Savings Accounts	–30	–140	–570	–960	–1,380	–1,920	–2,180	–7,010
101	Deductibility of medical expenses	6,240	6,880	7,900	8,480	9,180	10,200	10,990	46,750
102	Exclusion of interest on hospital construction bonds	1,620	1,780	1,930	2,060	2,160	2,290	2,360	10,800
103	Deductibility of charitable contributions (health)	3,390	3,090	3,350	3,670	3,890	4,150	4,450	19,510
104	Tax credit for orphan drug research	160	180	200	220	250	280	310	1,260
105	Special Blue Cross/Blue Shield deduction	350	320	310	280	310	260	290	1,450
106	Tax credit for health insurance purchased by certain displaced and retired individuals [4]	....	50	60	60	70	70	80	340
	Income Security								
107	Exclusion of railroad retirement system benefits	400	400	400	400	400	400	400	2,000
108	Exclusion of workers' compensation benefits	6,100	6,460	6,850	7,270	7,710	8,190	8,690	38,710
109	Exclusion of public assistance benefits (normal tax method)	400	410	430	450	470	490	510	2,350
110	Exclusion of special benefits for disabled coal miners	60	60	50	50	50	40	40	230
111	Exclusion of military disability pensions	100	110	110	110	110	120	120	570
	Net exclusion of pension contributions and earnings:.								
112	Employer plans	59,480	59,380	61,740	66,340	62,650	58,360	60,440	309,530

Table 18–1. ESTIMATES OF TOTAL INCOME TAX EXPENDITURES—Continued

(in millions of dollars)

		Total from corporations and individuals							
		2003	2004	2005	2006	2007	2008	2009	2005–09
113	401(k) plans	51,560	56,740	58,910	61,340	65,750	71,080	75,440	332,520
114	Individual Retirement Accounts	20,060	19,810	20,090	20,610	20,150	19,710	19,490	100,050
115	Low and moderate income savers credit	880	960	1,100	1,210	730	....	....	3,040
116	Keogh plans	6,020	8,730	9,260	9,860	10,530	11,480	12,500	53,630
	Exclusion of other employee benefits:								
117	Premiums on group term life insurance	1,800	1,830	1,860	1,890	1,920	1,950	1,990	9,610
118	Premiums on accident and disability insurance	230	240	250	260	270	280	290	1,350
119	Small business retirement plan credit	40	80	100	130	140	150	150	670
120	Income of trusts to finance supplementary unemployment benefits	30	30	30	30	30	30	30	....
121	Special ESOP rules	1,780	1,920	2,060	2,220	2,400	2,580	2,780	12,040
122	Additional deduction for the blind	40	30	40	40	40	40	40	200
123	Additional deduction for the elderly	1,840	1,710	1,800	1,900	1,960	1,920	1,940	9,520
124	Tax credit for the elderly and disabled	20	10	10	10	10	10	10	50
125	Deductibility of casualty losses	500	690	670	680	640	600	630	3,220
126	Earned income tax credit [5]	5,099	4,884	5,006	5,477	5,515	5,603	5,780	27,381
	Social Security								
	Exclusion of social security benefits:								
127	Social Security benefits for retired workers	18,600	19,620	19,040	19,370	20,390	19,710	19,910	98,420
128	Social Security benefits for disabled	3,230	3,570	3,720	3,840	4,080	4,280	4,500	20,420
129	Social Security benefits for dependents and survivors	4,060	4,380	4,310	4,160	4,190	4,030	4,040	20,730
	Veterans Benefits and Services								
130	Exclusion of veterans death benefits and disability compensation	3,320	3,330	3,600	3,930	4,170	4,300	4,560	20,560
131	Exclusion of veterans pensions	100	100	100	110	110	110	120	550
132	Exclusion of GI bill benefits	110	120	130	130	160	170	170	760
133	Exclusion of interest on veterans housing bonds	40	50	50	50	60	60	60	280
	General Purpose Fiscal Assistance								
134	Exclusion of interest on public purpose State and local bonds	25,480	25,980	26,370	26,440	26,150	26,940	27,750	133,650
135	Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	49,770	49,470	46,180	39,100	35,930	34,710	34,370	190,290
136	Tax credit for corporations receiving income from doing business in U.S. possessions	1,200	1,150	1,100	800	....	....	....	1,900
	Interest								
137	Deferral of interest on U.S. savings bonds	30	40	40	40	40	40	50	210
	Addendum: Aid to State and local governments:								
	Deductibility of:								
	Property taxes on owner-occupied homes	22,090	21,740	19,410	16,110	14,580	13,640	13,110	76,850
	Nonbusiness State and local taxes other than on owner-occupied homes	49,770	49,470	46,180	39,100	35,930	34,710	34,370	190,290
	Exclusion of interest on State and local bonds for:								
	Public purposes	25,480	25,980	26,370	26,440	26,150	26,940	27,750	133,650
	Energy facilities	90	100	110	110	120	130	130	600
	Water, sewage, and hazardous waste disposal facilities	450	490	530	570	590	630	650	2,970
	Small-issues	390	430	470	490	520	550	570	2,600
	Owner-occupied mortgage subsidies	910	990	1,080	1,150	1,200	1,280	1,320	6,030
	Rental housing	280	310	350	370	380	400	410	1,910
	Airports, docks, and similar facilities	770	840	910	970	1,020	1,080	1,110	5,090
	Student loans	260	280	310	320	340	360	380	1,710
	Private nonprofit educational facilities	780	850	930	990	1,030	1,100	1,130	5,180
	Hospital construction	1,620	1,780	1,930	2,060	2,160	2,290	2,360	10,800
	Veterans' housing	40	50	50	50	60	60	60	280
	Credit for holders of zone academy bonds	80	90	110	130	130	140	140	650

[1] In addition, the partial exemption from the excise tax for alcohol fuels results in a reduction in excise tax receipts (in millions of dollars) as follows: 2003 $1,100; 2004 $1,260; 2005 $1,370; 2006 $1,430; 2007 $1,470; 2008 $1,510; and 2009 $1,550.

[2] If corporate equity were to be included, the revenue loss estimates would be $48,540 in 2003, $51,510 in 2004, $56,970 in 2005, $62,140 in 2006, $68,690 in 2007, $92,320 in 2008, and $55,110 in 2009. Similarly, if the reduced tax rate on dividends were to be included, the revenue loss estimates would be $1,810 in 2003, $16,720 in 2004, $13,280 in 2005, $13,880 in 2006, $14,480 in 2007, $15,970 in 2008, and $8,540 in 2009.

[3] The figures in the table indicate the effect of the child tax credit on receipts. The effect of the credit on outlays (in millions of dollars) is as follows: 2003 $6,435; 2004 $7,447; 2005 $11,486; 2006 $8,440; 2007 $8,237; 2008 $7,956; and 2009 $7,909

[4] In addition to the receipts shown outlays of $60 million in 2004, $90 million in 2005, $100 million in 2006, $120 million in 2007, $130 million in 2008, and $140 million in 2009 are projected.

[5] The figures in the table indicate the effect of the earned income tax credit on receipts. The effect of the credit on outlays (in millions of dollars) is as follows: 2003 $31,961; 2004 $33,551; 2005 $34,148; 2006 $34,488; 2007 $34,338; 2008 $34,359; and 2009 $35,161.

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 $10 million. Provisions with estimates that rounded to zero in each year are not included in the table.

Table 18–2. ESTIMATES OF TAX EXPENDITURES FOR THE CORPORATE AND INDIVIDUAL INCOME TAXES

(in millions of dollars)

		Corporations								Individuals							
		2003	2004	2005	2006	2007	2008	2009	2005–09	2003	2004	2005	2006	2007	2008	2009	2005–09
	National Defense																
1	Exclusion of benefits and allowances to armed forces personnel	......	......	......	......	......	......	......	......	2,210	2,240	2,260	2,290	2,310	2,330	2,350	11,540
	International Affairs																
2	Exclusion of income earned abroad by U.S. citizens	......	......	......	......	......	......	......	......	2,620	2,680	2,750	2,810	2,940	3,100	3,270	14,870
3	Exclusion of certain allowances for Federal employees abroad	......	......	......	......	......	......	......	......	770	800	840	880	920	960	1,010	4,610
4	Extraterritorial income exclusion	5,150	5,510	5,890	6,290	6,730	7,200	7,700	33,810	......	......	......	......	......	......	......	......
5	Inventory property sales source rules exception	1,540	1,620	1,700	1,790	1,880	1,980	2,080	9,430	......	......	......	......	......	......	......	......
6	Deferral of income from controlled foreign corporations (normal tax method)	7,450	7,900	8,400	8,930	9,550	10,210	10,920	48,010	......	......	......	......	......	......	......	......
7	Deferred taxes for financial firms on certain income earned overseas	2,050	2,130	2,190	2,260	960	......	......	5,410	......	......	......	......	......	......	......	......
	General Science, Space, and Technology																
8	Expensing of research and experimentation expenditures (normal tax method)	−1,940	−2,300	4,400	8,130	6,970	6,240	5,460	31,200	−40	−50	100	160	140	120	110	630
9	Credit for increasing research activities	4,910	4,360	2,530	1,090	460	150	60	4,290	50	40	20	......	......	......	......	20
	Energy																
10	Expensing of exploration and development costs, fuels	180	240	150	70	60	50	30	360	30	30	20	10	10	10	10	60
11	Excess of percentage over cost depletion, fuels	530	510	480	490	510	510	510	2,500	110	110	100	100	100	100	100	500
12	Alternative fuel production credit	1,230	850	850	850	850	340	......	2,890	50	40	40	40	40	10	......	130
13	Exception from passive loss limitation for working interests in oil and gas properties	......	......	......	......	......	......	......	......	20	20	20	20	20	20	20	100
14	Capital gains treatment of royalties on coal	......	......	......	......	......	......	......	......	100	110	120	120	130	130	140	640
15	Exclusion of interest on energy facility bonds	20	20	20	20	20	20	20	100	70	80	90	90	100	110	110	500
16	Enhanced oil recovery credit	360	360	370	380	390	400	410	1,950	40	40	40	40	40	40	40	200
17	New technology credit	280	350	370	370	370	370	370	1,850	......	......	......	......	......	......	......	......
18	Alcohol fuel credits [1]	20	20	20	20	20	20	20	100	10	10	10	10	10	10	10	50
19	Tax credit and deduction for clean-fuel burning vehicles	50	40	10	−20	−60	−50	−60	−180	20	20	......	......	−10	−10	−10	−30
20	Exclusion from income of conservation subsidies provided by public utilities	......	......	......	......	......	......	......	......	80	80	80	80	80	80	80	400
	Natural Resources and Environment																
21	Expensing of exploration and development costs, nonfuel minerals	10	10	10	10	10	10	10	50	......	......	......	......	......	......	......	......
22	Excess of percentage over cost depletion, nonfuel minerals	230	230	240	240	250	260	260	1,250	20	20	20	20	20	20	20	100
23	Exclusion of interest on bonds for water, sewage, and hazardous waste facilities	100	100	100	110	110	110	120	550	350	390	430	460	480	520	530	2,420
24	Capital gains treatment of certain timber income	......	......	......	......	......	......	......	......	100	110	120	120	130	130	140	640
25	Expensing of multiperiod timber growing costs	230	230	240	250	260	280	290	1,320	110	110	110	120	120	120	120	590
26	Tax incentives for preservation of historic structures	210	230	240	250	260	270	290	1,310	60	60	60	70	70	70	80	350
	Agriculture																
27	Expensing of certain capital outlays	20	20	20	20	20	30	30	120	100	110	110	110	120	120	130	590
28	Expensing of certain multiperiod production costs	20	20	20	20	20	20	20	100	70	70	70	80	80	80	80	390
29	Treatment of loans forgiven for solvent farmers	......	......	......	......	......	......	......	......	10	10	10	10	10	10	10	50
30	Capital gains treatment of certain income	......	......	......	......	......	......	......	......	1,050	1,100	1,160	1,220	1,280	1,350	1,420	6,430
31	Income averaging for farmers	......	......	......	......	......	......	......	......	70	80	80	80	80	90	90	420
32	Deferral of gain on sale of farm refiners	10	10	10	10	20	20	20	80	......	......	......	......	......	......	......	......
	Commerce and Housing																
	Financial institutions and insurance:																
33	Exemption of credit union income	1,300	1,360	1,430	1,500	1,570	1,650	1,730	7,880	......	......	......	......	......	......	......	......
34	Excess bad debt reserves of financial institutions	40	30	20	20	10	......	......	50	......	......	......	......	......	......	......	......
35	Exclusion of interest on life insurance savings	2,090	2,250	2,410	2,590	2,780	2,980	3,200	13,960	16,810	18,250	19,720	21,420	23,270	25,280	27,460	117,150
36	Special alternative tax on small property and casualty insurance companies	120	120	130	130	140	140	140	680	......	......	......	......	......	......	......	......
37	Tax exemption of certain insurance companies owned by tax-exempt organizations	190	210	220	240	250	260	280	1,250	......	......	......	......	......	......	......	......
38	Small life insurance company deduction	90	90	90	90	90	90	90	450	......	......	......	......	......	......	......	......
	Housing:																
39	Exclusion of interest on owner-occupied mortgage subsidy bonds	200	200	210	220	220	230	240	1,120	710	790	870	930	980	1,050	1,080	4,910
40	Exclusion of interest on rental housing bonds	60	60	70	70	70	70	70	350	220	250	280	300	310	330	340	1,560
41	Deductibility of mortgage interest on owner-occupied homes	......	......	......	......	......	......	......	......	61,160	62,590	69,740	74,800	78,420	83,030	87,920	393,910

Table 18–2. ESTIMATES OF TAX EXPENDITURES FOR THE CORPORATE AND INDIVIDUAL INCOME TAXES—Continued

(in millions of dollars)

		Corporations								Individuals							
		2003	2004	2005	2006	2007	2008	2009	2005–09	2003	2004	2005	2006	2007	2008	2009	2005–09
42	Deductibility of State and local property tax on owner-occupied homes									22,090	21,740	19,410	16,110	14,580	13,640	13,110	76,850
43	Deferral of income from post 1987 installment sales	280	290	290	300	300	310	310	1,510	800	810	830	840	860	880	890	4,300
44	Capital gains exclusion on home sales									20,260	20,860	21,490	22,140	22,800	23,480	24,190	114,100
45	Exception from passive loss rules for $25,000 of rental loss									5,710	4,570	4,390	4,210	4,020	3,840	3,660	20,120
46	Credit for low-income housing investments	3,450	3,640	3,810	3,990	4,150	4,350	4,560	20,860	2,760	2,910	3,050	3,190	3,320	3,480	3,650	16,690
47	Accelerated depreciation on rental housing (normal tax method)	50	–10	–50	–110	–180	–260	–340	–940	1,170	630	–120	–1,000	–2,150	–3,300	–4,560	–11,130
	Commerce:																
48	Cancellation of indebtedness									20	30	30	30	40	40	40	180
49	Exceptions from imputed interest rules									50	50	50	50	50	50	50	250
50	Capital gains (except agriculture, timber, iron ore, and coal)[2]									25,730	27,300	30,190	32,930	36,410	48,930	29,210	177,670
51	Capital gains exclusion of small corporation stock									130	160	210	250	300	350	390	1,500
52	Step-up basis of capital gains at death									14,880	16,280	18,240	20,240	22,240	24,190	26,010	110,920
53	Carryover basis of capital gains on gifts									590	390	450	540	550	580	620	2,740
54	Ordinary income treatment of loss from small business corporation stock sale									40	50	50	50	50	50	50	250
55	Accelerated depreciation of buildings other than rental housing (normal tax method)	–2,190	–2,920	–3,740	–4,250	–6,060	–9,050	–12,360	–35,460	–100	–270	–320	–440	–750	–1,120	–2,070	–4,700
56	Accelerated depreciation of machinery and equipment (normal tax method)	40,600	38,830	–8,720	–32,980	–26,580	–23,990	–22,400	–114,670	7,920	7,970	–2,200	–4,960	–4,460	–4,780	–5,190	–21,590
57	Expensing of certain small investments (normal tax method)	420	710	1,790	680	–390	–140	–30	1,910	610	880	3,060	970	–100	110	160	4,200
58	Amortization of start-up costs (normal tax method)	100	110	120	130	140	140	140	670	10	10	10	20	20	20	20	90
59	Graduated corporation income tax rate (normal tax method)	3,030	3,090	3,910	4,650	4,800	4,890	5,040	23,290								
60	Exclusion of interest on small issue bonds	80	90	90	90	100	100	100	480	310	340	380	400	420	450	470	2,120
	Transportation																
61	Deferral of tax on shipping companies	20	20	20	20	20	20	20	100								
62	Exclusion of reimbursed employee parking expenses									2,130	2,240	2,360	2,490	2,610	2,740	2,880	13,080
63	Exclusion for employer-provided transit passes									320	380	450	520	590	660	730	2,950
	Community and Regional Development																
64	Investment credit for rehabilitation of structures (other than historic)	20	20	20	20	20	20	20	100	10	10	10	10	10	10	10	50
65	Exclusion of interest for airport, dock, and similar bonds	170	170	180	180	190	190	200	940	600	670	730	790	830	890	910	4,150
66	Exemption of certain mutuals' and cooperatives' income	60	60	70	70	70	70	70	350								
67	Empowerment zones, Enterprise communities, and Renewal communities	280	280	290	310	330	370	420	1,720	790	800	830	900	990	1,100	1,310	5,130
68	New markets tax credit	50	70	110	150	210	220	200	890	140	220	320	460	620	650	590	2,640
69	Expensing of environmental remediation costs	70	20	–10	–10	–10	–10	–10	–50	10							
	Education, Training, Employment, and Social Services																
	Education:																
70	Exclusion of scholarship and fellowship income (normal tax method)									1,260	1,260	1,340	1,400	1,410	1,420	1,420	6,990
71	HOPE tax credit									3,290	3,420	3,510	3,290	3,330	3,320	3,310	16,760
72	Lifetime Learning tax credit									1,910	2,250	2,180	2,120	2,320	2,320	2,300	11,240
73	Education Individual Retirement Accounts									70	110	140	190	240	300	370	1,240
74	Deductibility of student-loan interest									730	760	780	800	820	830	840	4,070
75	Deduction for higher education expenses									1,730	1,810	2,580	2,610				5,190
76	State prepaid tuition plans									50	150	320	430	510	590	660	2,510
77	Exclusion of interest on student-loan bonds	60	60	60	60	60	60	70	310	200	220	250	260	280	300	310	1,400
78	Exclusion of interest on bonds for private nonprofit educational facilities	170	170	180	190	190	200	200	960	610	680	750	800	840	900	930	4,220
79	Credit for holders of zone academy bonds	80	90	110	130	130	140	140	650								
80	Exclusion of interest on savings bonds redeemed to finance educational expenses									10	10	10	10	20	20	20	80
81	Parental personal exemption for students age 19 or over									3,140	3,130	2,550	2,000	1,760	1,580	1,430	9,320
82	Deductibility of charitable contributions (education)	490	510	540	560	590	620	660	2,970	3,180	2,880	3,120	3,440	3,640	3,890	4,170	18,260
83	Exclusion of employer-provided educational assistance									500	530	560	590	620	660	690	3,120
84	Special deduction for teacher expenses									140	140						

Table 18–2. ESTIMATES OF TAX EXPENDITURES FOR THE CORPORATE AND INDIVIDUAL INCOME TAXES—Continued
(in millions of dollars)

		Corporations								Individuals							
		2003	2004	2005	2006	2007	2008	2009	2005–09	2003	2004	2005	2006	2007	2008	2009	2005–09
	Training, employment, and social services:																
85	Work opportunity tax credit	370	310	140	60	20	......	......	220	60	60	30	10	10	......	......	50
86	Welfare-to-work tax credit	50	50	30	20	10	......	......	60	10	10	10	10	10	......	......	30
87	Employer provided child care exclusion	......	......	......	......	......	......	......	......	590	620	770	870	920	960	1,010	4,530
88	Employer-provided child care credit	......	......	......	......	......	......	......	......	90	130	140	150	160	170	180	800
89	Assistance for adopted foster children	......	......	......	......	......	......	......	......	250	290	330	380	430	480	540	2,160
90	Adoption credit and exclusion	......	......	......	......	......	......	......	......	220	450	500	540	560	570	580	2,750
91	Exclusion of employee meals and lodging (other than military)	......	......	......	......	......	......	......	......	780	810	850	890	930	970	1,000	4,640
92	Child credit[3]	......	......	......	......	......	......	......	......	37,970	24,340	29,860	24,810	24,680	24,480	25,430	129,260
93	Credit for child and dependent care expenses	......	......	......	......	......	......	......	......	2,720	2,950	2,690	2,210	2,030	1,900	1,780	10,610
94	Credit for disabled access expenditures	10	10	20	20	20	20	20	100	40	40	40	40	40	40	40	200
95	Deductibility of charitable contributions, other than education and health	1,110	1,170	1,230	1,290	1,360	1,430	1,500	6,810	28,910	26,200	28,440	31,260	33,140	35,360	37,910	166,110
96	Exclusion of certain foster care payments	......	......	......	......	......	......	......	......	430	430	440	450	460	470	570	2,390
97	Exclusion of parsonage allowances	......	......	......	......	......	......	......	......	380	400	420	450	480	510	540	2,400
	Health																
98	Exclusion of employer contributions for medical insurance premiums and medical care	......	......	......	......	......	......	......	......	101,920	106,720	112,990	120,940	129,820	139,620	150,300	653,670
99	Deductibility of self-employed medical insurance premiums	......	......	......	......	......	......	......	......	2,550	3,740	3,780	4,090	4,370	4,750	5,150	22,140
100	Medical Savings Accounts/Health Savings Accounts	......	......	......	......	......	......	......	......	–30	–140	–570	–960	–1,380	–1,920	–2,180	–7,010
101	Deductibility of medical expenses	......	......	......	......	......	......	......	......	6,240	6,880	7,900	8,480	9,180	10,200	10,990	46,750
102	Exclusion of interest on hospital construction bonds	350	360	370	390	400	410	420	1,990	1,270	1,420	1,560	1,670	1,760	1,880	1,940	8,810
103	Deductibility of charitable contributions (health)	140	150	160	160	170	180	190	860	3,250	2,940	3,190	3,510	3,720	3,970	4,260	18,650
104	Tax credit for orphan drug research	160	180	200	220	250	280	310	1,260	......	......	......	......	......	......	......	......
105	Special Blue Cross/Blue Shield deduction	350	320	310	280	310	260	290	1,450	......	......	......	......	......	......	......	......
106	Tax credit for health insurance purchased by certain displaced and retired individuals[4]	......	......	......	......	......	......	......	......	......	50	60	60	70	70	80	340
	Income Security																
107	Exclusion of railroad retirement system benefits	......	......	......	......	......	......	......	......	400	400	400	400	400	400	400	2,000
108	Exclusion of workers' compensation benefits	......	......	......	......	......	......	......	......	6,100	6,460	6,850	7,270	7,710	8,190	8,690	38,710
109	Exclusion of public assistance benefits (normal tax method)	......	......	......	......	......	......	......	......	400	410	430	450	470	490	510	2,350
110	Exclusion of special benefits for disabled coal miners	......	......	......	......	......	......	......	......	60	60	50	50	50	40	40	230
111	Exclusion of military disability pensions	......	......	......	......	......	......	......	......	100	110	110	110	110	120	120	570
	Net exclusion of pension contributions and earnings:																
112	Employer plans	......	......	......	......	......	......	......	......	59,480	59,380	61,740	66,340	62,650	58,360	60,440	309,530
113	401(k) plans	......	......	......	......	......	......	......	......	51,560	56,740	58,910	61,340	65,750	71080	75440	332,520
114	Individual Retirement Accounts	......	......	......	......	......	......	......	......	20,060	19,810	20,090	20,610	20,150	19,710	19,490	100,050
115	Low and moderate income savers credit	......	......	......	......	......	......	......	......	880	960	1,100	1,210	730	......	......	3,040
116	Keogh plans	......	......	......	......	......	......	......	......	6,020	8,730	9,260	9,860	10,530	11,480	12,500	53,630
	Exclusion of other employee benefits:																
117	Premiums on group term life insurance	1,800	1,830	1,860	1,890	1,920	1,950	1,990	9,610	......	......	......	......	......	......	......	......
118	Premiums on accident and disability insurance	......	......	......	......	......	......	......	......	230	240	250	260	270	280	290	1,350
119	Small business retirement plan credit	20	40	50	70	70	80	80	350	20	40	50	60	70	70	70	320
120	Income of trusts to finance supplementary unemployment benefits	......	......	......	......	......	......	......	......	30	30	30	30	30	30	30	......
121	Special ESOP rules	1460	1570	1690	1820	1970	2120	2280	9,880	320	350	370	400	430	460	500	2,160
122	Additional deduction for the blind	......	......	......	......	......	......	......	......	40	30	40	40	40	40	40	200
123	Additional deduction for the elderly	......	......	......	......	......	......	......	......	1,840	1,710	1,800	1,900	1,960	1,920	1,940	9,520
124	Tax credit for the elderly and disabled	......	......	......	......	......	......	......	......	20	10	10	10	10	10	10	50
125	Deductibility of casualty losses	......	......	......	......	......	......	......	......	500	690	670	680	640	600	630	3,220
126	Earned income tax credit[5]	......	......	......	......	......	......	......	......	5,099	4,884	5,006	5,477	5,515	5,603	5,780	27,381
	Social Security																
	Exclusion of social security benefits:																
127	Social Security benefits for retired workers	......	......	......	......	......	......	......	......	18,600	19,620	19,040	19,370	20,390	19,710	19,910	98,420
128	Social Security benefits for disabled	......	......	......	......	......	......	......	......	3,230	3,570	3,720	3,840	4,080	4,280	4,500	20,420
129	Social Security benefits for dependents and survivors	......	......	......	......	......	......	......	......	4,060	4,380	4,310	4,160	4,190	4,030	4,040	20,730
	Veterans Benefits and Services																
130	Exclusion of veterans death benefits and disability compensation	......	......	......	......	......	......	......	......	3,320	3,330	3,600	3,930	4,170	4,300	4,560	20,560
131	Exclusion of veterans pensions	......	......	......	......	......	......	......	......	100	100	100	110	110	110	120	550
132	Exclusion of GI bill benefits	......	......	......	......	......	......	......	......	110	120	130	130	160	170	170	760
133	Exclusion of interest on veterans housing bonds	10	10	10	10	10	10	10	50	30	40	40	40	50	50	50	230

Table 18–2. ESTIMATES OF TAX EXPENDITURES FOR THE CORPORATE AND INDIVIDUAL INCOME TAXES—Continued

(in millions of dollars)

		Corporations								Individuals							
		2003	2004	2005	2006	2007	2008	2009	2005–09	2003	2004	2005	2006	2007	2008	2009	2005–09
	General Purpose Fiscal Assistance																
134	Exclusion of interest on public purpose State and local bonds	5,710	5,880	6,060	6,240	6,420	6,620	6,820	32,160	19,770	20,100	20,310	20,200	19,730	20,320	20,930	101,490
135	Deductibility of nonbusiness State and local taxes other than on owner-occupied homes									49,770	49,470	46,180	39,100	35,930	34,710	34,370	190,290
136	Tax credit for corporations receiving income from doing business in U.S. possessions	1,200	1,150	1,100	800				1,900								
	Interest																
137	Deferral of interest on U.S. savings bonds									30	40	40	40	40	40	50	210
	Addendum: Aid to State and local governments:																
	Deductibility of:																
	Property taxes on owner-occupied homes									22,090	21,740	19,410	16,110	14,580	13,640	13,110	76,850
	Nonbusiness State and local taxes other than on owner-occupied homes									49,770	49,470	46,180	39,100	35,930	34,710	34,370	190,290
	Exclusion of interest on State and local bonds for:																
	Public purposes	5,710	5,880	6,060	6,240	6,420	6,620	6,820	32,160	19,770	20,100	20,310	20,200	19,730	20,320	20,930	101,490
	Energy facilities	20	20	20	20	20	20	20	100	70	80	90	90	100	110	110	500
	Water, sewage, and hazardous waste disposal facilities	100	100	100	110	110	110	120	550	350	390	430	460	480	520	530	2,420
	Small-issues	80	90	90	90	100	100	100	480	310	340	380	400	420	450	470	2,120
	Owner-occupied mortgage subsidies	200	200	210	220	220	230	240	1,120	710	790	870	930	980	1,050	1,080	4,910
	Rental housing	60	60	70	70	70	70	70	350	220	250	280	300	310	330	340	1,560
	Airports, docks, and similar facilities	170	170	180	180	190	190	200	940	600	670	730	790	830	890	910	4,150
	Student loans	60	60	60	60	60	60	70	310	200	220	250	260	280	300	310	1,400
	Private nonprofit educational facilities	170	170	180	190	190	200	200	960	610	680	750	800	840	900	930	4,220
	Hospital construction	350	360	370	390	400	410	420	1,990	1,270	1,420	1,560	1,670	1,760	1,880	1,940	8,810
	Veterans' housing	10	10	10	10	10	10	10	50	30	40	40	40	50	50	50	230
	Credit for holders of zone academy bonds	80	90	110	130	130	140	140	650								

[1] In addition, the partial exemption from the excise tax for alcohol fuels results in a reduction in excise tax receipts (in millions of dollars) as follows: 2003 $1,100; 2004 $1,260; 2005 $1,370; 2006 $1,430; 2007 $1,470; 2008 $1,510; and 2009 $1,550.

[2] If corporate equity were to be included, the revenue loss estimates would be $48,540 in 2003, $51,510 in 2004, $56,970 in 2005, $62,140 in 2006, $68,690 in 2007, $92,320 in 2008, and $55,110 in 2009. Similarly, if the reduced tax rate on dividends were to be included, the revenue loss estimates would be $1,810 in 2003, $16,720 in 2004, $13,280 in 2005, $13,880 in 2006, $14,480 in 2007, $15,970 in 2008, and $8,540 in 2009.

[3] The figures in the table indicate the effect of the child tax credit on receipts. The effect of the credit on outlays (in millions of dollars) is as follows: 2003 $6,435; 2004 $7,447; 2005 $11,486; 2006 $8,440; 2007 $8,237; 2008 $7,956; and 2009 $7,909

[4] In addition to the receipts shown outlays of $60 million in 2004, $90 million in 2005, $100 million in 2006, $120 million in 2007, $130 million in 2008, and $140 million in 2009 are projected.

[5] The figures in the table indicate the effect of the earned income tax credit on receipts. The effect of the credit on outlays (in millions of dollars) is as follows: 2003 $31,961; 2004 $33,551; 2005 $34,148; 2006 $34,488; 2007 $34,338; 2008 $34,359; and 2009 $35,161.

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 $10 million. Provisions with estimates that rounded to zero in each year are not included in the table.

Table 18–3. INCOME TAX EXPENDITURES RANKED BY TOTAL 2005–2009 PROJECTED REVENUE EFFECT

(in millions of dollars)

Provision	2005	2005–2009
Exclusion of employer contributions for medical insurance premiums and medical care	112,990	653,670
Deductibility of mortgage interest on owner-occupied homes	69,740	393,910
Net exclusion of pension contributions and earnings: 401(k) plans	58,910	332,520
Net exclusion of pension contributions and earnings: Employer plans	61,740	309,530
Deductibility of nonbusiness state and local taxes other than on owner-occupied homes	46,180	190,290
Capital gains (except agriculture, timber, iron ore, and coal)	30,190	177,670
Deductibility of charitable contributions, other than education and health	29,670	172,920
Exclusion of interest on public purpose State and local bonds	26,370	133,650
Exclusion of interest on life insurance savings	22,130	131,110
Child credit	29,860	129,260
Capital gains exclusion on home sales	21,490	114,100
Step-up basis of capital gains at death	18,240	110,920
Net exclusion of pension contributions and earnings: Individual Retirement Accounts	20,090	100,050
Social Security benefits for retired workers	19,040	98,420
Deductibility of State and local property tax on owner-occupied homes	19,410	76,850
Net exclusion of pension contributions and earnings: Keough Plans	9,260	53,630
Deferral of income from controlled foreign corporations (normal tax method)	8,400	48,010
Deductibility of medical expenses	7,900	46,750
Exclusion of workers' compensation benefits	6,850	38,710
Credit for low-income housing investments	6,860	37,550
Extraterritorial income exclusion	5,890	33,810
Expensing of research and experimentation expenditures (normal tax method)	4,500	31,830
Earned income tax credit	5,006	27,381
Graduated corporation income tax rate (normal tax method)	3,910	23,290
Deductibility of self-employed medical insurance premiums	3,780	22,140
Social Security benefits for dependents and survivors	4,310	20,730
Deductibility of charitable contributions (education)	3,660	21,230
Exclusion of veterans death benefits and disability compensation	3,600	20,560
Social Security benefits for disabled	3,720	20,420
Exception from passive loss rules for $25,000 of rental loss	4,390	20,120
Deductibility of charitable contributions (health)	3,350	19,510
HOPE tax credit	3,510	16,760
Exclusion of income earned abroad by U.S. citizens	2,750	14,870
Exclusion of reimbursed employee parking expenses	2,360	13,080
Special ESOP rules	2,060	12,040
Exclusion of benefits and allowances to armed forces personnel	2,260	11,540
Lifetime Learning tax credit	2,180	11,240
Exclusion of interest on hospital construction bonds	1,930	10,800
Credit for child and dependent care expenses	2,690	10,610
Premiums on group term life insurance	1,860	9,610
Additional deduction for the elderly	1,800	9,520
Inventory property sales source rules exception	1,700	9,430
Parental personal exemption for students age 19 or over	2,550	9,320
Exemption of credit union income	1,430	7,880
Exclusion of scholarship and fellowship income (normal tax method)	1,340	6,990
Empowerment zones, Enterprise communities, and Renewal communities	1,120	6,850
Capital gains treatment of certain income	1,160	6,430
Expensing of certain small investments (normal tax method)	4,850	6,110
Exclusion of interest on owner-occupied mortgage subsidy bonds	1,080	6,030
Deferral of income from post 1987 installment sales	1,120	5,810
Deferred taxes for financial firms on certain income earned overseas	2,190	5,410
Deduction for higher education expenses	2,580	5,190
Exclusion of interest on bonds for private nonprofit educational facilities	930	5,180
Exclusion of interest for airport, dock, and similar bonds	910	5,090
Exclusion of employee meals and lodging (other than military)	850	4,640
Exclusion of certain allowances for Federal employees abroad	840	4,610
Employer provided child care exclusion	770	4,530
Credit for increasing research activities	2,550	4,310
Deductibility of student-loan interest	780	4,070
New markets tax credit	430	3,530
Deductibility of casualty losses	670	3,220
Exclusion of employer-provided educational assistance	560	3,120
Low and moderate income savers credit	1,100	3,040
Alternative fuel production credit	890	3,020
Excess of percentage over cost depletion, fuels	580	3,000
Exclusion of interest on bonds for water, sewage, and hazardous waste facilities	530	2,970
Exclusion for employer-provided transit passes	450	2,950
Adoption credit and exclusion	500	2,750
Carryover basis of capital gains on gifts	450	2,740

Table 18–3. INCOME TAX EXPENDITURES RANKED BY TOTAL 2005–2009 PROJECTED REVENUE EFFECT—Continued

(in millions of dollars)

Provision	2005	2005–2009
Exclusion of interest on small issue bonds	470	2,600
State prepaid tuition plans	320	2,510
Exclusion of parsonage allowances	420	2,400
Exclusion of certain foster care payments	440	2,390
Exclusion of public assistance benefits (normal tax method)	430	2,350
Assistance for adopted foster children	330	2,160
Enhanced oil recovery credit	410	2,150
Exclusion of railroad retirement system benefits	400	2,000
Expensing of multiperiod timber growing costs	350	1,910
Exclusion of interest on rental housing bonds	350	1,910
Tax credit for corporations receiving income from doing business in U.S. possessions	1,100	1,900
New technology credit	370	1,850
Exclusion of interest on student-loan bonds	310	1,710
Tax incentives for preservation of historic structures	300	1,660
Capital gains exclusion of small corporation stock	210	1,500
Special Blue Cross/Blue Shield deduction	310	1,450
Excess of percentage over cost depletion, nonfuel minerals	260	1,350
Premiums on accident and disability insurance	250	1,350
Tax credit for orphan drug research	200	1,260
Tax exemption of certain insurance companies owned by tax-exempt organizations	220	1,250
Education Individual Retirement Accounts	140	1,240
Employer-provided child care credit	140	800
Exclusion of GI bill benefits	130	760
Amortization of start-up costs (normal tax method)	130	760
Expensing of certain capital outlays	130	710
Special alternative tax on small property and casualty insurance companies	130	680
Small business retirement plan credit	100	670
Credit for holders of zone academy bonds	110	650
Capital gains treatment of royalties on coal	120	640
Capital gains treatment of certain timber income	120	640
Exclusion of interest on energy facility bonds	110	600
Exclusion of military disability pensions	110	570
Exclusion of veterans pensions	100	550
Expensing of certain multiperiod production costs	90	490
Small life insurance company deduction	90	450
Income averaging for farmers	80	420
Expensing of exploration and development costs, fuels	170	420
Exclusion from income of conservation subsidies provided by public utilities	80	400
Exemption of certain mutuals' and cooperatives' income	70	350
Tax credit for health insurance purchased by certain displaced and retired individuals	60	340
Credit for disabled access expenditures	60	300
Exclusion of interest on veterans housing bonds	50	280
Work opportunity tax credit	170	270
Exceptions from imputed interest rules	50	250
Ordinary income treatment of loss from small business corporation stock sale	50	250
Exclusion of special benefits for disabled coal miners	50	230
Deferral of interest on U.S. savings bonds	40	210
Additional deduction for the blind	40	200
Cancellation of indebtedness	30	180
Alcohol fuel credits [1]	30	150
Investment credit for rehabilitation of structures (other than historic)	30	150
Deferral of tax on shipping companies	20	100
Exception from passive loss limitation for working interests in oil and gas properties	20	100
Welfare-to-work tax credit	40	90
Exclusion of interest on savings bonds redeemed to finance educational expenses	10	80
Deferral of gain on sale of farm refiners	10	80
Expensing of exploration and development costs, nonfuel minerals	10	50
Tax credit for the elderly and disabled	10	50
Treatment of loans forgiven for solvent farmers	10	50
Income of trusts to finance supplementary unemployment benefits	30	....
Expensing of environmental remediation costs	–10	–50
Tax credit and deduction for clean-fuel burning vehicles	10	–210
Medical Savings Accounts	–570	–7,010
Accelerated depreciation on rental housing (normal tax method)	–170	–12,070
Accelerated depreciation of buildings other than rental housing (normal tax method)	–4,060	–40,160
Accelerated depreciation of machinery and equipment (normal tax method)	–10,920	–136,260

Table 18–4. PRESENT VALUE OF SELECTED TAX EXPENDITURES FOR ACTIVITY IN CALENDAR YEAR 2003

(in millions of dollars)

	Provision	Present Value of Revenue Loss
1	Deferral of income from controlled foreign corporations (normal tax method)	7,630
2	Deferred taxes for financial firms on income earned overseas	2,080
3	Expensing of research and experimentation expenditures (normal tax method)	2,000
4	Expensing of exploration and development costs—fuels	120
5	Expensing of multiperiod timber growing costs	200
6	Expensing of certain multiperiod production costs—agriculture	170
7	Expensing of certain capital outlays—agriculture	200
8	Deferral of income on life insurance and annuity contracts	25,060
9	Expensing of certain small investments (normal tax method)	690
10	Amortization of start-up costs (normal tax method)	70
11	Deferral of tax on shipping companies	20
12	Credit for holders of zone academy bonds	110
13	Credit for low-income housing investments	3,470
14	Deferral for state prepaid tuition plans	1,510
15	Exclusion of pension contributions—employer plans	102,470
16	Exclusion of 401(k) contributions	81,610
17	Exclusion of IRA contributions and earnings	11,030
18	Exclusion of contributions and earnings for Keogh plans	9,530
19	Exclusion of interest on public-purpose bonds	19,440
20	Exclusion of interest on non-public purpose bonds	6,120
21	Deferral of interest on U.S. savings bonds	440

Outlay Equivalents

The concept of “outlay equivalents” is another theoretical measure of the budget effect of tax expenditures. It is the amount of budget outlays that would be required to provide the taxpayer the same after-tax income as would be received through the tax provision. The outlay-equivalent measure allows the cost of a tax expenditure to be compared with a direct Federal outlay on a more even footing. Outlay equivalents are reported in Table 18–5.

Table 18–5. OUTLAY EQUVALENT ESTIMATES FOR TAX EXPENDITURES

(in millions of dollars)

		2003	2004	2005	2006	2007	2008	2009	2005–09
	National Defense								
1	Exclusion of benefits and allowances to armed forces personnel	2,570	2,600	2,620	2,650	2,680	2,710	2,740	13,400
	International Affairs								
2	Exclusion of income earned abroad by U.S. citizens	3,470	3,530	3,640	3,700	3,880	4,100	4,320	19,640
3	Exclusion of certain allowances for Federal employees abroad	980	1,030	1,070	1,120	1,180	1,230	1,290	5,890
4	Extraterritorial income exclusion	7,920	8,480	9,060	9,680	10,350	11,080	11,850	52,020
5	Inventory property sales source rules exception	2,370	2,490	2,620	2,750	2,890	3,050	3,200	14,510
6	Deferral of income from controlled foreign corporations (normal tax method)	7,450	7,900	8,400	8,930	9,550	10,210	10,920	48,010
7	Deferred taxes for financial firms on certain income earned overseas	2,050	2,130	2,190	2,260	960	....	....	5,410
	General Science, Space, and Technology								
8	Expensing of research and experimentation expenditures (normal tax method)	–1,980	–2,350	4,500	8,290	7,110	6,360	5,570	31,830
9	Credit for increasing research activities	7,620	6,760	3,930	1,680	700	230	90	6,630
	Energy								
10	Expensing of exploration and development costs, fuels	230	290	190	80	70	70	50	460
11	Excess of percentage over cost depletion, fuels	910	780	760	810	820	810	820	4,020
12	Alternative fuel production credit	1,720	1,190	1,190	1,190	1,190	470	....	4,040
13	Exception from passive loss limitation for working interests in oil and gas properties	20	20	20	20	20	20	20	100
14	Capital gains treatment of royalties on coal	140	150	150	160	170	180	190	850
15	Exclusion of interest on energy facility bonds	130	150	160	160	170	190	190	870
16	Enhanced oil recovery credit	620	630	650	660	680	700	720	3,410
17	New technology credit	380	470	490	490	490	500	500	2,470
18	Alcohol fuel credits [1]	30	30	30	30	30	30	30	150
19	Tax credit and deduction for clean-fuel burning vehicles	90	80	20	–30	–90	–90	–100	–290
20	Exclusion from income of conservation subsidies provided by public utilities	110	110	110	110	100	100	100	520
	Natural Resources and Environment								
21	Expensing of exploration and development costs, nonfuel minerals	10	10	10	10	10	10	10	50
22	Excess of percentage over cost depletion, nonfuel minerals	320	330	330	360	370	370	390	1,820
23	Exclusion of interest on bonds for water, sewage, and hazardous waste facilities	650	700	760	820	850	900	940	4,270

Table 18–5. OUTLAY EQUVALENT ESTIMATES FOR TAX EXPENDITURES—Continued

(in millions of dollars)

		2003	2004	2005	2006	2007	2008	2009	2005–09
24	Capital gains treatment of certain timber income	140	150	150	160	170	180	190	850
25	Expensing of multiperiod timber growing costs	450	450	460	470	490	520	530	2,470
26	Tax incentives for preservation of historic structures	270	290	300	320	330	340	370	1,660
	Agriculture								
27	Expensing of certain capital outlays	150	160	160	160	170	180	190	860
28	Expensing of certain multiperiod production costs	110	110	110	110	110	120	110	560
29	Treatment of loans forgiven for solvent farmers	10	10	10	10	10	10	10	50
30	Capital gains treatment of certain income	1,400	1,470	1,550	1,630	1,710	1,800	1,890	8,580
31	Income averaging for farmers	90	90	90	100	100	100	110	500
32	Deferral of gain on sale of farm refiners	10	20	20	20	20	20	20	100
	Commerce and Housing								
	Financial institutions and insurance:								
33	Exemption of credit union income	1,650	1,730	1,820	1,910	2,000	2,100	2,210	10,040
34	Excess bad debt reserves of financial institutions	50	38	25	25	13	....	....	63
35	Exclusion of interest on life insurance savings	22,000	23,840	25,730	27,920	30,290	32,860	35,650	152,450
36	Special alternative tax on small property and casualty insurance companies	170	170	180	180	200	200	200	960
37	Tax exemption of certain insurance companies owned by tax-exempt organizations	270	300	310	340	350	370	390	1,760
38	Small life insurance company deduction	120	120	120	120	120	120	120	600
	Housing:								
39	Exclusion of interest on owner-occupied mortgage subsidy bonds	1,310	1,420	1,550	1,660	1,730	1,840	1,890	8,670
40	Exclusion of interest on rental housing bonds	400	440	510	530	550	580	590	2,760
41	Deductibility of mortgage interest on owner-occupied homes	61,160	62,590	69,740	74,800	78,420	83,030	87,920	393,910
42	Deductibility of State and local property tax on owner-occupied homes	22,090	21,740	19,410	16,110	14,580	13,640	13,110	76,850
43	Deferral of income from post 1987 installment sales	1,060	1,080	1,100	1,120	1,140	1,170	1,190	5,720
44	Capital gains exclusion on home sales	26,570	27,367	28,188	29,034	29,905	30,802	31,726	149,655
45	Exception from passive loss rules for $25,000 of rental loss	5,710	4,570	4,390	4,210	4,020	3,840	3,660	20,120
46	Credit for low-income housing investments	4,670	4,920	5,160	5,390	5,620	5,880	6,170	28,220
47	Accelerated depreciation on rental housing (normal tax method)	1,220	620	–170	–1,110	–2,330	–3,560	–4,900	–12,070
	Commerce:								
48	Cancellation of indebtedness	20	30	30	30	40	40	40	180
49	Exceptions from imputed interest rules	50	50	50	50	50	50	50	250
50	Capital gains (except agriculture, timber, iron ore, and coal)	34,310	36,400	40,260	43,910	48,540	65,240	38,950	236,900
51	Capital gains exclusion of small corporation stock	170	220	270	340	400	460	530	2,000
52	Step-up basis of capital gains at death	19,840	21,710	24,320	26,990	29,650	32,260	34,680	147,900
53	Carryover basis of capital gains on gifts	590	390	450	540	550	580	620	2,740
54	Ordinary income treatment of loss from small business corporation stock sale	50	60	60	60	60	60	60	300
55	Accelerated depreciation of buildings other than rental housing (normal tax method)	–2,290	–3,190	–4,060	–4,690	–6,810	–10,170	–14,430	–40,160
56	Accelerated depreciation of machinery and equipment (normal tax method)	48,520	46,800	–10,920	–37,940	–31,040	–28,770	–27,590	–136,260
57	Expensing of certain small investments (normal tax method)	1,030	1,590	4,850	1,650	–490	–30	130	6,110
58	Amortization of start-up costs (normal tax method)	110	120	130	150	160	160	160	760
59	Graduated corporation income tax rate (normal tax method)	4,670	4,760	6,020	7,150	7,390	7,520	7,760	35,840
60	Exclusion of interest on small issue bonds	560	610	670	700	750	790	820	3,730
	Transportation								
61	Deferral of tax on shipping companies	20	20	20	20	20	20	20	100
62	Exclusion of reimbursed employee parking expenses	2,750	2,900	3,050	3,210	3,370	3,540	3,710	16,880
63	Exclusion for employer-provided transit passes	400	480	560	650	740	820	910	3,680
	Community and Regional Development								
64	Investment credit for rehabilitation of structures (other than historic)	30	30	30	30	30	30	30	150
65	Exclusion of interest for airport, dock, and similar bonds	1,110	1,210	1,310	1,390	1,460	1,550	1,600	7,310
66	Exemption of certain mutuals' and cooperatives' income	70	80	80	80	80	80	90	410
67	Empowerment zones, Enterprise communities, and Renewal communities	1,070	1,080	1,120	1,210	1,320	1,470	1,730	6,850
68	New markets tax credit	190	290	430	610	830	870	790	3,530
69	Expensing of environmental remediation costs	110	40	–20	–10	–10	–10	–10	–60
	Education, Training, Employment, and Social Services								
	Education:								
70	Exclusion of scholarship and fellowship income (normal tax method)	1,390	1,380	1,480	1,540	1,550	1,560	1,560	7,690
71	HOPE tax credit	4,210	4,390	4,500	4,210	4,270	4,250	4,250	21,480
72	Lifetime Learning tax credit	2,440	2,890	2,800	2,720	2,970	2,970	2,950	14,410
73	Education Individual Retirement Accounts	90	130	180	240	310	390	470	1,590
74	Deductibility of student-loan interest	870	900	930	960	980	990	990	4,850
75	Deduction for higher education expenses	2,210	2,320	3,310	3,340	....	....	....	6,650
76	State prepaid tuition plans	50	150	320	430	510	590	660	2,510
77	Exclusion of interest on student-loan bonds	370	400	440	460	490	510	550	2,450
78	Exclusion of interest on bonds for private nonprofit educational facilities	1,120	1,220	1,340	1,420	1,480	1,580	1,630	7,450
79	Credit for holders of zone academy bonds	110	130	160	180	190	200	200	930
80	Exclusion of interest on savings bonds redeemed to finance educational expenses	20	20	20	20	20	20	20	100
81	Parental personal exemption for students age 19 or over	3,480	3,470	2,820	2,220	1,950	1,750	1,580	10,320

Table 18–5. OUTLAY EQUVALENT ESTIMATES FOR TAX EXPENDITURES—Continued

(in millions of dollars)

		2003	2004	2005	2006	2007	2008	2009	2005–09
82	Deductibility of charitable contributions (education)	3,670	3,390	3,660	4,000	4,230	4,510	4,830	21,230
83	Exclusion of employer-provided educational assistance	620	660	690	730	770	810	860	3,860
84	Special deduction for teacher expenses	180	170	....	....	....	....	....	....
	Training, employment, and social services:								
85	Work opportunity tax credit	430	370	170	70	30	....	....	270
86	Welfare-to-work tax credit	60	60	40	30	20	....	....	90
87	Employer provided child care exclusion	790	830	1,030	1,160	1,230	1,280	1,350	6,050
88	Employer-provided child care credit	120	170	190	200	220	230	240	1,080
89	Assistance for adopted foster children	280	330	370	420	480	540	610	2,420
90	Adoption credit and exclusion	280	570	640	690	710	730	750	3,520
91	Exclusion of employee meals and lodging (other than military)	950	990	1,030	1,080	1,130	1,180	1,210	5,630
92	Child credit [2]	50,520	25,950	39,010	32,280	31,960	31,450	31,450	166,150
93	Credit for child and dependent care expenses	3,630	3,930	3,590	2,950	2,710	2,530	2,370	14,150
94	Credit for disabled access expenditures	70	70	70	70	70	80	80	370
95	Deductibility of charitable contributions, other than education and health	30,020	27,370	29,670	32,550	34,500	36,790	39,410	172,920
96	Exclusion of certain foster care payments	490	500	510	520	530	540	650	2,750
97	Exclusion of parsonage allowances	460	490	520	550	580	620	660	2,930
	Health								
98	Exclusion of employer contributions for medical insurance premiums and medical care	129,010	133,400	141,590	151,940	163,510	176,320	190,300	823,660
99	Deductibility of self-employed medical insurance premiums	3,170	4,640	4,610	4,990	5,310	5,770	6,250	26,930
100	Medical Savings Accounts/Health Savings Accounts	–40	–180	–730	–1,230	–1,780	–2,460	–2,800	–9,000
101	Deductibility of medical expenses	6,700	7,400	8,540	9,170	9,930	11,060	11,930	50,630
102	Exclusion of interest on hospital construction bonds	2,330	2,560	2,770	2,960	3,110	3,290	3,390	15,520
103	Deductibility of charitable contributions (health)	3,390	3,090	3,350	3,670	3,890	4,150	4,450	19,510
104	Tax credit for orphan drug research	240	270	300	330	370	420	470	1,890
105	Special Blue Cross/Blue Shield deduction	440	400	390	350	390	330	360	1,820
106	Tax credit for health insurance purchased by certain displaced and retired individuals [3]	....	60	80	80	90	90	100	440
	Income Security								
107	Exclusion of railroad retirement system benefits	400	400	400	400	400	400	400	2,000
108	Exclusion of workers' compensation benefits	6,100	6,460	6,850	7,270	7,710	8,190	8,690	38,710
109	Exclusion of public assistance benefits (normal tax method)	400	410	430	450	470	490	510	2,350
110	Exclusion of special benefits for disabled coal miners	60	60	50	50	50	40	40	230
111	Exclusion of military disability pensions	100	110	110	110	110	120	120	570
	Net exclusion of pension contributions and earnings:								
112	Employer plans	72980	72410	75290	80900	76400	71170	73710	377,470
113	401(k) plans	63260	69200	71840	74800	80180	86680	92000	405,500
114	Individual Retirement Accounts	26220	26390	26910	27530	27010	26640	26320	134,410
115	Low and moderate income savers credit	880	960	1100	1210	730	....	....	3,040
116	Keogh plans	7640	11040	11660	12360	13140	14320	15600	67,080
	Exclusion of other employee benefits:								
117	Premiums on group term life insurance	2,400	2,440	2,480	2,520	2,560	2,600	2,650	12,810
118	Premiums on accident and disability insurance	310	320	330	350	360	370	390	1,800
119	Small business retirement plan credit	60	110	140	190	200	210	210	950
120	Income of trusts to finance supplementary unemployment benefits	30	30	30	30	30	30	30	150
121	Special ESOP rules	2,850	3,060	3,280	3,520	3,800	4,080	4,360	19,040
122	Additional deduction for the blind	40	40	40	40	40	40	50	210
123	Additional deduction for the elderly	2,220	2,070	2,180	2,290	2,380	2,330	2,350	11,530
124	Tax credit for the elderly and disabled	30	20	20	20	10	10	10	70
125	Deductibility of casualty losses	550	760	740	750	640	600	630	3,360
126	Earned income tax credit [4]	5,666	5,427	5,562	6,085	6,127	6,226	6,422	30,422
	Social Security								
	Exclusion of social security benefits:								
127	Social Security benefits for retired workers	18,600	19,620	19,040	19,370	20,390	19,710	19,910	98,420
128	Social Security benefits for disabled	3,230	3,570	3,720	3,840	4,080	4,280	4,500	20,420
129	Social Security benefits for dependents and survivors	4,060	4,380	4,310	4,160	4,190	4,030	4,040	20,730
	Veterans Benefits and Services								
130	Exclusion of veterans death benefits and disability compensation	3,320	3,330	3,600	3,930	4,170	4,300	4,560	20,560
131	Exclusion of veterans pensions	100	100	100	110	110	110	120	550
132	Exclusion of GI bill benefits	110	120	130	130	160	170	170	760
133	Exclusion of interest on veterans housing bonds	50	70	70	70	80	80	80	380
	General Purpose Fiscal Assistance								
134	Exclusion of interest on public purpose State and local bonds	36,550	37,270	37,830	37,920	37,490	38,620	39,770	191,630
135	Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	49,770	49,470	46,180	39,100	35,930	34,710	34,370	190,290
136	Tax credit for corporations receiving income from doing business in U.S. possessions	1,710	1,640	1,570	1,140	....	....	....	2,710
	Interest								
137	Deferral of interest on U.S. savings bonds	30	40	40	40	40	40	50	210

Table 18–5. OUTLAY EQUVALENT ESTIMATES FOR TAX EXPENDITURES—Continued

(in millions of dollars)

		2003	2004	2005	2006	2007	2008	2009	2005–09
	Addendum: Aid to State and local governments:								
	Deductibility of:								
	Property taxes on owner-occupied homes	22,090	21,740	19,410	16,110	14,580	13,640	13,110	76,850
	Nonbusiness State and local taxes other than on owner-occupied homes	49,770	49,470	46,180	39,100	35,930	34,710	34,370	190,290
	Exclusion of interest on State and local bonds for:								
	Public purposes	36,550	37,270	37,830	37,920	37,490	38,620	39,770	191,630
	Energy facilities	130	150	160	160	170	190	190	870
	Water, sewage, and hazardous waste disposal facilities	650	700	760	820	850	900	940	4,270
	Small-issues	560	610	670	700	750	790	820	3,730
	Owner-occupied mortgage subsidies	1,310	1,420	1,550	1,660	1,730	1,840	1,890	8,670
	Rental housing	400	440	510	530	550	580	590	2,760
	Airports, docks, and similar facilities	1,110	1,210	1,310	1,390	1,460	1,550	1,600	7,310
	Student loans	370	400	440	460	490	510	550	2,450
	Private nonprofit educational facilities	1,120	1,220	1,340	1,420	1,480	1,580	1,630	7,450
	Hospital construction	2,330	2,560	2,770	2,960	3,110	3,290	3,390	15,520
	Veterans' housing	50	70	70	70	80	80	80	380
	Credit for holders of zone academy bonds	110	130	160	180	190	200	200	930

[1] In addition, the partial exemption from the excise tax for alcohol fuels results in a reduction in excise tax receipts (in millions of dollars) as follows: 2002 $1,070; 2003 $1,140; 2004 $1,230; 2005 $1,320; 2006 $1,370; 2007 $1,400; and 2008 $1,430.

[2] The figures in the table indicate the effect of the child tax credit on receipts. The effect of the credit on outlays (in millions of dollars) is as follows: 2001 $980; 2002 $5,060 2003 $5,870; 2004 $5,860; 2005 $5,700; 2006 $7,630; 2007 $7,630; and 2008 $7,500

[3] In addition to the outlay equivalents shown outlays of $60 million in 2004, $90 million in 2005, $100 million in 2006, $120 million in 2007, $130 million in 2008, and $140 million in 2009 are projected.

[4] The figures in the table indicate the effect of the earned income tax credit on receipts. The effect of the credit on outlays (in millions of dollars) is as follows: 2002 $27,830; 2003 $30,610; 2004 $31,380; 2005 $32,090; 2006 $33,450; 2007 $34,480; and 2008 $35,380.

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 $10 million. Provisions with estimates that rounded to zero in each year are not included in the table.

Tax Expenditure Baselines

A tax expenditure is an exception to baseline provisions of the tax structure. The 1974 Congressional Budget Act, which mandated the tax expenditure budget, did not specify the baseline provisions of the tax law. As noted previously, deciding whether provisions are exceptions, therefore, is a matter of judgment. As in prior years, most of this year's tax expenditure estimates are presented using two baselines: the normal tax baseline and the reference tax law baseline. An exception is provided for the reduction in the tax rate on dividends and capital gains on corporate shares by the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), as dicussed below.

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 it is closer to existing law. Tax expenditures under the reference law baseline are generally tax expenditures under the normal tax baseline, but 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 only when it is 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.
- A comprehensive income tax would generally not exclude from the tax base amounts for personal exemptions or a standard deduction, except perhaps to ease tax administration.
- There generally is a separate corporate income tax.
- Values of assets and debt are not generally 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).

Although 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, by convention, 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. Again by convention, 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.[1] 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.[2]

Capital recovery. Under the reference tax law baseline no tax expenditures arise from accelerated depreciation. Under the normal tax baseline, the depreciation allowance for property is computed using estimates of economic depreciation. The latter represents a change in the calculation of the tax expenditure under normal law first made in the 2004 Budget. The Appendix provides further details on the new methodology and how it differs from the prior methodology.

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.

[1] Gross income does, however, include transfer payments associated with past employment, such as Social Security benefits.

[2] In the case 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. In addition, costs of earning income may be limited under the alternative minimum tax.

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.

Treatment of JGTRRA's Cut in the Tax Rates on Dividends and Capital Gains

Although not in line with previous reference tax law or normal tax law baselines, our tables exclude from the list of tax expenditures JGTRRA's reductions in the tax rate on dividends. Reference law used for the FY 2005 Budget includes capital gains as tax expenditure, but only to the extent capital gains have not previously been taxed under the corporate income tax. Similarly, the lower tax rate on dividends is not included as a tax expenditure under reference law because dividends have generally already been taxed under the corporate income tax. This exception was made as part of Treasury's ongoing reevaluation of the tax expenditure concept and to consider gradually changes in the baseline tax system to conform more closely with a comprehensive income tax that excludes double tax on corporate income. The same treatment is extended to the tax rate differential applied to capital gains on corporate shares, including JGTRRA's increase in this differential.

Performance Measures and the Economic Effects of Tax Expenditures

The Government Performance and Results Act of 1993 (GPRA) directs Federal agencies to develop annual and strategic plans for their programs and activities. These plans set out performance objectives to be achieved over a specific time period. Most of these objectives will be achieved through direct expenditure programs. Tax expenditures, however, may also contribute to achieving these goals. The report of the Senate Governmental Affairs Committee on GPRA[3] calls on the Executive branch to undertake a series of analyses to assess the effect of specific tax expenditures on the achievement of agencies' performance objectives.

The Executive Branch is continuing to focus on the availability of data needed to assess the effects of the tax expenditures designed to increase savings. Treasury's Office of Tax Analysis and Statistics of Income Division (IRS) have developed a new sample of individual income tax filers as one part of this effort. This new "panel" sample will follow the same taxpayers over a period of at least ten years. The first year of this panel sample was drawn from tax returns filed in 2000 for tax year 1999. The sample will capture the changing demographic and economic circumstances of individuals and the effects of changes in tax law over an extended period of time. Data from the sample will therefore permit more extensive, and better, analyses of many tax provisions than can be performed using only annual ("cross-section") data. In particular, data from this panel sample will enhance our ability to analyze the

[3] Committee on Government Affairs, United States Senate, "Government Performance and Results Act of 1993" (Report 103–58, 1993).

effect of tax expenditures designed to increase savings. Other efforts by OMB, Treasury, and other agencies to improve data available for the analysis of savings tax expenditures will continue over the next several years.

Comparison of tax expenditure, spending, and regulatory policies. Tax expenditures by definition work through the tax system and, particularly, the income tax. Thus, they may be relatively advantageous policy approaches when the benefit or incentive is related to income and is intended to be widely available.[4] Because there is an existing public administrative and private compliance structure for the tax system, the incremental administrative and compliance costs for a tax expenditure may be low in many cases. In addition, some tax expenditures actually simplify the tax system, (for example, the exclusion for up to $500,000 of capital gains on home sales). Tax expenditures also implicitly subsidize certain activities. Spending, regulatory or tax-disincentive policies can also modify behavior, but may have different economic effects. Finally, a variety of tax expenditure tools can be used—e.g., deductions; credits; exemptions; deferrals; floors; ceilings; phase-ins; phase-outs; dependent on income, expenses, or demographic characteristics (age, number of family members, etc.). This wide range means that tax expenditures can be flexible and can have very different economic effects.

Tax expenditures also have limitations. In many cases they add to the complexity of the tax system, which raises both administrative and compliance costs. For example, targeting personal exemptions and credits can complicate filing and decisionmaking. The income tax system may have little or no contact with persons who have no or very low incomes, and does not require information on certain characteristics of individuals used in some spending programs, such as wealth. These features may reduce the effectiveness of tax expenditures for addressing certain income-transfer objectives. Tax expenditures also generally do not enable the same degree of agency discretion as an outlay program. For example, grant or direct Federal service delivery programs can prioritize activities to be addressed with specific resources in a way that is difficult to emulate with tax expenditures. Finally, tax expenditures may not receive the same level of scrutiny afforded to other programs.

Outlay programs have advantages where direct Government service provision is particularly warranted—such as equipping and providing the armed forces or administering the system of justice. Outlay programs may also be specifically designed to meet the needs of low-income families who would not otherwise be subject to income taxes or need to file a tax return. Outlay programs may also receive more year-to-year oversight and fine tuning, through the legislative and executive budget process. In addition, many different types of spending programs—including direct Government provision; credit programs; and payments to State and local governments, the private sector, or individuals in the form of grants or contracts—provide flexibility for policy design. On the other hand, certain outlay programs—such as direct Government service provision—may rely less directly on economic incentives and private-market provision than tax incentives, which may reduce the relative efficiency of spending programs for some goals. Spending programs also require resources to be raised via taxes, user charges, or Government borrowing, which can impose further costs by diverting resources from their most efficient uses. Finally, spending programs, particularly on the discretionary side, may respond less readily to changing activity levels and economic conditions than tax expenditures.

Regulations have more direct and immediate effects than outlay and tax-expenditure programs because regulations apply directly and immediately to the regulated party (i.e., the intended actor)—generally in the private sector. Regulations can also be fine-tuned more quickly than tax expenditures, because they can generally be changed by the executive branch without legislation. Like tax expenditures, regulations often rely largely upon voluntary compliance, rather than detailed inspections and policing. As such, the public administrative costs tend to be modest, relative to the private resource costs associated with modifying activities. Historically, regulations have tended to rely on proscriptive measures, as opposed to economic incentives. This reliance can diminish their economic efficiency, although this feature can also promote full compliance where (as in certain safety-related cases) policymakers believe that trade-offs with economic considerations are not of paramount importance. Also, regulations generally do not directly affect Federal outlays or receipts. Thus, like tax expenditures, they may escape the type of scrutiny that outlay programs receive. However, major regulations are subjected to a formal regulatory analysis that goes well beyond the analysis required for outlays and tax-expenditures. To some extent, the GPRA requirement for performance evaluation will address this lack of formal analysis.

Some policy objectives are achieved using multiple approaches. For example, minimum wage legislation, the earned income tax credit, and the food stamp program are regulatory, tax expenditure, and direct outlay programs, respectively, all having the objective of improving the economic welfare of low-wage workers.

Tax expenditures, like spending and regulatory programs, 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 income); reducing private compliance costs and Government administrative costs (e.g., the exclusion for up to $500,000 of capital gains on home sales); 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 well suited.

[4] Although this section focuses upon tax expenditures under the income tax, tax expenditures also arise under the unified transfer, payroll, and excise tax systems. Such provisions can be useful when they relate to the base of those taxes, such as an excise tax exemption for certain types of consumption deemed meritorious.

Also, many tax expenditures, including those cited above, may have more than one objective. For example, accelerated depreciation may encourage investment. 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 usually the revenue effect. 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 certain investment 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). Effects on the incomes of members of particular groups may be an important measure for certain provisions.

An overview of evaluation issues by budget function. 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. However, it is premised on the assumption that the data needed to perform the analysis are available or can be developed. In practice, data availability is likely to be a major challenge, and data constraints may limit the assessment of the effectiveness of many provisions. In addition, such assessments can raise significant challenges in economic modeling.

National defense.—Some tax expenditures are intended to assist governmental activities. For example, tax preferences for military benefits reflect, among other things, the view that benefits such as housing, subsistence, and moving expenses are intrinsic aspects of military service, and are provided, in part, for the benefit of the employer, the U.S. Government. Tax benefits for combat service are intended to reduce tax burdens on military personnel undertaking hazardous service for the Nation. A portion of the tax expenditure associated with foreign earnings is targeted to benefit U.S. Government civilian personnel working abroad by offsetting the living costs that can be higher than those in the United States. These tax expenditures should be considered together with direct agency budget costs in making programmatic decisions.

International affairs.—Tax expenditures are also aimed at goals such as tax neutrality. These include the exclusion for income earned abroad by nongovernmental employees and exclusions for income of U.S.-controlled foreign corporations. Measuring the effectiveness of these provisions raises challenging issues.

General science, space and technology; energy; natural resources and the environment; agriculture; and commerce and housing.—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, it could be useful to consider the strength of the incentives by measuring their effects on the cost of capital (the interest rate which investments must yield to cover their costs) and effective tax rates. The impact of these provisions on the amounts of corresponding forms of investment (e.g., research spending, exploration activity, equipment) might also be estimated. In some cases, such as research, there is evidence that the investment can provide significant positive externalities—that is, economic benefits that are not reflected in the market transactions between private parties. It could be useful to quantify these externalities and compare them with the size of tax expenditures. Measures could also indicate the effects on production from these investments—such as numbers or values of patents, energy production and reserves, and industrial production. Issues to be considered include the extent to which the preferences increase production (as opposed to benefitting existing output) and their cost-effectiveness relative to other policies. Analysis could also consider objectives that are more difficult to measure but still are ultimate goals, such as promoting the Nation's technological base, energy security, environmental quality, or economic growth. Such an assessment is likely to involve tax analysis as well as consideration of non-tax matters such as market structure, scientific, and other information (such as the effects of increased domestic fuel production on imports from various regions, or the effects of various energy sources on the environment).

Housing investment also benefits from tax expenditures. The mortgage interest deduction on personal residences is reported as a tax expenditure because the value of owner-occupied housing services is not included in a taxpayer's taxable income. Taxpayers also may exclude up to $500,000 of the capital gains from the sale of personal residences. Measures of the effectiveness of these provisions could include their effects on increasing the extent of home ownership and the quality of housing.. Similarly, analysis of the extent of accumulated inflationary gains is likely to be relevant to evaluation of the capital gains for home sales. 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 intended to promote investment in rental housing could be evaluated for their effects on making such housing more available and affordable. These provisions should then be compared with alternative programs that address housing supply and demand.

Transportation.—Employer-provided parking is a fringe benefit that, for the most part, is excluded from taxation. The tax expenditure estimates reflect the cost of parking that is leased by employers for employees; an estimate is not currently available for the value of parking owned by employers and provided to their employees. The exclusion for employer-provided transit passes is intended to promote use of this mode of transportation, which has environmental and congestion benefits. The tax treatments of these different benefits could be compared with alternative transportation policies.

Community and regional development.—A series of tax expenditures is intended to promote community and regional development by reducing the costs of financing specialized infrastructure, such as airports, docks, and stadiums. Empowerment zone and enterprise community provisions are designed to promote activity in disadvantaged areas. These provisions can be compared with grants and other policies designed to spur economic development.

Education, training, employment, and social services.—Major provisions in this function are intended to promote post-secondary education, to offset costs of raising children, and to promote a variety of charitable activities. The education incentives can be compared with loans, grants, and other programs designed to promote higher education and training. The child credits are intended to adjust the tax system for the costs of raising children; as such, they could be compared to other Federal tax and spending policies, including related features of the tax system, such as personal exemptions (which are not defined as a tax expenditure). Evaluation of charitable activities requires consideration of the beneficiaries of these activities, who are generally not the parties receiving the tax reduction.

Health.—Individuals also benefit from favorable treatment of employer-provided health insurance. Measures of these benefits could include increased coverage and pooling of risks. 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 preventive health care or health care costs) could also be investigated.

Income security, Social Security, and veterans benefits and services.—Major tax expenditures in the income security function benefit retirement savings, through employer-provided pensions, individual retirement accounts, and Keogh plans. These provisions might be evaluated in terms of their effects on boosting retirement incomes, private savings, and national savings (which would include the effect on private savings as well as public savings or deficits). Interactions with other programs, including Social Security, also may merit analysis. As in the case of employer-provided health insurance, analysis of employer-provided pension programs requires imputing the value of benefits funded at the firm level to individuals.

Other provisions principally affect the incomes of members of certain groups, rather than affecting incentives. For example, tax-favored treatment of Social Security benefits, certain veterans benefits, and deductions for the blind and elderly provide increased incomes to eligible parties. The earned-income tax credit, in contrast, should be evaluated for its effects on labor force participation as well as the income it provides lower-income workers.

General purpose fiscal assistance and interest.—The tax-exemption for public purpose State and local bonds reduces the costs of borrowing for a variety of purposes (borrowing for non-public purposes is reflected under other budget functions). The deductibility of certain State and local taxes reflected under this function primarily relates to personal income taxes (property tax deductibility is reflected under the commerce and housing function). Tax preferences for Puerto Rico and other U.S. possessions are also included here. These provisions can be compared with other tax and spending policies as means of benefitting fiscal and economic conditions in the States, localities, and possessions. Finally, the tax deferral for interest on U.S. savings bonds benefits savers who invest in these instruments. The extent of these benefits and any effects on Federal borrowing costs could be evaluated.

The above illustrative discussion, although broad, is nevertheless incomplete, omitting important details both for the provisions mentioned and the many that are not explicitly cited. Developing a framework that is sufficiently comprehensive, accurate, and flexible to reflect the objectives and effects of the wide range of tax expenditures will be a significant challenge. OMB, Treasury, and other agencies will work together, as appropriate, to address this challenge. As indicated above, over the next few years the Executive Branch's focus will be on the availability of the data needed to assess the effects of the tax expenditures designed to increase savings.

Descriptions of Income Tax Provisions

Descriptions of the individual and corporate income tax expenditures reported upon in this chapter follow. These descriptions relate to current law as of December 31, 2003, and do not reflect proposals made elsewhere in the Budget.

National Defense

1. ***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

2. ***Income earned abroad.***— U.S. citizens who lived abroad, worked in the private sector, and satisfied a foreign residency requirement in 2001 may exclude up to $78,000 in foreign earned income from U.S. taxes. The exclusion increases to $80,000 in 2002 (and thereafter). In addition, if these taxpayers receive a specific allowance for foreign housing from their employers, they may also exclude the value of that allowance. If they do not receive a specific allowance for housing expenses, they may deduct against their U.S. taxes that portion of such expenses that exceeds one-sixth the salary of a civil servant at grade GS-14, step 1 ($72,381 in 2003).

3. ***Exclusion of certain allowances for Federal employees abroad.***—U.S. Federal civilian employees and Peace Corps members who work outside the continental United States are allowed to exclude from U.S. taxable income certain special allowances they receive to compensate them for the relatively high costs associated with living overseas. The allowances supplement wage income and cover expenses like rent, education, and the cost of travel to and from the United States.

4. ***Extraterritorial income exclusion.***[5]—For purposes of calculating U.S. tax liability, a taxpayer may exclude from gross income the qualifying foreign trade income attributable to foreign trading gross receipts. The exclusion generally applies to income from the sale or lease of qualifying foreign trade property and certain types of services income. The FSC Repeal and Extraterritorial Income Exclusion Act of 2000 created the extraterritorial income exclusion to replace the foreign sales corporation provisions, which the Act repealed. The exclusion is generally available for transactions entered into after September 30, 2000.

5. ***Sales 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 sales source rules for inventory property allow U.S. exporters to use more foreign tax credits 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 on actual economic activity.

6. ***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 considered to be subject to U.S. taxation, whether or not distributed. Thus, the normal tax method considers the amount of controlled foreign corporation income not yet distributed to a U.S. shareholder as tax-deferred income.

7. ***Exceptions under subpart F for active financing income.***—Financial firms can defer taxes on income earned overseas in an active business. Taxes on income earned through December 31, 2006 can be deferred.

General Science, Space, and Technology

8. ***Expensing R&E expenditures.***—Research and experimentation (R&E) projects can be viewed as investments because, if successful, their benefits accrue for several years. It is often difficult, however, to identify whether a specific R&E project is successful and, if successful, what its expected life will be. Under the normal tax method, 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.

9. ***R&E credit.***—The research and experimentation (R&E) 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" by the average amount of the company's gross receipts for the prior four years. The taxpayer's fixed base percentage generally is the ratio of its research expenses to gross receipts for 1984 through 1988. Taxpayers may also elect an alternative credit regime. Under the alternative credit regime the taxpayer is assigned a three-tiered fixed-base percentage that is lower than the fixed-base percentage that would otherwise apply, and the credit rate is reduced (the rates range from 2.65 percent to 3.75 percent). A 20-percent credit with a separate threshold is provided for a taxpayer's payments to universities for basic research. The credit applies to research conducted before July 1, 2004 and extends to research conducted in Puerto Rico and the U.S. possessions.

Energy

10. ***Exploration and development costs.***—For successful investments in domestic oil and gas wells, intangible drilling costs (e.g., wages, the costs of using machinery for grading and drilling, 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 deduct only 70 percent of such costs and must 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.

11. ***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 de-

[5] The determination of whether a provision is a tax expenditure is made on the basis of a broad concept of "income" that is larger in scope than is "income" as defined under general U.S. income tax principles. For that reason, the tax expenditure estimates include, for example, estimates related to the exclusion of extraterritorial income, as well as other exclusions, notwithstanding that such exclusions define income under the general rule of U.S. income taxation.

duct 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.

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

13. ***Oil and gas exception to passive loss limitation.***—Owners of working interests in oil and gas properties are exempt from the "passive income" limitations. As a result, 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.

14. ***Capital gains treatment of royalties on coal.***—Sales of certain coal under royalty contracts can be treated as capital gains rather than ordinary income.

15. ***Energy facility bonds.***—Interest earned on State and local bonds used to finance construction of certain energy facilities is tax-exempt. These bonds are generally subject to the State private-activity bond annual volume cap.

16. ***Enhanced oil recovery credit.***—A credit is provided equal to 15 percent of the taxpayer's costs for tertiary oil recovery on U.S. projects. 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.

17. ***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, biomass, and poultry waste facilities. The renewable resources credit applies only to electricity produced by a facility placed in service on or before December 31, 2004.

18. ***Alcohol fuel credits.***—An income tax credit is provided for ethanol that is derived from renewable sources and used as fuel. The credit equals 53 cents per gallon in 2001 and 2002; 52 cents per gallon in 2003 and 2004; and 51 cents per gallon in 2005, 2006, and 2007. To the extent that ethanol is mixed with taxable motor fuel to create gasohol, taxpayers may claim an exemption of the Federal excise tax rather than the income tax credit. In addition, small ethanol producers are eligible for a separate 10 cents per gallon credit.

19. ***Credit and deduction for clean-fuel vehicles and property.***—A tax credit of 10 percent (not to exceed $4,000) is provided for purchasers of electric vehicles. Purchasers of other clean-fuel burning vehicles and owners of clean-fuel refueling property may deduct part of their expenditures. The credit and deduction are phased out from 2004 through 2007,.

20. ***Exclusion of utility conservation subsidies.***—Non-business customers can exclude from gross income subsidies received from public utilities for expenditures on energy conservation measures.

Natural Resources and Environment

21. ***Exploration and development costs.***—Certain capital outlays associated with exploration and development of nonfuel minerals may be expensed rather than depreciated over the life of the asset.

22. ***Percentage depletion.***—Most nonfuel mineral extractors may use percentage depletion rather than cost depletion, with percentage depletion rates ranging from 22 percent for sulfur to 5 percent for sand and gravel.

23. Sewage, water, solid and hazardous waste facility bonds.—Interest earned on State and local bonds used to finance the construction of sewage, water, or hazardous waste facilities is tax-exempt. These bonds are generally subject to the State private-activity bond annual volume cap.

24. ***Capital gains treatment of certain timber.***—Certain timber sold under a royalty contract can be treated as a capital gain rather than ordinary income.

25. ***Expensing multiperiod timber growing costs.***—Most of the production costs of growing timber may be expensed rather than capitalized and deducted when the timber is sold. In most other industries, these costs are capitalized under the uniform capitalization rules.

26. ***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

27. ***Expensing certain capital outlays.***—Farmers, except for certain agricultural corporations and partnerships, are allowed to expense 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.

28. ***Expensing multiperiod livestock and crop production costs.***—The production of livestock and crops with a production period of less than two years is exempt 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.

29. ***Loans forgiven solvent farmers.***—Farmers are forgiven the tax liability on certain forgiven debt. Normally, debtors must include the amount of loan forgiveness as income or reduce their recoverable basis in the property to which the loan relates. If the debtor elects to reduce basis and the amount of forgiveness exceeds the basis in the property, the excess forgiveness is taxable. For insolvent (bankrupt) debtors, however, the amount of loan forgiveness reduces carryover losses, then unused credits, and then basis; any remainder of the forgiven debt is excluded from tax. Farmers with forgiven debt are considered insolvent for tax purposes, and thus qualify for income tax forgiveness.

30. ***Capital gains treatment of certain income.***—Certain agricultural income, such as unharvested crops, can be treated as capital gains rather than ordinary income.

31. ***Income averaging for farmers.***—Taxpayers can lower their tax liability by averaging, over the prior three-year period, their taxable income from farming.

32. ***Deferral of gain on sales of farm refiners.***—A taxpayer who sells stock in a farm refiner to a farmers' cooperative can defer recognition of gain if the taxpayer reinvests the proceeds in qualified replacement property.

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 be classified under the energy, natural resources and environment, agriculture, or transportation categories.

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

34. ***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.

35. ***Deferral of income on life insurance and annuity contracts.***—Favorable tax treatment is provided for investment income within qualified life insurance and annuity contracts. Investment income earned on qualified life insurance contracts held until death is permanently exempt from 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.

36. ***Small property and casualty insurance companies.***— Insurance companies that have annual net premium incomes of less than $350,000 are exempt from tax; those with $350,000 to $2.1 million of net premium incomes may elect to pay tax only on the income earned by their investment portfolio.

37. ***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 exempt from tax.

38. ***Small life insurance company deduction.***—Small life insurance companies (gross assets of less than $500 million) can deduct 60 percent of the first $3 million of otherwise taxable income. The deduction phases out for otherwise taxable income between $3 million and $15 million.

39. ***Mortgage housing bonds.***—Interest earned on State and local bonds used to finance homes purchased by first-time, low-to-moderate-income buyers is tax-exempt. The amount of State and local tax-exempt bonds that can be issued to finance these and other private activity is limited. The combined volume cap for private activity bonds, including mortgage housing bonds, rental housing bonds, student loan bonds, and industrial development bonds was $62.50 per capita ($187.5 million minimum) per State in 2001, and $75 per capita ($225 million minimum) in 2002. The Community Renewal Tax Relief Act of 2000 accelerated the scheduled increase in the state volume cap and indexed the cap for inflation, beginning in 2003. States may issue mortgage credit certificates (MCCs) in lieu of mortgage revenue bonds. MCCs entitle home buyers to income tax credits for a specified percentage of interest on qualified mortgages. The total amount of MCCs issued by a State cannot exceed 25 percent of its annual ceiling for mortgage-revenue bonds.

40. ***Rental housing bonds.***—Interest earned on State and local government bonds used to finance multifamily rental housing projects is tax-exempt. At least 20 percent (15 percent in targeted areas) of the units must be 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.

41. ***Interest on owner-occupied homes.***—Owner-occupants of homes may deduct mortgage interest 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 value of owner-occupied housing services is not included in a taxpayer's taxable income. The Appendix provides an alternative calculation of the tax expenditure based on the implicit rental income on owner-occupied housing, which is generally viewed as a more accurate measure of the tax expenditure relative to a comprehensive income tax base.

42. ***Taxes on owner-occupied homes.***—Owner-occupants of homes may deduct property taxes on their primary and secondary residences even though they are not required to report the value of owner-occupied housing services as gross income.

43. ***Installment sales.***—Dealers in real and personal property (i.e., sellers who regularly hold property for sale or resale) cannot defer taxable income from installment sales until the receipt of the loan repayment. Nondealers (i.e., sellers of real property used in their business) are required to pay interest 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 million is, therefore, a tax expenditure.

44. ***Capital gains exclusion on home sales.***—A homeowner can exclude from tax up to $500,000 ($250,000 for singles) of the capital gains from the sale of a principal residence. The exclusion may not be used more than once every two years.

45. ***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 exempt from this rule.

46. ***Low-income housing credit.***—Taxpayers who invest in certain low-income housing are eligible for a tax credit. The credit rate is set so that the present value of the credit is equal to 70 percent for new construction and 30 percent for (1) housing receiving other Federal benefits (such as tax-exempt bond financing), or (2) substantially rehabilitated existing housing. The credit is allowed in equal amounts over 10 years. State agencies determine who receives the credit; States are limited in the amount of credit they may authorize annually. The Community Renewal Tax Relief Act of 2000 increased the per-resident limit to $1.50 in 2001 and to $1.75 in 2002 and indexed the limit for inflation, beginning in 2003. The Act also created a $2 million minimum annual cap for small States beginning in 2002; the cap is indexed for inflation, beginning in 2003.

47. ***Accelerated depreciation of rental property.***—The tax depreciation allowance provisions are part of the reference law rules, and thus do not give rise to tax expenditures under the reference method. Under the normal tax method, however, economic depreciation is assumed. This calculation is described in more detail in the Appendix.

48. ***Cancellation of indebtedness.***—Individuals are not required to report the cancellation of certain indebtedness as current income. If the canceled debt is not reported as current income, however, the basis of the underlying property must be reduced by the amount canceled.

49. ***Imputed interest rules.***—Holders (issuers) of debt instruments are generally required to report interest earned (paid) in the period it accrues, not when paid. In addition, the amount of interest accrued is determined by the actual price paid, not by the stated principal and interest stipulated in the instrument. In general, any debt associated with the sale of property worth less than $250,000 is excepted from the general interest accounting rules. This general $250,000 exception is not a tax expenditure under reference law but is under normal law. Exceptions above $250,000 are a tax expenditure under reference law; these exceptions include the following: (1) sales of personal residences worth more than $250,000, and (2) sales of farms and small businesses worth between $250,000 and $1 million.

50. ***Capital gains (other than agriculture, timber, iron ore, and coal).***—Capital gains on assets held for more than 1 year are taxed at a lower rate than ordinary income. Under the revised reference law baseline used for the FY 2005 Budget, the lower rate on capital gains is considered a tax expenditure under the reference law method, but only for capital gains that have not been previously taxed under the corporate income tax. As discussed above, this treatment excludes the double tax on corporate income and is more consistent with a comprehensive income tax base.

Prior to passage of the Jobs Growth Tax Relief Reconciliation Act (JGTRRA), the top capital gains tax rate for most assets held for more than 1 year was 20 percent. For assets acquired after December 31, 2000, the top capital gains tax rate for assets held for more than 5 years was 18 percent. Since January 1, 2001, taxpayers may mark-to-market existing assets to start the 5-year holding period. Losses from the mark-to-market are not recognized.

For assets held for more than 1 year by taxpayers in the 15-percent ordinary tax bracket, the top capital gains tax rate was 10 percent. After December 31, 2000, the top capital gains tax rate for assets held by these taxpayers for more than 5 years was 8 percent.

JGTRRA reduced the previous 20 percent and 18 percent rates on net capital gains to 15 percent and the previous 10 percent and 8 percent rates to 5 percent (0 percent, in 2008). The lower rates apply to assets held for more than one year. The lower rates apply to assets sold after May 6, 2003 through 2008.

51. ***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.

52. ***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. After repeal of the estate tax for 2010 under the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001, the basis for property acquired from a decedent will be the lesser of fair market value or the decedent's basis. Certain types of additions to basis will be allowed so that assets in most estates that are not currently subject to estate tax will not be subject to capital gains tax in the hands of the heirs.

53. ***Carryover basis of capital gains on gifts.***—When a gift is made, the donor's basis in the transferred property (the cost that was incurred when the transferred property was first acquired) carries-over to the donee. The carryover of the donor's basis allows a continued deferral of unrealized capital gains. Even though the estate tax is repealed for 2010 under EGTRRA, the gift tax is retained with a lifetime exemption of $1 million.

54. ***Ordinary income treatment of losses from sale of small business corporate stock shares.***—Up to $100,000 in losses from the sale of small business corporate stock (capitalization less than $1 million) may be treated as ordinary losses. Such losses would, thus, not be subject to the $3,000 annual capital loss write-off limit.

55. ***Accelerated depreciation of non-rental-housing buildings.***—The tax depreciation allowance provisions are part of the reference law rules, and thus do not give rise to tax expenditures under reference law. Under normal law, however, economic depreciation is assumed. This calculation is described in more detail in the Appendix.

56. ***Accelerated depreciation of machinery and equipment.***—The tax depreciation allowance provisions are part of the reference law rules, and thus do not give rise to tax expenditures under reference law. Under the normal tax baseline, this tax depreciation allowance is measured relative to economic depreciation. This calculation is described in more detail in the Appendix.

57. ***Expensing of certain small investments.***—In 2002, qualifying investments in tangible property up to $24,000 could be expensed rather than depreciated over time. The expensing limit increases to $25,000 in 2003. To the extent that qualifying investment during the year exceeds $200,000, the amount eligible for expensing is decreased. In 2002, the amount expensed was completely phased out when qualifying investments exceeded $224,000.

58. ***Business start-up costs.***—When taxpayers enter into a new business, certain start-up expenses, such as the cost of legal services, are normally incurred. Taxpayers may elect to amortize these outlays over 60 months even though they are similar to other payments made for nondepreciable intangible assets that are not recoverable until the business is sold. The normal tax method treats this amortization as a tax expenditure; the reference tax method does not.

59. ***Graduated corporation income tax rate schedule.***—The corporate income tax schedule is graduated, with rates of 15 percent on the first $50,000 of taxable income, 25 percent on the next $25,000, and 34 percent on the next $9.925 million. Compared with a flat 34-percent rate, the lower rates provide an $11,750 reduction in tax liability for corporations with taxable income of $75,000. This benefit is recaptured for corporations with taxable incomes exceeding $100,000 by a 5-percent additional tax on corporate incomes in excess of $100,000 but less than $335,000.

The corporate tax rate is 35 percent on income over $10 million. Compared with a flat 35-percent tax rate, the 34-percent rate provides a $100,000 reduction in tax liability for corporations with taxable incomes of $10 million. This benefit is recaptured for corporations with taxable incomes exceeding $15 million by a 3-percent additional tax on income over $15 million but less than $18.33 million. Because the corporate rate schedule is part of reference tax law, it is not considered 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 is considered a tax expenditure under this concept.

60. ***Small issue industrial development bonds.***—Interest earned on small issue industrial development bonds (IDBs) issued by State and local governments to finance manufacturing facilities is tax-exempt. Depreciable property financed with small issue IDBs must be depreciated, however, using the straight-line method. The annual volume of small issue IDBs is subject to the unified volume cap discussed in the mortgage housing bond section above.

Transportation

61. ***Deferral of tax on U.S. shipping companies.***—Certain companies that operate U.S. flag vessels can defer 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 investments. Once indefinite, the deferral has been limited to 25 years since January 1, 1987.

62. ***Exclusion of employee parking expenses.***—Employee parking expenses that are paid for by the employer or that are received in lieu of wages are excludable from the income of the employee. Since 2002, the maximum amount of the parking exclusion is $185 (indexed) per month. The tax expenditure estimate does not include parking at facilities owned by the employer.

63. ***Exclusion of employee transit pass expenses.***—Transit passes, tokens, fare cards, and vanpool expenses paid for by an employer or provided in lieu of wages to defray an employee's commuting costs are excludable from the employee's income. Since 2002, the maximum amount of the exclusion is $100 (indexed) per month.

Community and Regional Development

64. ***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. The taxpayer's recoverable basis must be reduced by the amount of the credit.

65. ***Airport, dock, and similar facility bonds.***—Interest earned on State and local bonds issued to finance high-speed rail facilities and government-owned airports, docks, wharves, and sport and convention facilities is tax-exempt. These bonds are not subject to a volume cap.

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

67. ***Empowerment zones, enterprise communities, and renewal communities.***—Qualifying businesses in designated economically depressed areas can receive tax benefits such as an employer wage credit, increased expensing of investment in equipment, special tax-exempt financing, accelerated depreciation, and certain capital gains incentives. The Job Creation and Worker Assistance Act of 2002 expanded the existing provisions by adding the "New York City Liberty Zone." In addition, certain first-time buyers of a principal residence in the District of Columbia can receive a tax credit on homes purchased on or before December 31, 2003, and investors in certain D.C. property can receive a capital gains break. The Community Renewal Tax Relief Act of 2000 created the renewal communities tax benefits, which begin on January 1, 2002 and expires on December 31, 2009. The Act also created additional empowerment zones, increased the tax benefits for empowerment zones, and extended the expiration date of (1) empowerment zones from December 31, 2004 to December 31, 2009, and (2) the D.C. home-buyer credit from December 31, 2001 to December 31, 2003.

68. ***New markets tax credit.***—Taxpayers who invest in a community development entity (CDE) after December 31, 2000 are eligible for a tax credit. The total equity investment available for the credit across all CDEs is $1.0 billion in 2001, $1.5 billion in 2002 and 2003, $2.0 billion in 2004 and 2005, and $3.5 billion in 2006 and 2007. The amount of the credit equals (1) 5 percent in the year of purchase and the following 2 years, and (2) 6 percent in the following 4 years. A CDE is any domestic firm whose primary mission is to serve or provide investment capital for low-income communities/individuals; a CDE must be accountable to residents of low-income communities. The Community Renewal Tax Relief Act of 2000 created the new markets tax credit.

69. ***Expensing of environmental remediation costs.***—Taxpayers who clean up certain hazardous substances at a qualified site may expense the clean-up costs, rather than capitalize the costs, even though the expenses will generally increase the value of the property significantly or appreciably prolong the life of the property. The expensing only applies to clean-up costs incurred on or before December 31, 2003. The Community Renewal Tax Relief Act of 2000 extended the expiration date from December 31, 2001 to December 31, 2003. The Act also expanded the number of qualified sites.

Education, Training, Employment, and Social Services

70. ***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. The exclusion, however, is considered a tax expenditure under the normal tax method, which includes gift-like transfers of Government funds in gross income (many scholarships are derived directly or indirectly from Government funding).

71. ***HOPE tax credit.***— The non-refundable HOPE tax credit allows a credit for 100 percent of an eligible student's first $1,000 of tuition and fees and 50 percent of the next $1,000 of tuition and fees. The credit only covers tuition and fees paid during the first two years of a student's post-secondary education. In 2003, the credit is phased out ratably for taxpayers with modified AGI between $83,000 and $103,000 ($41,000 and $51,000 for singles), indexed.

72. ***Lifetime Learning tax credit.***—The non-refundable Lifetime Learning tax credit allows a credit for 20 percent of an eligible student's tuition and fees. For tuition and fees paid after December 31, 2002, the maximum credit per return is $2,000. The credit is phased out ratably for taxpayers with modified AGI between $83,000 and $103,000 ($41,000 and $51,000 for singles) (indexed beginning in 2002). The credit applies to both undergraduate and graduate students.

73. ***Deduction for Higher Education Expenses.***—The maximum annual deduction for qualified higher education expenses is $3,000 in 2003 for taxpayers with adjusted gross income up to $130,000 on a joint return ($65,000 for singles). The maximum deduction increases to $4,000 in 2004. Taxpayers with adjusted gross income up to $160,000 on a joint return ($80,000 for

singles) may deduct up to $2,000 beginning in 2004. No deduction is allowed for expenses paid after December 31, 2005.

74. ***Education Individual Retirement Accounts.***—Contributions to an education IRA are not tax-deductible. Investment income earned by education IRAs is not taxed when earned, and investment income from an education IRA is tax-exempt when withdrawn to pay for a student's tuition and fees. The maximum contribution to an education IRA in 2003 is $200 per beneficiary. The maximum contribution is phased down ratably for taxpayers with modified AGI between $159,000 and $220,000 ($95,000 and $110,000 for singles). EGTRRA increases the maximum contribution to $2,000 and the phase-out range for joint filers to $190,000 through $220,000 of modified AGI, double the range of singles.

75. ***Student-loan interest.***—Taxpayers may claim an above-the-line deduction of up to $2,500 on interest paid on an education loan. Interest may only be deducted for the first five years in which interest payments are required. In 2003, the maximum deduction is phased down ratably for taxpayers with modified AGI between $100,000 and $130,000 ($50,000 and $65,000 for singles), indexed.

76. ***State prepaid tuition plans.***—Some States have adopted prepaid tuition plans and prepaid room and board plans, which allow persons to pay in advance for college expenses for designated beneficiaries. In 2001 taxes on the earnings from these plans are paid by the beneficiaries and are deferred until tuition is actually paid. Beginning in 2002, investment income is not taxed when earned, and is tax-exempt when withdrawn to pay for qualified expenses. These changes were the result of EGTRRA.

77. ***Student-loan bonds.***—Interest earned on State and local bonds issued to finance student loans is tax-exempt. The volume of all such private activity bonds that each State may issue annually is limited.

78. ***Bonds for private nonprofit educational institutions.***—Interest earned on State and local Government bonds issued to finance the construction of facilities used by private nonprofit educational institutions is not taxed.

79. ***Credit for holders of zone academy bonds.***—Financial institutions that own zone academy bonds receive a non-refundable tax credit (at a rate set by the Treasury Department) rather than interest. The credit is included in gross income. Proceeds from zone academy bonds may only be used to renovate, but not construct, qualifying schools and for certain other school purposes. The total amount of zone academy bonds that may be issued is limited to $1.6 billion—$400 million in each year from 1998 to 2003.

80. ***U.S. savings bonds for education.***—Interest earned on U.S. savings bonds issued after December 31, 1989 is tax-exempt if the bonds are transferred to an educational institution to pay for educational expenses. The tax exemption is phased out for taxpayers with AGI between $87,750 and $117.750 ($58,500 and $73,500 for singles) in 2003.

81. ***Dependent students age 19 or older.***—Taxpayers may claim personal exemptions for dependent children age 19 or over who (1) receive parental support payments of $1,000 or more per year, (2) are full-time students, and (3) do not claim a personal exemption on their own tax returns.

82. ***Charitable contributions to educational institutions.***—Taxpayers may deduct contributions to nonprofit educational institutions. Taxpayers who donate capital assets to educational institutions can deduct the assets' current value without being taxed on any appreciation in value. An individual's total charitable contribution generally may not exceed 50 percent of adjusted gross income; a corporation's total charitable contributions generally may not exceed 10 percent of pre-tax income.

83. ***Employer-provided educational assistance.***—Employer-provided educational assistance is excluded from an employee's gross income even though the employer's costs for this assistance are a deductible business expense. EGTRRA permanently extended this exclusion and extended the exclusion to also include graduate education (beginning in 2002).

84. ***Special deduction for teacher expenses.***—Educators in both public and private elementary and secondary schools, who work at least 900 hours during a school year as a teacher, instructor, counselor, principal or aide, may subtract up to $250 of qualified expenses when figuring their adjusted gross income (AGI).

85. ***Work opportunity tax credit.***—Employers can claim a tax credit for qualified wages paid to individuals who begin work on or before December 31, 2004 and who are certified as members of various targeted groups. The amount of the credit that can be claimed is 25 percent for employment of less than 400 hours and 40 percent for employment of 400 hours or more. The maximum credit per employee is $2,400 and can only be claimed on the first year of wages an individual earns from an employer. Employers must reduce their deduction for wages paid by the amount of the credit claimed.

86. ***Welfare-to-work tax credit.***—An employer is eligible for a tax credit on the first $20,000 of eligible wages paid to qualified long-term family assistance recipients during the first two years of employment. The credit is 35 percent of the first $10,000 of wages in the first year of employment and 50 percent of the first $10,000 of wages in the second year of employment. The maximum credit is $8,500 per employee. The credit applies to wages paid to employees who are hired on or before December 31, 2004.

87. ***Employer-provided child care exclusion.***—Employer-provided child care is excluded from an employee's gross income even though the employer's costs for the child care are a deductible business expense.

88. ***Employer-provided child care credit.***—Employers can deduct expenses for supporting child care or child care resource and referral services. EGTRRA

provides a tax credit to employers for qualified expenses beginning in 2002. The credit is equal to 25 percent of qualified expenses for employee child care and 10 percent of qualified expenses for child care resource and referral services. Employer deductions for such expenses are reduced by the amount of the credit. The maximum total credit is limited to $150,000 per taxable year.

89. ***Assistance for adopted foster children.***—Taxpayers who adopt eligible children from the public foster care system can receive monthly payments for the children's significant and varied needs and a reimbursement of up to $2,000 for nonrecurring adoption expenses. These payments are excluded from gross income.

90. ***Adoption credit and exclusion.***—Taxpayers can receive a nonrefundable tax credit for qualified adoption expenses. The maximum credit is $10,160 per child for 2003. The credit is phased-out ratably for taxpayers with modified AGI between $152,390 and $192,390 in 2003. The credit amounts and the phase-out thresholds are indexed for inflation beginning in 2003. Unused credits may be carried forward and used during the five subsequent years. Taxpayers may also exclude qualified adoption expenses from income, subject to the same maximum amounts and phase-out as the credit. The same expenses cannot qualify for tax benefits under both programs; however, a taxpayer may use the benefits of the exclusion and the tax credit for different expenses. Stepchild adoptions are not eligible for either benefit.

91. ***Employer-provided meals and lodging.***—Employer-provided meals and lodging are excluded from an employee's gross income even though the employer's costs for these items are a deductible business expense.

92. ***Child credit.***—Taxpayers with children under age 17 can qualify for a $1,000 refundable per child credit. The maximum credit is equal to $700 in 2005, $800 in 2009, and $1,000 in 2010, and declines to $500 in 2011 and later years. The credit is phased out for taxpayers at the rate of $50 per $1,000 of modified AGI above $110,000 ($75,000 for singles).

93. ***Child and dependent care expenses.***—Married couples with child and dependent care expenses may claim a tax credit 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 single parents and by divorced or separated parents who have custody of children. Expenditures up to a maximum $3,000 for one dependent and $6,000 for two or more dependents are eligible for the credit. The credit is equal to 35 percent of qualified expenditures for taxpayers with incomes of $15,000. The credit is reduced to a minimum of 20 percent by one percentage point for each $2,000 of income in excess of $15,000.

94. ***Disabled access expenditure credit.***—Small businesses (less than $1 million in gross receipts or fewer than 31 full-time employees) can claim a 50-percent credit for expenditures in excess of $250 to remove access barriers for disabled persons. The credit is limited to $5,000.

95. ***Charitable contributions, other than education and health.***—Taxpayers may deduct contributions to charitable, religious, and certain other nonprofit organizations. Taxpayers who donate capital assets to charitable organizations can deduct the assets' current value without being taxed on any appreciation in value. An individual's total charitable contribution generally may not exceed 50 percent of adjusted gross income; a corporation's total charitable contributions generally may not exceed 10 percent of pre-tax income.

96. ***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 excluded from the gross incomes of foster parents; the expenses they incur are nondeductible.

97. ***Parsonage allowances.***—The value of a minister's housing allowance and the rental value of parsonages are not included in a minister's taxable income.

Health

98. ***Employer-paid medical insurance and expenses.***—Employer-paid health insurance premiums and other medical expenses (including long-term care) are deducted as a business expense by employers, but they are not included in employee gross income. The self-employed also may deduct part of their family health insurance premiums.

99. ***Self-employed medical insurance premiums.***—Self-employed taxpayers may deduct a percentage of their family health insurance premiums. Taxpayers without self-employment income are not eligible for the special percentage deduction. The deductible percentage is 60 percent in 2001, 70 percent in 2002, and 100 percent in 2003 and thereafter.

100. ***Medical and health savings accounts.***—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, 2003. The Medicare Prescription Drug, Improvemnet, and Modernization Act of 2003 introduced health savings accounts (HSA) which provides a tax-favored savings for health care expenses. The definition of a high-

deductible health plan is less restrictive for HSAs than for MSAs.

101. ***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.

102. ***Hospital construction bonds.***—Interest earned on State and local government debt issued to finance hospital construction is excluded from income subject to tax.

103. ***Charitable contributions to health institutions.***—Individuals and corporations may deduct contributions to nonprofit health institutions. Tax expenditures resulting from the deductibility of contributions to other charitable institutions are listed under the education, training, employment, and social services function.

104. ***Orphan drugs.***—Drug firms can claim a tax credit of 50 percent of the costs for clinical testing required by the Food and Drug Administration for drugs that treat rare physical conditions or rare diseases.

105. ***Blue Cross and Blue Shield.***—Blue Cross and Blue Shield health insurance providers in existence on August 16, 1986 and certain other nonprofit health insurers are provided exceptions from otherwise applicable insurance company income tax accounting rules that substantially reduce (or even eliminate) their tax liabilities.

106. ***Tax credit for health insurance purchased by certain displaced and retired individuals.***—The Trade Act of 2002 provided a refundable tax credit of 65 percent for the purchase of health insurance covergae by individuals eligible for Trade Adjustment Assitance and certain PBGC pension recipients.

Income Security

107. ***Railroad retirement benefits.***—Railroad retirement benefits are not generally subject to the income tax unless the recipient's gross income reaches a certain threshold. The threshold is discussed more fully under the Social Security function.

108. ***Workers' compensation benefits.***—Workers compensation provides payments to disabled workers. These benefits, although income to the recipients, are not subject to the income tax.

109. ***Public assistance benefits.***—Public assistance benefits are excluded from tax. The normal tax method considers cash transfers from the Government as taxable and, thus, treats the exclusion for public assistance benefits as a tax expenditure.

110. ***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.

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

112. ***Employer-provided pension contributions and earnings.***—Certain employer contributions to pension plans are excluded from an employee's gross income even though the employer can deduct the contributions. In addition, the tax on the investment income earned by the pension plans is deferred until the money is withdrawn.

113. ***401(k) plans.***—Individual taxpayers can make tax-preferred contributions to certain types of employer-provided 401(k) plans (and 401(k)-type plans like 403(b) plans and the Federal government's Thrift Savings Plan). In 2001, an employee could exclude up to $12,000 of wages from AGI under a qualified arrangement with an employer's 401(k) plan. This increases to $13,000 in 2004, $14,000 in 2005 and $15,000 in 2006 (indexed thereafter). The tax on the investment income earned by 401(k)-type plans is deferred until withdrawn.

Employees are allowed to make after-tax contributions to 401(k) and 401(k)-type plans. These contributions are not excluded from AGI, but the investment income of such after-tax contributions is not taxed when earned or withdrawn.

114. ***Individual Retirement Accounts.***—Individual taxpayers can take advantage of several different Individual Retirement Accounts (IRAs): deductible IRAs, non-deductible IRAs, and Roth IRAs. The annual contributions limit applies to the total of a taxpayer's deductible, non-deductible, and Roth IRAs contributions. The IRA contribution limit to $3,000 in 2003, $4,000 in 2005, and $5,000 in 2008 (indexed thereafter) and allows taxpayers over age 50 to make additional "catch-up" contributions of $1,000 (by 2006).

Taxpayers whose AGI is below $70,000 ($50,000 for non-joint filers) in 2003 can claim a deduction for IRA contributions. The IRA deduction is phased out for taxpayers with AGI between $60,000 and $70,000 ($40,000 and $50,000 for non-joint). The phase-out range increases annually until it reaches $80,000 to $100,000 in 2007 ($50,000 to $60,000 in 2005 for non-joint filers). Taxpayers whose AGI is above the phase-out range can also claim a deduction for their IRA contributions depending on whether they (or their spouse) are an active participant in an employer-provided retirement plan. The tax on the investment income earned by 401(k) plans, non-deductible IRAs, and deductible IRAs is deferred until the money is withdrawn.

Taxpayers with incomes below $160,000 ($110,000 for nonjoint filers) can make contributions to Roth IRAs. The maximum contribution to a Roth IRA is phased out for taxpayers with AGI between $150,000 and $160,000 ($95,000 and $110,000 for singles). Investment income of a Roth IRA is not taxed when earned nor when withdrawn. Withdrawals from a Roth IRA are penalty free if: (1) the Roth IRA was opened at least 5 years before the withdrawal, and (2) the taxpayer either (a) is at least $59\frac{1}{2}$, (b) dies, (c) is disabled, or (d) purchases a first-time house.

Taxpayers can contribute to a non-deductible IRA regardless of their income and whether they are an active participant in an employer-provided retirement plan. The tax on investment income earned by non-deductible IRAs is deferred until the money is withdrawn.

115. ***Low and moderate income savers' credit.***—EGTRRA provides an additional incentive for lower-income taxpayers to save through a nonrefundable credit of up to 50 percent on IRA contributions. This credit is in addition to any deduction or exclusion. The credit is completely phased out by $50,000 for joint filers and $25,000 for single filers. This temporary credit is in effect from 2002 through 2006.

116. ***Keogh plans.***—Self-employed individuals can make deductible contributions to their own retirement (Keogh) plans equal to 25 percent of their income, up to a maximum of $40,000 in 2001. Total plan contributions are limited to 25 percent of a firm's total wages. The tax on the investment income earned by Keogh plans is deferred until withdrawn.

117. ***Employer-provided life insurance benefits.***—Employer-provided life insurance benefits are excluded from an employee's gross income even though the employer's costs for the insurance are a deductible business expense.

118. ***Small business retirement plan credit.***—EGTRRA provides businesses with 100 or fewer employees a credit for 50 percent of the qualified startup costs associated with a new qualified retirement plan. The credit is limited to $500 annually and may only be claimed for expenses incurred during the first three years from the start of the qualified plan. Qualified startup expenses include expenses related to the establishment and administration of the plan, and the retirement-related education of employees. The credit applies to costs incurred beginning in 2002.

119. ***Employer-provided accident and disability benefits.***—Employer-provided accident and disability benefits are excluded from an employee's gross income even though the employer's costs for the benefits are a deductible business expense.

120. ***Employer-provided supplementary unemployment benefits.***—Employers may establish trusts to pay supplemental unemployment benefits to employees separated from employment. Interest payments to such trusts are exempt from taxation.

121. ***Employer Stock Ownership Plan (ESOP) provisions.***—ESOPs are a special type of tax-exempt employee benefit plan. 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; (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) employees who sell appreciated company stock to the ESOP may defer any taxes due until they withdraw benefits; and (4) dividends paid to ESOP-held stock are deductible by the employer.

122. ***Additional deduction for the blind.***—Taxpayers who are blind may take an additional $1,150 standard deduction if single, or $950 if married in 2003.

123. ***Additional deduction for the elderly.***—Taxpayers who are 65 years or older may take an additional $1,150 standard deduction if single, or $950 if married in 2003.

124. ***Tax credit for the elderly and disabled.***—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. Income is limited to no more than $5,000 for single individuals or married couples filing a joint return where only one spouse is 65 years of age or older, and up to $7,500 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.

125. ***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. Taxpayers, however, may deduct uninsured casualty and theft losses of more than $100 each, but only to the extent that total losses during the year exceed 10 percent of AGI.

126. ***Earned income tax credit (EITC).***—The EITC may be claimed by low income workers. For a family with one qualifying child, the credit is 34 percent of the first $7,490 of earned income in 2003. The credit is 40 percent of the first $10,510 of income for a family with two or more qualifying children. The credit is phased out beginning when the taxpayer's income exceeds $13,730 at the rate of 15.98 percent (21.06 percent if two or more qualifying children are present). It is completely phased out when the taxpayer's modified adjusted gross income reaches $29,666 ($33,692 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 2003, the credit is 7.65 percent of the first $4,990 of earned income. When the taxpayer's income exceeds $6,240, the credit is phased out at the rate of 7.65 percent. It is completely phased out at $11,230 of modified adjusted gross income.

For workers with or without children, the income levels at which the credit begins to phase-out and the maximum amounts of income on which the credit can be taken are adjusted for inflation. For married taxpayers filing a joint return, The base amount for the phase-out increases by $2,000 in 2005 through 2007, and $3,000 in 2008 (indexed thereafter).

Earned income tax credits in excess of tax liabilities owed through the individual income tax system are re-

fundable to individuals. This portion of the credit is shown as an outlay, while the amount that offsets tax liabilities is shown as a tax expenditure.

Social Security

127. ***Social Security benefits for retired workers.***—The non-taxation of Social Security benefits that exceed the beneficiary's contributions out of taxed income 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.

128. ***Social Security benefits for the disabled.***—Benefit payments from the Social Security Trust Fund for disability are partially excluded from a beneficiary's gross incomes.

129. ***Social Security benefits for dependents and survivors.***—Benefit payments from the Social Security Trust Fund for dependents and survivors are partially excluded from a beneficiary's gross income.

Veterans Benefits and Services

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

131. ***Veterans pension payments.***—Pension payments made by the Veterans Administration are excluded from gross income.

132. ***G.I. Bill benefits.***—G.I. Bill benefits paid by the Veterans Administration are excluded from gross income.

133. ***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

134. ***Public purpose State and local bonds.***—Interest earned on State and local government bonds issued to finance public-purpose construction (e.g., schools, roads, sewers), equipment acquisition, and other public purposes is tax-exempt. Interest on bonds issued by Indian tribal governments for essential governmental purposes is also tax-exempt.

135. ***Deductibility of certain nonbusiness State and local taxes.***—Taxpayers may deduct State and local income taxes and property taxes even though these taxes primarily pay for services that, if purchased directly by taxpayers, would not be deductible.

136. ***Business income earned in U.S. possessions.***—U.S. corporations operating in a U.S. possession (e.g., Puerto Rico) can claim a credit against some or all of their U.S. tax liability on possession business income. The credit expires December 31, 2005.

Interest

137. ***U.S. savings bonds.***—Taxpayers may defer paying tax on interest earned on U.S. savings bonds until the bonds are redeemed.

Appendix:

TREASURY REVIEW OF THE TAX EXPENDITURE PRESENTATION

This appendix provides an initial presentation of the Treasury Department review of the tax expenditure budget, which was first prepared for the 2004 Budget. The review focuses on three issues: (1) using comprehensive income as a baseline tax system, (2) using a consumption tax as a baseline tax system, and (3) defining negative tax expenditures (provisions that cause taxpayers to pay too much tax).

The first section of this appendix compares major tax expenditures in the current budget to those implied by a comprehensive income baseline. This comparison includes a discussion of negative tax expenditures. The second section compares the major tax expenditures in the current budget to those implied by a consumption tax baseline, and also discusses negative tax expenditures. The final section addresses concerns that have been raised over the measurement of some current tax expenditures by describing a new estimate of the tax expenditure caused by accelerated depreciation and alternative estimates of the tax expenditures resulting from the tax exemption of the return earned on owner-occupied housing and preferential treatment of capital gains. The final section also provides an estimate of the negative tax expenditure caused by the double tax on corporate profits.

DIFFERENCES BETWEEN OFFICIAL TAX EXPENDITURES AND THOSE BASED ON COMPREHENSIVE INCOME

As discussed in the main body of the tax expenditure chapter, official tax expenditures are measured relative to normal law or reference law baselines that deviate from a uniform tax on a comprehensive concept of income. Consequently, tax expenditures identified in the budget can differ from those that would be identified if a comprehensive income tax were chosen as the baseline tax system. This appendix addresses this issue by comparing major tax expenditures listed in the current tax expenditure budget with those implied by a comprehensive income baseline. Most large tax expenditures would continue to be tax expenditures were the baseline taken to be comprehensive income, although some would be much smaller. A comprehensive income baseline would also result in a number of additional tax provisions being counted as tax expenditures.

Current budgetary practice excludes from the list of official tax expenditures those provisions that over-tax certain items of income. This exclusion conforms to the view that tax expenditures are substitutes for direct Government spending programs. However, this treatment gives a one-sided picture of how current law deviates from the baseline tax system. Relative to comprehensive income, a number of current tax provisions would be negative tax expenditures. Some of these also might be negative tax expenditures under the reference law or normal law baselines, expanded to admit negative tax expenditures.

Treatment of Major Tax Expenditures from the Current Budget under a Comprehensive Income Tax Baseline

Comprehensive income, also called Haig-Simons income, is the real, inflation adjusted, accretion to one's economic power arising between two points in time, e.g., the beginning and ending of the year. It includes all accretions to wealth, whether or not realized, whether or not related to a market transaction, and whether a return to capital or labor. Inflation adjusted capital gains (and losses) would be included in comprehensive income as they accrue. Business, investment, and casualty losses, including losses caused by depreciation, would be deducted. Implicit returns, such as those accruing to homeowners, also would be included in comprehensive income. A comprehensive income tax baseline would tax all sources of income once. Thus, it would not include a separate tax on corporate income that leads to the double taxation of corporate income.

While comprehensive income can be defined on the sources side of the consumer's balance sheet, it sometimes is instructive to use the identity between the sources of wealth and the uses of wealth to redefine it as the sum of consumption during the period plus the change in net worth between the beginning and the end of the period.

Comprehensive income is widely held to be the idealized base for an income tax even though it is not a perfectly defined concept.[6] It suffers from conceptual ambiguities, some of which are discussed below, as well as practical problems in measurement and tax administration, e.g., how to implement a practicable deduction for economic depreciation or include in income the return earned on consumer durable goods, including housing, automobiles, and major appliances.

Furthermore, comprehensive income does not necessarily represent an ideal tax base; efficiency or equity might be improved by deviating from comprehensive income as a tax base, e.g., by reducing the tax on capital income in order to further spur economic growth or by subsidizing certain types of activities in order to correct for market failures or to improve the after-tax distribution of income. In addition, some elements of comprehensive income would be difficult or impossible to include in a tax system that is administrable.

Classifying items under a comprehensive income baseline is difficult, in part because of the ambiguity of the baseline. It also is difficult because of interactions between tax provisions (or their absence). These interactions mean that it may not always be appropriate to consider each item in isolation. Nonetheless, Appendix Table 1 attempts such a classification for each of the thirty largest tax expenditures from the Budget.

We classify fourteen of the thirty items as tax expenditures under a comprehensive tax base (those in panel A). Most of these give preferential tax treatment to the return on certain types of savings or investment. They are a result of the explicitly hybrid nature of the existing tax system, and arise out of policy decisions that reflect discomfort with the high tax rate on capital income that would otherwise arise under the current structure of the income tax. Even these relatively clear cut items, however, can raise ambiguities particularly in light of the absence of integration of the corporate and individual tax systems. Consider, for example, the tax expenditures related to retirement savings. Considered alone, these items clearly would be tax expenditures under a comprehensive income tax baseline. However, much of the income earned in these accounts is subject to the corporate income tax, and would not be taxed again under a comprehensive income tax. If account is taken simultaneously of the corporate income tax and the individual income tax, then much of what is measured in these tax expenditures might not be considered preferential tax treatment under a comprehensive income tax baseline. But, if the corporate level income tax is separately itemized as a surcharge, or a negative tax expenditure, then the preferential treatments of retirement saving would remain tax expenditures.

[6] See, e.g., David F. Bradford, *Untangling the Income Tax* (Cambridge, MA: Harvard University Press, 1986), pp. 15–31, and Richard Goode, "The Economic Definition of Income" in Joseph Pechman, ed., *Comprehensive Income Taxation* (Washington, D.C.: The Brookings Institution, 1977), pp. 1–29.

The exclusion of worker's compensation benefits also would be a tax expenditure under comprehensive income principles. Under comprehensive income tax principles, if the worker were to buy the insurance himself, he would be able to deduct the premium (since it represents a reduction in net worth) but should include in income the benefit when paid (since it represents an increase in net worth).[7] If the employer pays the premium, the proper treatment would allow the employer a deduction and allow the employee to disregard the premium, but he would take the proceeds, if any, into income. Current law allows the employer to deduct the premium and excludes both the premium and the benefits from the employee's tax base.

Panel B deals with items that probably are tax expenditures, but that raise some issues. The step-up of basis at death lowers the income tax on capital gains for those who inherit assets below what it would be otherwise. From that perspective it would be a tax expenditure under a comprehensive income baseline. Nonetheless, there are ambiguities. Under a comprehensive income baseline, all real inflation adjusted gains would be taxed as accrued, so there would be no deferred unrealized gains on assets held at death.

The lack of full taxation of Social Security benefits also is listed in panel B. Consider first Social Security retirement benefits. To the extent that Social Security is viewed as a pension, a comprehensive income tax would include in income all contributions to Social Security retirement funds (payroll taxes) and tax accretions to value as they arise (inside build-up).[8] Benefits paid out of prior contributions and the inside build-up, however, would not be included in the tax base because the fall in the value of the individual's Social Security account would be offset by an increase in cash. In contrast, to the extent that Social Security is viewed as a transfer program, all contributions should be deductible from the income tax base and all benefits received should be included in the income tax base.

A similar analysis applies to Social Security benefits paid to dependents and survivors. If these benefits represent transfers from the Government, then they should be included in the tax base. If the taxpaying unit consists of the worker plus dependents and survivors, then to the extent that Social Security benefits represent payments from a pension, the annual pension earnings should be taxed in the same way that earnings accruing to retirees are taxed. However, benefits paid to dependents and survivors might be viewed as a gift or transfer from the decedent, in which case the dependents and survivors should pay tax on the full amount of the benefit received. (In this case the decedent or his estate should pay tax on the pension income as well, to the extent that the gift represents consumption rather than a reduction in net worth).

In addition, dependent and survivors benefits might be viewed in part as providing life insurance. In that case, the annual premiums paid each year, or the portion of Social Security taxes attributable to the premiums, should be deducted from income, since they represent a decline in net worth, while benefits should be included in income. Alternatively, taxing premiums and excluding benefits also would represent appropriate income tax policy.

In contrast to any of these treatments, current law excludes one-half of contributions (employer-paid payroll taxes) from the base of the income tax, makes no attempt to tax accretions, and subjects some, but not all, benefits to taxation. The difference between current law's treatment of Social Security benefits and their treatment under a comprehensive income tax would qualify as a tax expenditure, but such a tax expenditure differs in concept from that included in the official budget.

The tax expenditures in the official budget[9] reflect exemptions for lower income beneficiaries from the tax on 85 percent of Social Security benefits.[10] Historically, payroll taxes paid by the employee represented no more than 15 percent of the expected value of the retirement benefits received by a lower-earnings Social Security beneficiary. The 85 percent inclusion rate is therefore intended to tax the remaining amount of the retirement benefit payment arising from the payroll tax contributions made by employers and the implicit return on the employee and employer contributions. Thus, the tax expenditure conceived and measured in the current budget is not intended to capture the deviation from comprehensive income baseline, which would additionally account for the deferral of tax on these components (less an inflation adjustment attributable to the employee's payroll tax contributions). Rather, it is intended to approximate the taxation of private pensions with employee contributions made from after-tax income,[11] on the assumption that Social Security is comparable to such pensions. Hence, the official tax expenditure understates the tax advantage accorded Social Security retirement benefits relative to a comprehensive income baseline.

To the extent that the benefits paid to dependents and survivors should be taxed as private pensions, the same conclusion applies: the official tax expenditure understates the tax advantage.

To the extent that the personal and dependent care exemptions and the standard deduction properly remove from taxable income all expenditures that do not

[7] Suppose a taxpayer buys a one year term unemployment insurance policy at the beginning of the year. At that time he exchanges one asset, cash, for another, the insurance policy, so there is no change in net worth. But, at the end of the year, the policy expires and so is worthless, hence the taxpayer has a reduction in net worth equal to the premium. If the policy pays off during the year (i.e., the taxpayer has a work related injury), then the taxpayer would include the proceeds in income because they represent an increase in his net worth.

[8] As a practical matter, this may be impossible to do. Valuing claims subject to future contingencies is very difficult, as discussed in Bradford, *Untangling the Income Tax,* pp. 23–24.

[9] This includes the tax expenditure for benefits paid to workers, that for benefits paid to survivors and dependents, and that for benefits paid to dependents.

[10] The current budget does not include as a tax expenditure the absence of income taxation on the employer's contributions (payroll taxes) to Social Security retirement at the time these contributions are made.

[11] Private pensions allow the employee to defer tax on all inside build-up. They also allow the employee to defer tax on contributions made by the employer, but not on contributions made directly by the employee. Applying these tax rules to Social Security would require the employee to include in his taxable income benefits paid out of inside build-up and out of the employer's contributions, but would allow the employee to exclude from his taxable income benefits paid out of his own contributions.

yield consumption value, then the child care credit and the earned income tax credit would be tax expenditures. In contrast, a competing perspective views these credits as appropriate modifications that account for differing taxpaying capacity. Even accepting this competing perspective, however, one might question why these programs come in the form of credits rather than deductions.

The next category (panel C) includes items whose treatment is less certain. The proper treatment of some of these items under a comprehensive income tax is ambiguous, while others perhaps serve as proxies for what would be a tax expenditure under a comprehensive income base.[12] Consider, for example, the items relating to charitable contributions. Under existing law, charitable contributions are deductible, and this deduction is considered on its face a tax expenditure in the current budget.[13]

The treatment of charitable donations, however, is ambiguous under a comprehensive income tax. If charitable contributions are a consumption item for the giver, then they are properly included in his taxable income; a deduction for contributions would then be a tax expenditure relative to a comprehensive income tax baseline. In contrast, charitable contributions could represent a transfer of purchasing power from the giver to the receiver. As such, they would represent a reduction in the giver's net worth, not an item of consumption, and so properly would be deductible, implying that current law's treatment is not a tax expenditure. At the same time, the value of the charitable benefits received is income to the recipient. Under current law, such income generally is not taxed, and so represents a tax expenditure whose size might be approximated by the size of the donor's contribution.[14]

Medical expenditures may or may not be an element of income (or consumption), depending on one's point of view. Some argue that medical expenditures don't represent discretionary spending, and so aren't consumption. Instead, they are a reduction of net worth and should be excluded from the tax base. Others argue that there is no way to logically distinguish medical care from other consumption items. Moreover, clearly there is choice in health care decisions, e.g., whether to go to the best doctor, whether to have voluntary surgical procedures, and whether to exercise and eat nutritiously so as to improve and maintain one's health and minimize medical expenditures.

The exemption of full taxation of Social Security benefits paid to the disabled also raises some issues. Social Security benefits for the disabled most closely resemble either Government transfers or insurance. A comprehensive income tax would require the worker to include the benefit fully in his income and would allow him to deduct associated Social Security taxes. If viewed as insurance, he also could include the premium (i.e., tax) and exclude the benefit. The deviation between such treatment and current law's treatment (described above) would be a tax expenditure under a comprehensive income baseline.

In contrast, as described above, the official tax expenditure measures the benefit of exemption for low income beneficiaries from the tax on 85 percent of Social Security benefits. This measurement does not correspond closely to that required under a comprehensive income base. If the payment of the benefit is viewed as a transfer and divorced from the treatment of Social Security taxes, then the current tax expenditure understates the tax expenditure measured relative to a comprehensive income baseline. If the payment of the benefit is viewed as a transfer but the inability to deduct the employee's share of the Social Security tax is simultaneously considered, then it is less likely that the current tax expenditure overstates the tax expenditure relative to a comprehensive income baseline, and in some cases it may generate a negative tax expenditure. Negative tax expenditures arise when the actual tax treatment imposes a higher tax burden than would the baseline tax system, and are discussed in more detail below. If the benefit is viewed as insurance and the tax as a premium, then the current tax expenditure overstates the tax expenditure relative to a comprehensive income baseline. Indeed, in the insurance model, the ability to exclude from tax only ½ of the premium might suggest that ½ of the payout should be taxed, so that the current tax rules impose a greater tax burden than that implied by a comprehensive income tax, i.e., a negative tax expenditure.

The deduction of nonbusiness state and local taxes other than on owner-occupied homes also is included here. These taxes include both income taxes and property taxes. The stated justification for this tax expenditure is that "Taxpayers may deduct State and local income taxes and property taxes even though these taxes primarily pay for services that, if purchased directly by taxpayers, would not be deductible."[15] The idea is that these taxes represent consumption expenditures, and so are elements of income.

In contrast to the view in the official budget, the deduction for State and local taxes might not be a tax expenditure if the baseline were comprehensive income. Properly measured comprehensive income would include the value of State and local government benefits received, but would allow a deduction for State and local taxes paid.[16] Thus, in this sense the deductibility of State and local taxes is consistent with comprehensive income tax principles; it should not be a tax expenditure. However, imputing the value of State and local services may be difficult and, as a rough correction, the tax system might disallow the deduction for State and local taxes.[17] So, if the value of services

[12] See, for example, Goode, *The Economic Definition of Income,* pp. 16–17, and Bradford, Untangling the Income Tax, pp. 19–21, and pp.30–31.

[13] The item also includes gifts of appreciated property, at least part of which represents a tax expenditure relative to an ideal income tax, even if one assumes that charitable donations are not consumption.

[14] If recipients tend to be in lower tax brackets, then the tax expenditure is smaller than when measured at the donor's tax rates.

[15] *Fiscal Year 2003 Budget of the United States Government, Analytical Perspectives* (Washington, D.C.: U.S. Government Printing Office, 2002) p. 127.

[16] U.S. Treasury, Blueprints for Basic Tax Reform (Washington, D.C.: U.S. Government Printing Office, 1977) p. 92.

[17] Home mortgage interest and property taxes on owner-occupied housing raise the same ambiguity. Classifying them as probably not tax expenditures arguably is inconsistent. It

from State and local governments is excluded from the tax base, as it generally is under current law, a deduction for taxes might be viewed as a tax expenditure relative to a comprehensive income baseline.[18]

Mortgage interest would be deductible from the base of a comprehensive income tax, since comprehensive income would include implicit rental income on owner-occupied housing. Similarly, property taxes on owner-occupied housing would be deductible, since they represent a reduction in net worth. One could argue, however, that because current law does not impute rental income nor does it impute the value of Government services, the home mortgage interest deduction and the deduction for property taxes move away from rather than towards the outcome observed under a comprehensive income tax base, and so might be considered tax expenditures. Alternatively, they might be viewed as proxies for the correct tax expenditures. They are, however, extremely crude proxies for the implicit rental income earned on owner-occupied housing. The interest deduction proxy, for example, understates the extent of the tax expenditure associated with ignoring implicit rental income to the extent a house is unencumbered by a mortgage that approximates the house's market value, and does not include the effects on net income of such costs as depreciation, maintenance, and repairs.

The final category (panel D) includes items that would not be tax expenditures under a comprehensive income tax base. Most versions of a comprehensive income tax would assign tax liability to individuals. There would be no separate corporation income tax. Hence, the issue of graduated corporate tax rates would not arise.[19] A tax based on comprehensive income would allow all losses to be deducted. Hence, the exception from the passive loss rules would not be a tax expenditure.[20]

Major Tax Expenditures under a Comprehensive Income Tax That Are Excluded from the Current Budget

While most of the major tax expenditures in the current budget also would be tax expenditures under a comprehensive income base, there also are tax expenditures relative to a comprehensive income base that are not found on the existing tax expenditure list. These additional tax expenditures include the imputed return from consumer durables and owner-occupied housing, the difference between capital gains (and losses) as they accrue and capital gains as they are realized, private gifts and inheritances received, in-kind benefits from such Government programs as food-stamps, Medicaid, and public housing, the value of payouts from insurance policies,[21] and benefits received from private charities. Under some ideas of comprehensive income, the value of leisure and of household production of goods and services also would be included as tax expenditures. The personal exemption and standard deduction also might be considered tax expenditures, although they can be viewed differently, e.g., as elements of the basic tax rate schedule. The foreign tax credit also might be a tax expenditure, since a deduction for foreign taxes, rather than a credit, would seem to measure the income of U.S. residents properly.

Negative Tax Expenditures

Under current budgetary practice, negative tax expenditures, tax provisions that raise rather than lower taxes, are excluded from the official tax expenditure list. This exclusion conforms with the view that tax expenditures are intended to be similar to Government spending programs.

If attention is expanded from a focus on spending-like programs to include any deviation from the baseline tax system, negative tax expenditures would be of interest. Relative to a comprehensive income baseline, there are a number of important negative tax expenditures, some of which also might be viewed as negative tax expenditures under an expanded interpretation of the normal or reference law baseline. Among the more important negative tax expenditures is the corporation income tax, or more generally the double tax on corporate profits, which would be eliminated under a comprehensive income tax. The Jobs and Growth Tax Relief and Reconciliation Act of 2003 (JGTRRA) reduced the tax rate on dividends and capital gains to 15 percent, thus reducing the double tax compared to prior law. Nonetheless, as discussed later in the Appendix, current law still imposes a substantial double tax on corporate profits. The passive loss rules, restrictions on the deductibility of capital losses, and NOL carry-forward requirements each would generate a negative tax expenditure, since a comprehensive income tax would allow full deductibility of losses. If human capital were considered an asset, then its cost (e.g., certain education and training expenses, including perhaps the cost of college and professional school) should be amortizable, but it is not under current law.[22] Some restricted deductions under the individual AMT might be negative tax expenditures as might the phase-out of personal exemptions and of itemized deductions. The inability to deduct consumer interest also might

reflects the judgment that no comprehensive tax is likely to tax the value of State and local services, while it appears somewhat easier to impute and tax the rental income from owner-occupied housing.

[18] Under the normal tax method employed by the Joint Committee on Taxation, the value of some public assistance benefits provided by State Governments is included as a tax expenditure, thereby raising a potential double counting issue.

[19] As discussed below, the double tax on corporate profits would be a major negative tax expenditure.

[20] In contrast, the passive loss rules themselves, which restrict the deduction of losses, would be a negative tax expenditure when compared to a comprehensive tax base.

[21] To the extent that premiums are deductible.

[22] Current law offers favorable treatment to some education costs, thereby creating (positive) tax expenditures. Current law allows expensing of that part of the cost of education and career training that is related to foregone earnings and this would be a tax expenditure under a comprehensive income baseline. In addition, some education has consumption value, and under a comprehensive income definition would be taxable to that extent, but is not taxable under current law.

be a negative tax expenditure, as an interest deduction may be required to properly measure income, as seen by the equivalence between borrowing and reduced lending.[23] As discussed above, the current treatment of Social Security payments to the disabled also might represent a negative tax expenditure, if viewed as payments on an insurance policy.

Current tax law also fails to index for inflation interest receipts, capital gains, depreciation, and inventories. This failure leads to negative tax expenditures because comprehensive income would be indexed for inflation. Current law, however, also fails to index for inflation the deduction for interest payments; this represents a (positive) tax expenditure.

The issue of indexing also highlights that even if one wished to focus only on tax policies that are similar to spending programs, accounting for some negative tax expenditures may be required. For example, the net subsidy created by accelerated depreciation is properly measured by the difference between depreciation allowances specified under existing tax law and economic depreciation, which is indexed for inflation.[24]

DIFFERENCES BETWEEN OFFICIAL TAX EXPENDITURES AND TAX EXPENDITURES RELATIVE TO A CONSUMPTION BASE

This section compares tax expenditures listed in the official tax expenditure budget with those implied by a comprehensive consumption tax baseline. It first discusses some of the difficulties encountered in trying to compare current tax provisions to those that would be observed under a comprehensive consumption tax. Next, it discusses which of the thirty largest official tax expenditures would be tax expenditures under the consumption tax baseline, concluding that about one-half of the top thirty official tax expenditures would remain tax expenditures under a consumption tax baseline. Most of those that fall off the list are tax incentives for saving and investment.

The section next discusses some major differences between current law and a comprehensive consumption tax baseline that are excluded from the current list of tax expenditures. These differences include the consumption value of owner-occupied housing and other consumer durables, benefits from in-kind Government transfers, and gifts. It concludes with a discussion of negative tax expenditures relative to a consumption tax baseline

Ambiguities in Determining Tax Expenditures Relative to a Consumption Baseline

A broad-based consumption tax is a combination of an income tax plus a deduction for net saving. This follows from the definition of comprehensive income as consumption plus the change in net worth. It therefore seems straightforward to say that current law's deviations from a consumption base are the sum of (a) tax expenditures on an income base associated with exemptions and deductions for certain types of income, plus (b) overpayments of tax, or negative tax expenditures, to the extent net saving is not deductible from the tax base. In reality, however, the situation is more complicated. A number of issues arise, some of which also are problems in defining a comprehensive income tax, but seem more severe, or at least only more obvious, for the consumption tax baseline.

It is not always clear how to treat certain items under a consumption tax. One problem is determining whether a particular expenditure is an item of consumption. Spending on medical care and charitable donations are two examples. Another problem relates to foreign source income. It is sometimes argued that a credit for foreign income taxes is inappropriate against the base of a consumption tax. Does that mean that the current foreign tax credit is a tax expenditure for a consumption tax base? The classification below suggests that medical spending and charitable contributions might be included in the definition of consumption, but also considers an alternative view. It makes no judgment about the treatment of foreign taxes, but provides a brief discussion of the issues.

There may be more than one way to treat various items under a consumption tax. For example, a consumption tax might ignore borrowing and lending by excluding from the borrower's tax base the proceeds from loans, denying the borrower a deduction for payments of interest and principal, and excluding interest and principal payments received from the lender's tax base. On the other hand, a consumption tax might include borrowing and lending in the tax base by requiring the borrower to add the proceeds from loans in his tax base, allowing the lender to deduct loans from his tax base, allowing the borrower to deduct payments of principal and interest, and requiring the lender to include receipt of principal and interest payments. In present value terms, the two approaches are equivalent for both the borrower and the lender; in particular both allow the tax base to measure consumption and both impose a zero effective tax rate on interest income. But which approach is taken obviously has different implications (at least on an annual flow basis) for the treatment of many important items of income and expense, such as the home mortgage interest deduction. The classification below suggests that the deduction for home mortgage interest could well be a tax expenditure, but takes note of alternative views.

Some exclusions of income are equivalent in many respects to consumption tax treatment that immediately deducts the cost of an investment while taxing the future cash-flow. For example, exempting invest-

[23] See Bradford, *Untangling the Income Tax,* p. 41.

[24] Accelerated depreciation can be described as the equivalent of an interest free loan from the Government to the taxpayer. Under federal budget accounting principles, such a loan would be treated as an outlay equal to the present value of the foregone interest.

ment income is equivalent to consumption tax treatment as far as the normal rate of return on new investment is concerned. This is because expensing generates a tax reduction that offsets in present value terms the tax paid on the investment's future normal returns. Expensing gives the income from a marginal investment a zero effective tax rate. However, a yield exemption approach differs from a consumption tax as far as the distribution of income and Government revenue is concerned. Pure profits in excess of the normal rate of return would be taxed under a consumption tax, because they are an element of cash-flow, but would not be taxed under a yield exemption tax system. Should exemption of certain kinds of investment income, and certain investment tax credits, be regarded as the equivalent of consumption tax treatment? The classification that follows takes a fairly broad view of this equivalence and considers many tax provisions that reduce or eliminate the tax on capital income to be roughly consistent with a broad-based consumption tax.

Looking at provisions one at a time can be misleading. The hybrid character of the existing tax system leads to many provisions that might make good sense in the context of a consumption tax, but that generate inefficiencies because of the problem of the "uneven playing field" when evaluated within the context of the existing tax rules. It is not clear how these should be classified. For example, many saving incentives are targeted to specific tax favored sources of capital income, and so potentially distort economic choices in ways that would not occur under a broad-based consumption tax. As another example, under a consumption VAT based on the destination principle, there would be a rebate of the VAT on exports and a tax on imports. Does this mean that the extraterritorial income exclusion (the successor of the Foreign Sales Corporation provision) is not a tax expenditure? Resolution comes down to judgments about how broad is broad enough to be considered general, or whether it even matters at all that a provision is targeted in some way. The classification that follows views many savings incentives, even if targeted, as roughly consistent with a broad based consumption tax.

Capital gains would not be a part of a comprehensive consumption tax base. Proceeds from asset sales and sometimes borrowing would be part of the cash-flow tax base, but, for transactions between domestic investors at a flat tax rate, would cancel out in the economy as a whole. How should existing tax expenditures related to capital gains be classified? The classification below generally views available capital gains tax breaks as consistent with a broad-based consumption tax because they lower the tax rate on capital income toward the zero rate that is consistent with a consumption-based tax.

Such considerations suggest that trying to compute the current tax's deviations from "the" base of a consumption tax is impossible because deviations cannot be uniquely determined, making it very difficult to do a consistent accounting of the differences between the current tax base and a consumption tax base. Nonetheless, Appendix Table 2 attempts a classification based on the criteria outlined above.

Treatment of Major Tax Expenditures under a Comprehensive Consumption Baseline

As noted above, the major difference between a comprehensive consumption tax and a comprehensive income tax is in the treatment of saving, or in the taxation of capital income. Consequently, many current tax expenditures related to preferential taxation of capital income would not be tax expenditures under a consumption tax. However, preferential treatment of items of income that is unrelated to moderately broad-based saving or investment incentives would remain tax expenditures under a consumption baseline. In addition, several official tax expenditures relating to items of income and expense are difficult to properly classify, while others may serve as proxies for properly measured tax expenditures.

Appendix Table 2 shows the thirty largest official tax expenditures from the Budget classified according to whether they would be considered a tax expenditure under a consumption tax. One of the thirty items clearly would be a tax expenditure (shown in panel A) under a consumption tax, while an additional four (those in panel B) probably would be tax expenditures.

Exclusion of workers' compensation benefits allows an exclusion from income that is unrelated to investment, and so should be included in the base of a comprehensive consumption tax.

The official tax expenditures for Social Security benefits reflects exceptions for low income taxpayers from the general rule that 85 percent of Social Security benefits are included in the recipient's tax base. The 85 percent inclusion is intended as a simplified mechanism for taxing Social Security benefits as if the Social Security program were a private pension with employee contributions made from after-tax income. Under these tax rules, income earned on contributions made by both employers and employees benefits from tax deferral, but employer contributions also benefit because the employee may exclude them from his taxable income, while the employee's own contributions are included in his taxable income. These tax rules give the equivalent of consumption tax treatment, a zero effective tax rate on the return, to the extent that the original pension contributions are made by the employer, but give less generous treatment to the extent that the original contributions are made by the employee. Income earned on employee contributions is taxed at a low, but positive, effective tax rate. Based on historical calculations, the 85 percent inclusion reflects roughly the outcome of applying these tax rules to a lower-income earner when one-half of the contributions are from the employer and one-half from the employee.

The current tax expenditure measures a tax benefit relative to a baseline that is somewhere between a com-

prehensive income tax and a consumption tax. The properly measured tax expenditure relative to a consumption tax baseline would include only those Social Security benefits that are accorded treatment more favorable than that implied by a consumption tax, which would correspond to including 50 percent of Social Security benefits in the recipient's tax base.

A similar analysis would apply to exclusion of Social Security benefits of dependents and retirees.

The child credit and the earned income tax credit can be viewed as social welfare programs unrelated to measuring and taxing consumption. As such, they would be tax expenditures relative to a consumption baseline.

The treatment of the items in panels C is less uncertain. Several of these items relate to the costs of medical care or to charitable contributions. As discussed in the previous section of the appendix, there is disagreement within the tax policy community over the extent to which medical care and charitable giving represent consumption items. While widely held to be consumption, a competing view is that they represent reductions in net worth that should be excluded from the tax base because they do not yield direct satisfaction to taxpayer who makes the expenditure.

There also is the issue of how to tax medical insurance premiums. Under current law, employees do not have to include insurance premiums paid for by employers in their income. The self-employed also may exclude (via a deduction) medical insurance premiums from their taxable income. From some perspectives, these premiums should be in the tax base because they appear to represent consumption. Yet an alternative perspective would support excluding the premium from tax as long as the consumption tax base included the value of any medical services paid for by the insurance policy, because the premium equals the expected value of insurance benefits received. But even from this alternative perspective, the official tax expenditure might continue to be a tax expenditure under a consumption tax baseline because current law excludes the value of medical services paid with insurance benefits from the employee's taxable income.

If medical spending is not consumption, one approach to measuring the consumption base would ignore insurance, but allow the consumer to deduct the value of all medical services obtained. An alternative approach would allow a deduction for the premium but include the value of any insurance benefits received, while continuing to allow a deduction for a value of all medical services obtained. In either case, the official tax expenditure for the exclusion of employer provided medical insurance and expenses would not be a tax expenditure relative to a consumption tax baseline.

Consider next the deductibility of home mortgage interest. A consumption tax seeks to tax the consumption value of housing services consumed no matter how the house is financed. From this perspective, home mortgage interest should not be deductible. However, what governs the proper treatment of interest under a consumption tax is whether financial flows are in or out of the consumption tax base. A result equivalent to disallowing the interest deduction would require that the loan be taken into income and would permit the associated interest and principal payments to be deducted. If the loans are taken into income (as they would be under some types of consumption taxes), then the associated interest and principal payments should be deductible, otherwise not. Without specifying how financial flows are treated, it is unclear how to treat the home mortgage interest deduction. Nonetheless, given that loans are not taken into income under current law, and this treatment's equivalency to disallowing the interest deduction, classifying the deduction of home mortgage interest as a tax expenditure might be reasonable.

Ambiguities arise about the proper treatment of State and local taxes under a consumption tax, as they do under an income tax. These taxes are not of themselves consumption items, but might serve as proxies for the value of Government services consumed.

The extraterritorial income exclusion replaces the previous Foreign Sales Corporation program. It provides an exclusion from income for certain exports. To the extent that the program is viewed as a component of a destination based VAT it might not be a tax expenditure. In addition, to the extent that the exclusion is an investment subsidy, it might be consistent with consumption tax principles (i.e., a low tax rate on capital income).

The taxation of Social Security benefits for the disabled also is difficult to classify. As discussed in this appendix above, these benefits generally ought to be taxed because they represent purchasing power. However, the associated Social Security taxes ought to be fully deductible, but they are not. Hence the proper treatment is unclear. Moreover, if the insurance model is applied, the taxation of Social Security benefits might be a negative tax expenditure.

The credit for low income housing acts to lower the tax burden on qualified investment, and so from one perspective would not be a tax expenditure under a consumption tax baseline. However, in some cases the credit is too generous; it can give a negative tax on income from qualified investment rather than the zero tax called for under consumption tax principles. In addition, the credit is very narrowly targeted. Consequently, it could be considered a tax expenditure relative to a consumption tax baseline.

The final panel (D) shows items that are not likely to be tax expenditures under a consumption base. Most of these relate to tax provisions that eliminate or reduce the tax on various types of capital income because a zero tax on capital income is consistent with consumption tax principles. But in those cases where a tax remains, a negative tax expenditure under the consumption tax is created.

The graduated corporate income tax rates would not be a tax expenditure under a comprehensive consumption baseline. A consumption tax would have no tax

on corporate income or profits, hence the issue of whether the rate structure on corporate income provides a special benefit to corporations with low income would not arise.

The exception from the passive loss rules probably would not be a tax expenditure because proper measurement of income, and hence of consumption, requires full deduction of losses.

Major Tax Expenditures under a Consumption Tax That Are Excluded from the Current Budget

Several differences between current law and a consumption tax are left off the official tax expenditure list. Additional tax expenditures include the imputed consumption value from consumer durables and owner-occupied housing, private gifts and inheritances received, possibly benefits paid by insurance policies, in-kind benefits from such Government programs as food-stamps, Medicaid, and public housing, and benefits received from charities. Under some ideas of a comprehensive consumption tax, the value of leisure and of household production of goods and services would be included as a tax expenditure.

A consumption tax implemented as a tax on cash flows would tax all proceeds from sales of capital assets when consumed, rather than just capital gains; because of expensing, taxpayers effectively would have a zero basis. The proceeds from borrowing would be in the base of a consumption tax that also allowed a deduction for repayment of principal and interest, but are excluded from the current tax base. The deduction of business interest expense might be a tax expenditure, since under some forms of consumption taxation interest is neither deducted from the borrower's tax base nor included in the lender's tax base. The personal exemption and standard deduction also might be considered tax expenditures, although they can be viewed differently, e.g., as elements of the basic tax rate schedule.

Negative Tax Expenditures

Importantly, current law also deviates from a consumption tax norm in ways that increase, rather than decrease, tax liability. These could be called negative tax expenditures. The official budget excludes negative tax expenditures on the theory that tax expenditures are intended to substitute for Government spending programs. Yet excluding negative tax expenditures would give a very one-sided look at the differences between the existing tax system and a consumption tax.

A large item on this list would be the inclusion of capital income in the current individual income tax base, including the income earned on inside-build up in Social Security accounts. The revenue from the corporation income tax, or more generally a measure of the double tax on corporate profits, also would be a negative tax expenditure. Depreciation allowances, even if accelerated, would be a negative tax expenditure since consumption tax treatment generally would require expensing. Depending on the treatment of loans, the borrower's inability to deduct payments of principal and the lender's inability to deduct loans might be a negative tax expenditure. The passive loss rules, restrictions on the deductibility of capital losses, and NOL carryforward provisions also would generate negative tax expenditures, because the change in net worth requires a deduction for losses. If human capital were considered an asset, then its cost (e.g., certain education and training expenses, including perhaps costs of college and professional school) should be expensed, but it is not under current law. Certain restrictions under the individual AMT as well as the phase-out of personal exemptions and of itemized deductions also might be considered negative tax expenditures. Under some views, the current tax treatment of Social Security benefits paid to the disabled would be a negative tax expenditure.

REVISED ESTIMATES OF SELECTED TAX EXPENDITURES

Accelerated Depreciation

Under the reference tax law baseline no tax expenditures arise from accelerated depreciation. In the past, official tax expenditure estimates of accelerated depreciation under the normal tax law baseline compared tax allowances based on the historic cost of an asset with allowances calculated using the straight-line method over relatively long recovery periods. Normal law allowances also were determined by the historical cost of the asset and so did not adjust for inflation, although such an adjustment is required when measuring economic depreciation, the age related fall in the real value of the asset.

Beginning with the 2004 Budget, the tax expenditures for accelerated depreciation under the normal law concept have been recalculated using as a baseline depreciation rates and replacement cost indexes from the National Income and Product Accounts.[25] The revised estimates are intended to approximate the degree of acceleration provided by current law over a baseline determined by real, inflation adjusted, and economic depreciation. Current law depreciation allowances for machinery and equipment include the benefits of a temporary expensing provision.[26] The estimates are shown in tables in the body of the main text, e.g., Table 18.1.

[25] See Barbara Fraumeni, "The Measurement of Depreciation in the U.S. National Income and Product Accounts," in Survey of Current Business 77 No. 7 (Washington, D.C.: Department of Commerce, Bureau of Economic Analysis, July, 1997), pp. 7–42, and the *National Income and Product Accounts of the United States,* Table 7.6, "Chain-type Quantity and Price Indexes for Private Fixed Investment by Type," U.S. Department of Commerce, Bureau of Economic Analysis.

[26] The temporary provision allows 30 percent of the cost of a qualifying investment to be deducted immediately rather than capitalized and depreciated over time. It is generally effective for qualifying investments made after September 10, 2001 and before September 11, 2004. The Jobs and Growth Tax Relief Reconciliation Act of 2003 raised the deduction to 50 percent depreciation (up from 30 percent) of the cost new equipment purchased after May 5, 2003 and placed into service before January 1, 2005. Qualifying investments generally are limited to tangible property with depreciation recovery periods of 20 years or less, certain software, and leasehold improvements, but this set of assets corresponds closely to machinery and equipment.

The revised tax expenditure estimates differ substantially from estimates calculated under the old methodology. In general, the new tax expenditure estimates are smaller than the old estimates.[27] In part this is because the new baseline uses depreciation allowances that are faster than those in the old baseline. In addition, the new baseline calculates depreciation on a replacement cost basis rather on the historic cost basis previously used; this translates into larger depreciation allowances to the extent that asset prices rise over time. In many years the new tax expenditures are negative, indicating that current law's tax depreciation allowances are smaller than those implied by economic depreciation. Because these estimates are on a cash flow, rather than a present value, basis, the negative value does not necessarily indicate that tax depreciation is decelerated relative to economic depreciation over the life of an investment. Even when tax depreciation is accelerated over the life of an investment, negative annual cash flow estimates could obtain in the later years of an investment's economic life. This type of vintage effect contributes importantly to the negative tax expenditures calculated for equipment in 2005–2009 because the temporary expensing provision expires at the end of 2004. Calculations that compare the present value of tax depreciation (without the temporary expensing) with the present value of inflation indexed economic depreciation over each investment's economic life show that for many types of assets tax depreciation is accelerated, but only slightly, assuming a moderate rate of inflation.[28]

Owner-Occupied Housing

A homeowner receives a flow of housing services equal in gross value to the rent that could have been earned had the owner chosen to rent the house to others. Comprehensive income would include in its base the implicit net rental income earned on investment in owner-occupied housing. Current law, however, excludes from its tax base such net rental income. This exclusion is a tax expenditure relative to a comprehensive income base.

In contrast to a comprehensive income baseline, the official list of tax expenditures does not include the exclusion of implicit rental income on owner-occupied housing. Instead, it includes as tax expenditures deductions for home mortgage interest and for property taxes. These are poor proxies for the exclusion of implicit net rental income. To the extent that a homeowner owns his house outright, unencumbered by a mortgage, he would have no home mortgage interest deduction, yet he still would enjoy the benefits of receiving tax free the implicit rental income earned on his house. When measuring the net income from an investment in owner-occupied housing, mortgage interest and property taxes generally would be deductible. The official tax expenditures do not allow for depreciation and other costs incurred by the homeowner that must be deducted in determining his net rental income.

[27] Estimates under the old methodology are no longer shown in the tables.

[28] U.S. Department of the Treasury, *Report to the Congress on Depreciation Recovery Periods and Methods* (Washington, D.C.: U.S. Government Printing Office, July, 2000), p. 32.

Appendix Table 3 shows an estimate of the tax expenditure caused by the exclusion of implicit net rental income from investment in owner-occupied housing. This estimate starts with the NIPA calculated value of gross rent on owner-occupied housing, and subtracts interest, taxes, economic depreciation, and other costs in arriving at an estimate of net-rental income from owner-occupied housing.[29]

The tax expenditure estimate is substantial, growing from $24 billion in 2005 to $35 billion in 2009. Nonetheless, it is only about one-third as large as the official tax expenditure for the deduction of home mortgage interest. In part this discrepancy reflects depreciation and other expenses that must be subtracted from gross rents in arriving at net rental income. In part, it also might reflect homeowners' ability to borrow against their homes to fund other spending, leading to a relatively high debt/equity ratio for housing.

Accrued Capital Gains

Under a comprehensive income baseline, all real gains would be taxed as accrued. These gains would be taxed as ordinary income rather than at preferential rates. There would be no deferred unrealized gains on assets held at death, nor gains carried over on gifts, or other preferential treatments. Indeed, all of the provisions related to capitals gains listed in the tax expenditure budget would be dropped. Instead, in their place the difference between the ordinary tax on real gains accrued and the actual tax paid would be calculated. For 1999, for instance, the tax on real accrued gains on corporate equity is estimated at $594 billion. This compares to an estimated tax on realized gains of $62 billion, for forgone revenues of $562 billion. However, this tax expenditure may easily turn into a penalty given the limits on capital losses. For 2000, for instance, real accrued losses in corporate equity amounted to $1.4 trillion. Yet, taxpayers paid an estimated $70 billion in capital gains taxes. This roughly translates into an overpayment of taxes to the tune of $464 billion.

Double Tax on Corporate Profits

A comprehensive income tax would tax all sources of income once. Taxes would not vary by type or source of income.

In contrast to this benchmark, current law taxes income that shareholders earn on investment in corporate stocks at least twice, and at combined rates that generally are higher than those imposed on other sources of income. Corporate profits are taxed once at the company level under the corporation income tax. They are taxed again at the shareholder level when received as a dividend or recognized as a capital gain. Corporate profits can be taxed more then twice when they pass through multiple corporations before being distributed to noncorporate shareholders. Corporate level taxes cas-

[29] *National Income and Production Accounts,* Table 2.4.

cade because corporations are taxed on capital gains they realize on the sale of stock shares and on some dividend income received. Compared to a comprehensive income tax current law's double (or more) tax on corporate profits is an example of a negative tax expenditure because it subjects income to a larger tax burden than implied by a comprehensive income baseline.

Appendix Table 3 provides an estimate of the negative tax expenditure caused by the multiple levels of tax on corporate profits. This negative tax expenditure is measured as the shareholder level tax on dividends paid and capital gains realized out of earnings that have been fully taxed at the corporate level. It also includes the corporate tax paid on inter-corporate dividends and on corporate capital gains attributable to the sale of stock shares. The estimate includes the reduction in the dividends and capital gains tax rates enacted in JGTRRA.

The negative tax expenditure is large in magnitude; it exceeds $33 billion in the years 2005 through in 2009. It is comparable in size (but opposite in sign) to all but the largest official tax expenditures. JGTRRA reduced but did not eliminate the double tax on corporate profits.

Appendix Table 1. COMPARISON OF CURRENT TAX EXPENDITURES WITH THOSE IMPLIED BY A COMPREHENSIVE INCOME TAX [1]

(In millions of dollars)

Description	2005 Revenue Effect
A. Tax Expenditure Under a Comprehensive Income Tax	
Net exclusion of pension contributions and earnings: Employer plans	61,740
Net exclusion of pension contributions and earnings: 401(k) plans	58,910
Capital gains (except agriculture, timber, iron ore, and coal)	30,190
Exclusion of interest on public purpose State and local bonds	26,370
Exclusion of interest on life insurance savings	22,130
Capital gains exclusion on home sales	21,490
Net exclusion of pension contributions and earnings: Individual Retirement Accounts	20,090
Net exclusion of pension contributions and earnings: Keogh plans	9,260
Deferral of income from controlled foreign corporations (normal tax method)	8,400
Credit for low-income housing investments	6,860
Exclusion of workers' compensation benefits	6,850
Extraterritorial income exclusion	5,890
Expensing of certain small investments (normal tax method)	4,850
Expensing of research and experimentation expenditures (normal tax method)	4,500
B. Possibly a Tax Expenditure Under a Comprehensive Income Tax, But With Some Qualifications	
Child credit	29,860
Exclusion of Social Security benefits for retired workers	19,040
Step-up basis of capital gains at death	18,240
Earned income tax credit	5,006
Exclusion of Social security benefits of dependents and survivors	4,310
C. Uncertain	
Exclusion of employer contributions for medical insurance premiums and medical care	112,990
Deductibility of mortgage interest on owner-occupied homes	69,740
Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	46,180
Deductibility of charitable contributions, other than education and health	29,670
Deductibility of State and local property tax on owner-occupied homes	19,410
Deductibility of medical expenses	7,900
Deductibility of self-employed medical insurance premiums	3,780
Social Security benefits for disabled	3,720
Deductibility of charitable contributions (education)	3,660
D. Probably Not a Tax Expenditure Under a Comprehensive Income Tax	
Exception from passive loss rules for $25,000 of rental loss	4,390
Graduated corporation income tax rate (normal tax method)	3,910

[1] The measurement of certain tax expenditures under a comprehensive income tax baseline may differ from the official budget estimate even when the provision would be a tax expenditure under both baselines.

Source: Table 18–2, Tax Expenditure Budget.

Appendix Table 2. COMPARISON OF CURRENT TAX EXPENDITURES WITH THOSE IMPLIED BY A COMPREHENSIVE CONSUMPTION TAX [1]

(In millions of dollars)

Description	2005 Revenue Effect
A. Tax Expenditure Under a Consumption Base	
Exclusion of workers' compensation benefits	6,850
B. Probably a Tax Expenditure Under a Consumption Base,	
Child credit	29,860
Exclusion of Social Security benefits for retired workers	19,040
Earned income tax credit	5,006
Exclusion of Social security benefits of dependents and survivors	4,310
C. Uncertain	
Exclusion of employer contributions for medical insurance premiums and medical care	112,990
Deductibility of mortgage interest on owner-occupied homes	69,740
Deductibility of nonbusiness state and local taxes other than on owner-occupied homes	46,180
Deductibility of charitable contributions, other than education and health	29,670
Deductibility of State and local property tax on owner-occupied homes	19,410
Deductibility of medical expenses	7,900
Credit for low-income housing investments	6,860
Extraterritorial income exclusion	5,890
Deductibility of self-employed medical insurance premiums	3,780
Deductibility of charitable contributions (education)	3,660
Social Security benefits for disabled	3,720
D. Not a Tax Expenditure under a Consumption Base	
Net exclusion of pension contributions and earnings: Employer plans	61,740
Net exclusion of pension contributions and earnings: 401(k) plans	58,910
Capital gains (except agriculture, timber, iron ore, and coal) (normal tax method)	30,190
Exclusion of interest on public purpose State and local bonds	26,370
Exclusion of interest on life insurance savings	22,130
Capital gains exclusion on home sales	21,490
Net exclusion of pension contributions and earnings: Individual Retirement Accounts	20,090
Step-up basis of capital gains at death	18,240
Net exclusion of pension contributions and earnings: Keogh plans	9,260
Deferral of income from controlled foreign corporations (normal tax method)	8,400
Expensing of certain small investments (normal tax method)	4,850
Expensing of research and experimentation expenditures (normal tax method)	4,500
Exception from passive loss rules for $25,000 of rental loss	4,390
Graduated corporation income tax rate (normal tax method)	3,910

[1] The measurement of certain tax expenditures under a consumption tax baseline may differ from the official budget estimate even when the provision would be a tax expenditure under both baselines.

Source: Table 6–2, Tax Expenditure Budget.

Appendix Table 3. REVISED TAX EXPENDITURE ESTIMATES [1]

(In millions of dollars)

Provision	Revenue Loss						
	2003	2004	2005	2006	2007	2008	2009
Imputed Rent On Owner-Occupied Housing	18,340	20,540	24,100	25,160	28,250	31,400	34,710
Double Tax on corporate profit [2]	–24,020	–26,740	–34,940	–33,340	–33,260	–33,660	–34,280

[1] Calculations described in the appendix text.

[2] This is a negative tax expenditure, a tax provision that overtaxes income relative to the treatment specified by the baseline tax system.