2:00 PM - EPB PRESIDENTIAL MEETING
Re: Tax Policy
Cabinet Room

Monday, December 13, 1976

File

Tax Policy

THE WHITE HOUSE

WASHINGTON

December 11, 1976

MEETING WITH THE ECONOMIC POLICY BOARD
EXECUTIVE COMMITTEE

December 13, 1976
2:00 p.m.
Cabinet Room

From: L. William Seidman

I. PURPOSE

A. To discuss tax policy issues in preparation for your FY 1978 budget and for your Tax and State of the Union messages.

B. To review the Treasury Department Basic Tax Reform Report.

II. BACKGROUND, PARTICIPANTS, AND PRESS PLAN

A. Background: Several tax policy issues require resolution in preparation for your FY 1978 budget and for your Tax and State of the Union Messages. A memorandum reviewing your past tax proposals and seeking your decision on the level of personal income tax reductions, social security tax increases, possible modifications of other outstanding tax proposals, and possible additional tax measures to stimulate increased investment, is attached.

The Treasury, for the past year, has reviewed alternatives to our present tax system to develop a tax system more simple, more equitable, and more economically efficient. A paper, prepared by the Department of the Treasury, briefly summarizing their Basic Tax Reform Report is attached at Tab F.

B. Participants: William E. Simon, L. William Seidman, James T. Lynn, Alan Greenspan, Elliot L. Richardson, W.J. Usery, James M. Cannon, Frank G. Zarb, Arthur F. Burns, John O. Marsh, Max Friedersdorf.

C. Press Plan: White House Press Corps Photo Opportunity.

III. AGENDA

A. Tax Policy Issues

Secretary Simon will review the tax policy issues requiring your decision in preparation for your FY 1978 budget and for your Tax and State of the Union messages.

B. Basic Tax Reform Report

Secretary Simon will review the major findings of the Treasury Department Basic Tax Reform Report.

THE WHITE HOUSE

WASHINGTON

December 11, 1976

MEMORANDUM FOR THE PRESIDENT

FROM: L. WILLIAM SEIDMAN

SUBJECT: Tax Policy Issues

Several tax policy issues require resolution in preparation for your FY 1978 budget and for your Tax and State of the Union messages. This memorandum reviews your past tax proposals, seeks your decision on whether they should be reproposed and/or modified, and discusses possible additions to your tax program to stimulate private investment.

Description of Current Program

In your 1975 State of the Union address and in your October 6, 1975 message you proposed a number of individual and corporate tax reductions. Variants of some of these proposals including estate tax reform and unemployment tax increases were enacted. The remaining proposals are listed with revenue impacts in Table A-4 which is attached at Tab A. These estimates are modified to provide for a phase-in of your proposed social security tax increases and to adjust your deeper personal income tax reductions to account for changes made by the Tax Reform Act of 1976. Your outstanding proposals, as modified, would have an overall effect of reducing tax revenues by approximately $16 billion in FY 1978 and approximately $15 billion in FY 1979.

Budget and Economic Outlook

Under the Case 1 economic projections and OMB's present expenditure estimates, your outstanding tax proposals would yield budget receipts in FY 1979, the year in which you have been aiming for budget balance, of $442.2 billion and a deficit of $25.5 billion.

All of the estimates in this memorandum are based on the economic assumptions shown in Table A-2 which is attached at Tab A. These are not the final economic projections which will be used in the FY 1978 budget. Some of your advisers think these assumptions are too optimistic. The sensitivity of the budget to changes in economic assumptions is significant. For example, a reduction in the real growth rate of 0.5 percentage point beginning in the first quarter of 1977 raises the FY 1979 deficit by $7.5 billion. Similarly, a reduction in the inflation rate of 0.5 percentage point beginning in the first quarter of 1977 raises the FY 1979 deficit by $4.5 billion. Changes in our recent economic forecasts are shown in Table A-3 at Tab A.

Issue 1: Level of personal income tax reductions

Your October 6, 1975, individual income tax cut proposal had three principal components:

✓ 1. Increasing the personal exemption from $750 to $1,000

2. Changing the standard deduction provisions to a flat standard deduction

3. Reducing marginal tax rates

Two features of the Tax Reform Act of 1976 -- the taxable income credit and increases in the standard deduction -- would cause your October 1975 proposal to result in tax increases for approximately 1.5 million taxpayers if it were substituted for current law.

Options

Two revised versions of your original proposal which address this problem are presented for your consideration.

Which is a commitment?

Option 1: Reduce tax revenues by approximately $11 billion in FY 1979 by increasing the personal exemption, lowering marginal tax rates, and raising the low income allowance levels of the current law to the flat standard deduction levels you originally proposed ($1,800 for single returns and $2,500 for joint returns).

An $11 billion reduction would achieve the following three objectives:

1. Increase the personal exemption from $750 to $1,000.

2. Assure that tax liabilities are not increased for anyone relative to the Tax Reform Act of 1976, except as a result of the repeal of the earned income credit.

3. Assure that individual income tax liabilities for all income groups are reduced at least to the levels that you proposed in October 1975.

Option 2: Reduce tax revenues by approximately $8 billion in FY 1979 by increasing the personal exemption to $1,000 and lowering marginal tax rates.

An $8 billion reduction in individual income taxes in FY 1979 would fulfill the first two objectives of increasing the personal exemption to $1,000 and preventing tax increases from present law. However, it would not realize the third objective of assuring that income tax liabilities for all income groups are reduced at least to the levels that you proposed in 1975.

Data on the distribution of the tax changes and the tax burdens on individuals of different income and family sizes under these two alternative proposals are presented in tables attached at Tab B.

Decision

Option 1 ✓ Reduce tax revenues by approximately $11 billion in FY 1979 by increasing the personal exemption, lowering marginal tax rates, and raising the low income allowance levels of the current law to the flat standard deduction levels you originally proposed ($1,800 for single returns and ($2,500 for joint returns).

Supported by:

Option 2 ________ Reduce tax revenues by approximately $8 billion in FY 1979 by increasing the personal exemption to $1,000 and lowering marginal tax rates.

Supported by:

Issue 2: Social Security Tax Increases

Current law mandates annual base increases for social security taxes and a 0.4 percentage point increase in the combined employer-employee tax rate in 1978 for hospital insurance.

In the 1977 budget you recommended a 0.6 percentage point increase for January 1, 1977, in order to maintain the solvency of the social security trust fund. The Congress did not act on this proposal. If the 0.6 percentage point increase were reproposed effective January 1, 1978, this would result in a full percentage point increase in the rate in addition to the base increase already legislated. This would impose a heavy burden concentrated in 1978 for most American workers.

Your advisers recommend that the needed social security tax increase be phased in gradually. Specifically, the EPB Executive Committee recommends (1) an increase of 0.6 percentage points on January 1, 1978 (the o.4 point increase scheduled in current law plus a further 0.2 point), (2) a further increase of 0.6 point on January 1, 1979, and (3) a further 0.3 point increase January 1, 1980.

The cumulative tax increase proposed is almost twice as large as that proposed last year. This increase is necessitated, in part, by the unwillingness of Congress to enact your original proposal. A more detailed discussion of the social security tax issue, including other alternatives with different combinations of rate and base increases, is presented at Tab C.

Recommendation: That you propose increasing the combined employer-employee social security tax 0.6 percentage point on January 1, 1978, a further 0.6 percentage point on January 1, 1979, and a further 0.3 percentage point on January 1, 1980.

Approved ✓ ________ Disapproved ________

Issue 3: Modifying Other Outstanding Proposals to Increase Tax Revenues

The 1977 budget included a number of tax proposals. In order to increase tax revenues and lower the deficit you may wish to modify or delete some of these proposals. A detailed description of each of these proposals is attached at Tab D. The following table lists the proposals and their revenue impact.

	Effects on Fiscal Year Receipts ($ billions) 1977	1978	1979	
Retain ~~Delete~~ accelerated depreciation in high unemployment areas	*	0.2	0.4	Yes
Delete utility relief package reductions	0.2	0.8	1.1	No
Delete 2 percentage point surtax rate reduction	1.1	2.6	2.8	No
Delete financial institutions reform	0.3	0.7	0.7	No
Delete BSOP	*	0.4	0.5	No
Retain ~~Delete~~ proposal to end withholding on dividends to foreigners	0.1	0.2	0.3	?
Retain ~~Delete~~ sliding scale capital gains tax	-0.1	0.6	0.9	Yes
Delete home insulation credit		0.2	0.2	No
Retain ~~Delete~~ Limited Employee Retirement Accounts	0.1	0.4	0.5	Yes
Retain ~~Delete~~ education tax credit proposal **	*	0.3	0.4	What priority [illegible] Yes
Retain Delete exclusion of charitable contributions from minimum tax	*	0.1	0.1	?
Totals	1.7	6.5	7.9	

* Less than $50 million
** Mentioned during campaign rather than in 1977 budget

Issue 4: Possible Stimulative Investment Measures

The Troika forecasting group in its preliminary December forecast concluded that with no new fiscal initiatives the growth rate in the economy during 1977 will likely be slower than previously forecast and well below the rate assumed in the mid-year review. Accordingly, the EPB Executive Committee has considered options for additional stimulus. Three factors have guided our review: (1) Business fixed investment is well below its normal share of GNP and is a major reason for the lower forecast. (2) Your basic program already includes significant individual income tax reductions. (3) Proposals designed to provide near term investment incentives should also incorporate structural changes which are desirable on a permanent basis.

Options

Three alternatives to stimulate increased investment are presented for your consideration. The levels of the changes are illustrative. The measures are not mutually exclusive and could be adjusted to different scales.

Option 1: Advance the dividend deduction feature of the integration proposal.

One way to accelerate the Administration's proposal to integrate the individual and corporate income taxes is to start the dividend deductibility at a higher level immediately (as of January 1, 1977). Permitting deductibility of 30 percent of dividends starting January 1, 1977, would reduce calendar year 1977 liabilities by approximately $4.8 billion and fiscal 1979 receipts $5.2 billion. This phase-in would maintain the level of 30 percent dividend deductibility through 1981.

Advantages:

- o Accelerating the integration proposal reduces taxes on businesses and thus would increase corporate profits.
- o It would encourage the payment of dividends and may therefore have a larger effect than other proposals in raising stock prices.
- o Accelerating the integration proposal would partially remove the bias against equity financing, could help improve debt/equity ratios, improve corporate flexibility and thus increase confidence in future investment.

Disadvantages:

- o The integration issue is extraordinarily complicated and unlikely to secure congressional approval quickly. Thus, it may be an inappropriate measure for providing an immediate investment stimulus.

- o The proposal reduces taxes on dividends and will therefore in the long run encourage corporate distributions. The direct effect on investment will therefore require an improved availability of equity capital in the stock market.

- o The proposal may be attacked as favoring the wealthy.

Option 2: Increase the benefits provided by the investment tax credit

The investment tax credit would be changed to:

1. Permit the full amount of the credit earned by an investor each year to be credited against all income tax liabilities and refundable to the extent it is in excess of current tax liabilities.

2. Reduce the basis of qualified property by the amount of the credit.

3. Make the investment tax credit permanent.

4. Increase the schedule of rates to 4 percent on assets with lives of 3 or 4 years; 8 percent on assets with lives of 5 or 6 years; 12 percent on assets with lives 7 through 11 years; and 14 percent on assets with lives of 12 years or more.

These changes would reduce calendar 1977 tax receipts by $4.4 billion and would reduce FY 1979 tax receipts by $4.0 billion.

Currently, the investment tax credit is larger for long-term investments up to 7 years; beyond 7 years there is no increase in the credit. This results in a bias against longer term investments. The amount of credit which may be taken in any year is also generally limited by the asset purchaser's tax liability. This means that many cyclically sensitive businesses and growing enterprises cannot fully utilize the credit. For these reasons, the effectiveness of the present investment credit is less than its current rate of 10 percent.

Advantages:

- o The tax credit in effect reduces the cost of new investments and thus raises the anticipated returns of all prospective investments.
- o The tax credit provides a source of funds for the corporation from which it can finance investments.
- o The investment tax credit, by working directly on new investments, is likely to have a greater impact than a reduction in the corporate tax rate.
- o The tax credit could have a beneficial effect in improving business confidence by implicitly recognizing the importance of profits in stimulating capital investment.
- o The tax credit was used successfully in earlier periods to spur lagging investment.

Disadvantages:

- o The proposal discriminates in favor of investments in equipment and against investment in structures. The investment tax credit also favors short-lived over long-lived investments although this tendency is countered to some extent by providing shorter lived investments with a lower credit.
- o The proposal may be attacked as one favoring the wealthy.
- o Businessmen complain that frequent upward and downward adjustments in the investment tax credit make planning difficult. This suggests making the increase permanent.

<u>Option 3:</u> <u>Reduce the corporate income tax rate from 48 percent to 44 percent or 2 percentage points more than your original proposal</u>.

Reducing the corporate income tax rate from 48 percent to 44 percent would reduce calendar 1977 receipts approximately $4.4 billion and would reduce FY 1979 receipts approximately $5.3 billion.

Advantages:

- o Tax reductions increase the cash flow for corporations. While corporations now have sufficient internally available funds to finance their current low levels of investment, such additional funds would be very helpful in financing the larger investments needed in future years.
- o Reduction in corporate tax rates improves the profit prospects of future investment and therefore tends to stimulate capital spending.
- o Rate reduction could have a beneficial effect in improving business confidence by implicity recognizing the importance of profits in stimulating capital investment.
- o Rate reduction was used in the early 1960's to spur lagging investment.

Disadvantages:

- o Corporate rate reduction does not act directly on new investment itself. Thus, relative to measures such as an increase in the investment tax credit, straight tax reduction would probably have a lesser effect per dollar of revenue loss on the stimulation of investment in the short run.
- o The proposal may be attacked as favoring the wealthy.

None of these

Decision

Option 1 ________ Advance the dividend deduction feature of the integration proposal.

Supported by:

Option 2 ________ Increase the benefits provided by the investment tax credit.

Supported by:

Option 3 __________ Reduce the corporate income tax rate from from 48 percent to 44 percent or 2 percentage points more than your original proposal.

Supported by:

Small Business

The changes in the investment tax credit discussed above would be especially helpful for small business. The Secretary of the Treasury's Small Business Advisory Committee recently made a number of proposals which are listed in Table E-2 but which have not yet been fully staffed.

TAB A

Table A-1

Unified Budget Summary Based on the Office of Management and Budget's December 4, 1976 Outlay Estimates

($ billions)

Tax law	Fiscal Years 1977	1978	1979
Current tax law:			
Receipts	357.7	411.1	470.8
Outlays	412.5	442.0	467.7
Surplus or deficit (-)	-54.8	-30.9	3.1
Current tax law plus extension of temporary tax provisions:			
Receipts	357.7	403.2	457.1
Outlays	412.5	442.0	468.5
Surplus or deficit (-)	-54.8	-38.8	-11.4
Current Administration tax policy (including extensions):			
Receipts	348.6	387.1	442.2
Outlays	412.5	442.0	467.7
Surplus or deficit (-)	-63.9	-54.9	-25.5

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Office of Tax Analysis

December 10, 1976

Note: Surplus and deficit estimates are based on rounded numbers.

Table A-2

Economic Assumptions

($ billions)

	Calendar Years						
	1976	1977	1978	1979	1980	1981	1982
GNP	1,694	1,876	2,066	2,279	2,512	2,733	2,914
GNP (1972 dollars)	1,266	1,334	1,396	1,464	1,545	1,625	1,689
(Percent change)	(6.2%)	(5.4)	(4.7)	(4.9)	(5.5)	(5.2)	(3.9)
GNP deflator (1972 = 100)	133.8	140.7	147.9	155.6	162.6	168.2	172.5
(Percent change)	(5.1%)	(5.1)	(5.2)	(5.2)	(4.5)	(3.4)	(2.6)
Unemployment rate	7.5%	6.9	6.5	6.3	5.7	5.1	4.9
Incomes (current dollars):							
Personal income	1,382	1,534	1,682	1,855	2,043	2,221	2,365
Wages and salaries	894	996	1,097	1,211	1,333	1,449	1,543
Corporate profits	145	161	178	200	225	248	268

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December 10, 1976

Table A-3

Comparison of Economic Assumptions in January Budget,
Mid-Session Review and in This Memo ("Case I")

($ billions)

	Calendar Years 1976	1977	1978
Gross national product:			
Current dollars:			
Amount:			
January	1,684	1,890	2,124
Mid-session	1,687	1,890	2,121
Case I	1,694	1,876	2,066
Percent change:			
January	12.4%	12.2	12.4
Mid-session	12.5	12.0	12.2
Case I	11.7	10.8	10.1
Constant (1972) dollars:			
Amount:			
January	1,260	1,332	1,411
Mid-session	1,267	1,339	1,418
Case I	1,266	1,334	1,396
Percent change:			
January	6.2%	5.7	5.9
Mid-session	6.8	5.7	5.9
Case I	6.2	5.4	4.7
Price level (percentage change):			
GNP deflator:			
Year over year:			
January	5.9%	6.2	6.1
Mid-session	5.3	6.0	6.0
Case I	5.1	5.1	5.2
Consumer price index:			
January	6.3%	6.0	5.9
Mid-session	5.7	5.6	5.6
Case I	5.7	5.0	4.8
Unemployment rate (percent):			
Total:			
January	7.7%	6.9	6.4
Mid-session	7.3	6.4	5.7
Case I	7.5	6.9	6.5

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Office of Tax Analysis

December 10, 1976

Table A-4

Estimated Unified Budget Receipts Under Current Law and Assuming Enactment as Soon as Practicable of Outstanding Administration Proposals Not Superseded by the Tax Reform Act of 1976 1/

($ billions)

Item	Effective date	Fiscal Years 1977	1978	1979
Current law receipts 2/		357.7	411.1	470.8
Permanent extension of temporary tax provisions:				
Extend Tax Reform Act of 1976 reductions:	1/1/78			
Individuals 3/			-6.8	-11.3
Corporations			-1.0	-2.4
Total			-7.8	-13.7
Receipts after permanent extension of temporary provisions		357.7	403.2	457.1
Proposed legislation:				
Repeal Tax Reform Act of 1976 (Extended) tax reductions and replace with President's proposed reductions:	1/1/77			
Individual tax cuts		-7.9	-10.3	-10.9
Corporate tax rate cuts		-1.1	-2.6	-2.8
Utility relief package		-0.2	-0.8	-1.1
Total		-9.3	-13.6	-14.7
Social security tax rate increase	1/1/78		1.3	6.2
Railroad retirement tax rate increase	1/1/78		*	0.1
Financial institutions reform:	1/1/77			
Individuals		- *	-0.1	-0.1
Corporations		-0.3	-0.6	-0.7
Total		-0.3	-0.7	-0.7
Stock ownership incentives:	1/1/77			
Individuals			-0.4	-0.5
Repeal ESOP	1/1/77	0.1	0.3	0.3
Accelerated depreciation in high unemployment areas:	1/1/77			
Individuals		-*	-*	-0.1
Corporations		-*	-0.1	-0.3
Total		-*	-0.2	-0.4
Corporation tax integration:	1/1/78			
Individuals				-0.1
Corporations			-1.1	-3.0
Total			-1.1	-3.1

Table A-4 Continued

($ billions)

	Effective date	Fiscal Years 1977	1978	1979
Write-off liability on silver certificates	9/15/77	0.2		
Fees for regulatory and judicial services	1/1/77	0.1	0.1	0.1
Miscellaneous (waterway) fees	1/1/77	0.1	0.1	0.2
Repeal withholding on portfolios of foreigners ..	1/1/77	-0.1	-0.2	-0.3
Exclude charitable contributions from minimum tax	1/1/77		-0.1	-0.1
Reduce administrative fees on foundations	1/1/77		-*	-*
Capital gains of individuals	1/1/77	0.1	-0.6	-0.9
Taxable municipal bond option 4/	1/1/78		*	*
Industrial development bonds 5/	1/1/78		*	*
Home insulation credit	1/1/77		-0.2	-0.2
Limited employee retirement accounts 6/	1/1/77	-0.1	-0.4	-0.5
Education tax credit	7/1/77		-0.3	-0.4
Receipts after proposed legislation		348.6	387.1	442.2
Changes in receipts from current law:				
Due to permanent extensions of temporary tax provisions			-7.8	-13.7
Due to proposed legislation		-9.2	-16.1	-14.9
Total		-9.2	-23.9	-28.6

Office of the Secretary of the Treasury, Office of Tax Analysis   December 10, 1976

*Less than $50 million.   Note: Details may not add to totals due to rounding.

1/ Based on an economic forecast which assumes high unemployment and low inflation.
2/ Includes impact of the Tax Reform Act of 1976, recent administrative action to triple import duties on sugar and H.R. 10210 which increases unemployment taxes on employers.
3/ Assumes no change in withholding rates. Excludes outlay effects of permanently extending the earned income credit.
4/ Excludes outlays estimated to be $13 million in 1978 and $31 million in 1979.
5/ Excludes outlays estimated to be $20 million in 1978 and $50 million in 1979.
6/ Endorsement of House plus Senate provisions.

TAB B

Table B-1

Income Tax Distributions Under Various Plans

(1976 Levels of Income)

($ millions)

Adjusted gross income class ($000)	1976 Law 1/	President's original proposal 2/	President's Proposal	
			Option 1 3/	Option 2 4/
Less than 5	1,136	876	876	1,106
5 - 10	10,422	9,051	9,045	10,300
10 - 15	19,858	17,759	17,598	19,102
15 - 20	23,675	21,991	21,601	22,270
20 - 30	33,485	31,630	31,372	31,218
30 - 50	22,280	21,612	21,551	21,111
50 - 100	16,421	16,099	16,087	15,947
100 and over	13,138	13,052	13,050	13,019
Total	140,414	132,070	131,179	134,073

Office of the Secretary of the Treasury
Office of Tax Analysis

December 10, 1976

1/ Excludes earned income credit transfers.

2/ Replace the per capita, taxable income and earned income credits with a $250 increase in the personal exemption (from $750 to $1,000) reduce tax rates, replace standard deduction provision with flat amount of $1,800 for single returns, $2,500 for joint returns.

3/ Same as footnote 2 except keep current percentage and maximum standard deduction; raise low-income allowance to $1,800 for single returns, $2,500 for married returns.

4/ Replace the per capita, taxable income, and earned income credits with a $250 increase in the personal exemption (from $750 to $1,000), retain current law standard deduction provisions, and reduce tax rates.

Table B-2

Proposed Income Tax Burdens 1/

Single Individual

(Dollars)

Wage Income	Current Law	Option 1	Option 2
5,000	363	307	356
7,000	714	641	712
10,000	1,331	1,227	1,321
15,000	2,409	2,307	2,387
20,000	3,667	3,553	3,633
30,000	6,790	6,665	6,375
40,000	10,535	10,375	10,455
50,000	14,897	14,725	14,805
100,000	41,420	41,215	41,295

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December 11, 1976

1/ Tax calculations assume deductible expenses equal 16 percent of income but do not reflect savings from the maximum tax on earned income.

Table B-3

Proposed Income Tax Burdens 1/

Married Couple, No Children

(Dollars)

Wage Income	Current Law	Option 1	Option 2
5,000	130	60	126
7,000	448	335	434
10,000	948	800	933
15,000	1,882	1,750	1,830
20,000	2,905	2,780	2,782
30,000	5,384	5,328	5,174
40,000	8,552	8,444	8,274
50,000	12,200	12,080	11,910
100,000	34,610	34,440	34,270

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Office of Tax Analysis

December 11, 1976

1/ Tax calculations assume deductible expenses equal 16 percent of income but do not reflect savings from the maximum tax on earned income.

Table B-4

Proposed Income Tax Burdens 1/

Married Couple, Two Children

(Dollars)

Wage Income	Current Law 2/	Option 1	Option 2
5,000	0	0	-
7,000	135	60	126
10,000	651	485	594
15,000	1,552	1,325	1,430
20,000	2,530	2,280	2,302
30,000	4,904	4,468	4,534
40,000	7,934	7,664	7,494
50,000	11,510	11,180	11,010
100,000	33,740	33,280	33,110

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Office of Tax Analysis

December 11, 1976

1/ Tax calculations assume deductible expenses equal 16 percent of income but do not reflect savings from the maximum tax on earned income.

2/ Assumes no earned income credit with earned income credits tax. The lowest two income levels would appear as follows under current law:

Income	Tax less credit
5,000	-300
7,000	35

Table B-5

Tax Rate Schedule for President's Original and Revised Proposals

(Single Taxpayers)

Taxable income bracket	Present rates	Proposed rates: Option 1	Proposed rates: Option 2
	(....................	percent	)
$ 0 - 500	14%	12%	14%
500 - 1,000	15	13	15
1,000 - 1,500	16	15	16
1,500 - 2,000	17	15	16
2,000 - 3,000	19	16	17
3,000 - 4,000	19	17	18
4,000 - 5,000	21	18	19
5,000 - 6,000	21	19	19
6,000 - 8,000	24	21	22
8,000 - 10,000	25	24	24
10,000 - 12,000	27	27	27
12,000 - 14,000	29	29	29
14,000 - 16,000	31	(Same as current law)	
16,000 - 18,000	34	"	"
18,000 - 20,000	36	"	"
20,000 - 22,000	38	"	"
22,000 - 26,000	40	"	"
26,000 - 32,000	45	"	"
32,000 - 38,000	50	"	"
38,000 - 44,000	55	"	"
44,000 - 50,000	60	"	"
50,000 - 60,000	62	"	"
60,000 - 70,000	64	"	"
70,000 - 80,000	66	"	"
80,000 - 90,000	68	"	"
90,000 - 100,000	69	"	"
100,000 and over	70	"	"

Office of the Secretary of the Treasury
Office of Tax Analysis

December 10, 1976

Table B-6

Tax Rate Schedule for President's Original and Revised Proposals

(Married Taxpayers Filing Jointly)

Taxable income bracket	Present rates	Proposed rates: Option 1	Proposed rates: Option 2
	(.................... percent	....	..................)
$ 0 - 1,000	14%	12%	14%
1,000 - 2,000	15	14	15
2,000 - 3,000	16	15	16
3,000 - 4,000	17	15	16
4,000 - 6,000	19	16	17
6,000 - 8,000	19	17	18
8,000 - 10,000	22	21	20
10,000 - 12,000	22	22	20
12,000 - 16,000	25	25	24
16,000 - 20,000	28	29 1/	27
20,000 - 24,000	32	34 1/	32
24,000 - 28,000	36	36	36
28,000 - 32,000	39	(Same as current law)	
32,000 - 36,000	42	"	"
36,000 - 40,000	45	"	"
40,000 - 44,000	48	"	"
44,000 - 52,000	50	"	"
52,000 - 64,000	53	"	"
64,000 - 76,000	55	"	"
76,000 - 88,000	58	"	"
88,000 - 100,000	60	"	"
100,000 - 120,000	62	"	"
120,000 - 140,000	64	"	"
140,000 - 160,000	66	"	"
160,000 - 180,000	68	"	"
180,000 - 200,000	69	"	"
200,000 and over	70	"	"

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Office of Tax Analysis

December 10, 1976

1/ While two rates are increased in the higher brackets, taxpayers with income taxed in those brackets will benefit from rate reductions in the lower brackets so that on balance the changes in rates reduce taxes even for those affected by the increased rates.

TAB C

Table C-1

Proposed Social Security Tax Structure

Rate of Tax on Employee Wages

Year	Taxable wage base 1/	OAHSDI Rates	
		Current law	Proposed
1976	$15,300	5.85%	5.85%
1977	16,500	5.85	5.85
1978	17,700	6.05	6.15
1979	19,200	6.05	6.45
1980	20,700	6.05	6.60
1981	22,500	6.30	6.85
1982	24,000	6.30	6.85

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Office of Tax Analysis

December 10, 1976

1/ Current law wage base assuming the Case I forecast.

Table C-2

Proposed Social Security (OASDHI) Tax Burdens 1/

(Dollars)

Taxable Wages	Current Law		Proposed Law		
	1976	1977	1978	1979	1980
3,000	88	88	92	97	99
5,000	146	146	154	161	165
7,000	205	205	215	226	231
10,000	292	292	308	322	330
15,000	439	439	461	484	495
20,000	448	483	544	619	660
30,000	448	483	544	619	683
40,000	448	483	544	619	683
50,000	448	483	544	619	683

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Office of Tax Analysis

December 11, 1976

1/ Employee share only.

Table C-3

Proposed Combined Income Tax and Social Security (OASDHI) Tax Burdens 1/

Single Individual

(Dollars)

Wage income	Current law 1976 taxes	Proposed taxes					
		Income Tax Option 1			Income Tax Option 2		
		1977	1978	1979	1977	1978	1979
5,000	509	453	461	468	502	510	517
7,000	919	846	856	867	917	927	938
10,000	1,623	1,519	1,535	1,549	1,613	1,629	1,643
15,000	2,848	2,746	2,768	2,791	2,826	2,848	2,871
20,000	4,115	4,036	4,097	4,172	4,116	4,177	4,252
30,000	7,238	7,138	7,199	7,274	6,858	6,919	6,994
40,000	10,983	10,858	10,919	10,994	10,938	10,999	11,074
50,000	15,345	15,208	15,269	15,344	15,288	15,349	15,424
100,000	41,868	41,688	41,759	41,838	41,778	41,839	41,914

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December 11, 1976

1/ Tax calculations assume deductible expenses equal 16 percent of income.

Table C- 4

Proposed Combined Income Tax and Social Security (OASDHI) Tax Burdens 1/

Married Couple, Two Children

(Dollars)

Wage income	Current law 1976 taxes	Proposed taxes: Income Tax Option 1			Proposed taxes: Income Tax Option 2		
		1977	1978	1979	1977	1978	1979
5,000	146	146	154	161	146	154	161
7,000	340	265	275	286	331	341	769
10,000	943	777	793	807	886	1,457	916
15,000	1,991	1,764	1,786	1,809	1,869	1,891	1,914
20,000	2,978	2,763	2,824	2,899	2,785	2,846	2,921
30,000	5,352	5,131	5,192	5,267	5,017	5,078	5,153
40,000	8,382	8,147	8,208	8,283	7,977	8,038	8,113
50,000	11,958	11,663	11,724	11,799	11,493	11,554	11,629
100,000	34,188	33,763	33,824	33,899	33,593	33,654	33,729

Office of the Secretary of the Treasury
Office of Tax Analysis

December 11, 1976

1/ Tax calculations assume deductible expenses equal 16 percent of income.

Social Security Payroll Tax Recommendation

The revenues provided by current payroll tax law are not sufficient to finance the current old age, survivors, and disability benefits provided by the social security system. If the tax law remains unchanged, the combined old age and disability trust funds will be exhausted by the end of 1982 given the economic assumptions used in the 1976 Trustees Report. The disability fund will be exhausted during 1979.

The 1977 Budget proposed a 0.6 percentage point increase, effective January 1, 1977, in the combined tax rate for employers and employees (0.3 percentage point increase in both the employers and employee share) bringing the total 1977 OASDHI tax rate to 12.3 percent. An increase of 0.9 percentage points was proposed for the self-employed in order to restore the self employed rate to its traditional level of 3/4 of the combined employer-employee rate.

The Congress failed to act on this proposal. For a variety of technical reasons retroactive social security tax increases are not feasible so that this year's budget could not include an increase for calendar year 1977. Because of the delay, a larger tax increase is now required to keep the trust fund solvent. Assuming an effective date of January 1, 1978, the required tax increase is 0.9 percent in addition to the 0.4 percent increase scheduled under current law. At the same time, the wage base will rise automatically from $16,500 in 1977 to an estimated $17,700 in 1978. If an increase of 0.9 percentage points is added to the increases already scheduled, a major tax hike is imposed on wage earnings. A payroll tax increase of this magnitude would have a major dampening impact on the economy and would initiate cost push inflationary pressures by increasing labor costs for employers.

For these reasons your advisors recommend phasing in the payroll tax increases:

- a 0.2 percentage point increase effective January 1, 1978 in addition to the 0.4 percentage point increase mandated by current law. The self employment tax would also be adjusted upward.
- a 0.6 percentage point increase effective January 1, 1979.
- a 0.3 percent point increase effective January 1, 1980.

The three-year combined rate increase (over current law) of 1.1 percentage points is greater than a January 1, 1978 increase of 0.9 percentage points because the fiscal impact of postponement must be offset.

Other rate change options were considered:

- Increase social security taxes 0.3 percentage points on January 1, 1978, another 0.3 percentage points on January 1, 1979, and a further 0.5 percentage points on January 1, 1980.
- Increases in social security taxes of 0.6 percentage points on January 1, 1979 and of a further 0.6 percentage points on January 1, 1980.

The first was rejected in favor of the recommendation discussed above because rate increases of 0.6 percentage points (the combined current law and recommended increase for 1978 and the recommended increase for 1979) appeared consistent with last year's proposal.

The second was rejected because it would appear to delay confronting the social security problem even further.

This recommendation relies solely on tax rate increases to provide sufficient revenues for the social security system. The same revenues could be obtained with a lower tax rate if the payroll tax base were increased. Options involving a higher tax base were considered last year, but were rejected because, given the current benefit structure or the structure proposed under the Administration's decoupling option, a higher tax base results in higher benefit payments in the long run thus worsening the social security's financial problems in the future.

The Social Security Administration has estimated that the following combinations of base and rate increases would solve the short-run financial problems of the trust fund.

1. A base increase to $18,300 in 1978 (compared to current law's $17,700) combined with a rate increase of 0.7 percent in 1978 and 0.2 percent in 1980.
2. A base increase of $22,800 in 1978 combined with a rate increase of 0.3 percent in 1978.
3. A base increase to $28,500 in 1978 with no rate increase.

If last year's decisions are reversed and if base increases are deemed desirable, additional options should be investigated to reduce the tax increase implied for 1978 and to improve the integration with personal income tax reductions. A base increase would also require a re-examination of the benefit structure recommended in the Administration's decoupling proposal.

TAB D

Tab D
12-10-76
6:00p

DESCRIPTION OF OUTSTANDING PROPOSALS

Table of Contents

CORPORATE TAX RATE CUTS

The corporate income tax is levied in two parts, the normal tax and the surtax. For firms with over $50,000 of taxable income the normal tax rate is 22 percent and the surtax rate is 26 percent--resulting in a combined rate of 48 percent. The proposal would descrease the surtax rate to 24 percent and the combined rate to 46 percent.

A reduction in the corporate rate would be expected to reduce somewhat the tax bias against investment and stimulate increased capital formation.

This proposal was first presented as part of the President's October 1975 tax cut and budgetary restraint package and was included in FY 1977 budget.

	Fiscal Years					
	Billions of dollars					
	1977	1978	1979	1980	1981	1982
Effect on receipts....... (assumes 1/1/77 effective date)	-1.1	-2.6	-2.8	-3.0	-3.4	-3.6

CORPORATE SURTAX EXEMPTION PROVISIONS

Prior to the Tax Reduction Act of 1975, corporate taxable income was subject to a 22 percent normal tax and a 26 percent surtax, with a surtax exemption of $25,000. This Act modified the corporate surtax exemption provisions in two ways for calendar year 1975. First, the surtax exemption was increased from $25,000 to $50,000. Second, in place of a normal tax rate of 22 percent on corporate income, a 20 percent normal rate was established on the first $25,000 of income and a 22 percent normal rate on income above $25,000.

In October 1975, the Administration proposed making these changes in the surtax exemption provisions permanent, and included this proposal in the President's FY 1977 budget. The Revenue Adjustment Act of 1975 extended these provisions until June 30, 1976, and the Tax Reform Act of 1976 further extended these provisions until December 31, 1977.

	Fiscal Years					
		Billions of dollars				
	1977	1978	1979	1980	1981	1982
Effect on receipts........ (assumes 1/1/78 effective date)		-1.0	-2.4	-2.6	-2.8	-3.0

PUBLIC UTILITY TAX PACKAGE

The President's Labor-Management Committee's 6-point program of tax measures to stimulate construction of new electric utility facilities, was presented to the Committee on Ways and Means on July 8, 1975.

The program would revise the tax laws applicable to electric utilities by (1) permanently increasing the investment tax credit to 12 percent; (2) permitting immediate investment credit on construction progress payments; (3) extending 5-year amortization for pollution control facilities until 1981; (4) providing 5-year amortization for costs incurred in converting from a petroleum-fuled generating facility; (5) permitting depreciation of construction progress expenditures during the construction period; and (6) allowing utility shareholders to defer taxes on reinvested dividends.

The Tax Reform Act of 1976 extends the 10 percent investment credit for all qualified property (including utility property) through the end of 1980, but no special provision for electric utilities is made. The Act also liberalizes and extends the election for 5-year amortization of certain pollution control facilities and for the first time permits a 5 percent investment credit on such facilities.

	Fiscal Years Billions of dollars					
	1977	1978	1979	1980	1981	1982
Effect on receipts........ (assumes 1/1/77 effective date)	-.2	-.8	-1.1	-1.4	-1.6	-1.8

MORTGAGE INTEREST TAX CREDIT

The MITC provision of the FIA, coupled with repeal of the special bad debt allowance, was originally designed and supported by the Administration as a revenue neutral means to encourage mortgage lending. The credit would equal a percentage of residential mortgage interest income, rising from 1.5 to 3.8, as the percentage of mortgages in the portfolios of financial institutions increases from 10 to 80 percent. Since the proposal was first made in 1973, cost estimates have risen markedly. Under the most optimistic projections, benefits in terms of new home construction are small relative to the costs. If, for example, 50,000 new housing starts resulted from a reduction in mortgage interest rates of .25 percentage points, the implied cost would be $20,000 per unit. The sliding scale of the mortgage interest subsidy has effects contrary to the intent of promoting competition among financial institutions. Since the subsidy rate increases with mortgage holdings, the greatest benefits go to institutions with the greatest proportion of assets in mortgages, thereby making it more difficult for life insurance companies, commercial banks, and mutual savings banks to offer rates competitive with savings and loan associations.

	Fiscal Years					
	Billions of dollars					
	1977	1978	1979	1980	1981	1982
Effect on receipts..... (assumes 1/1/77 effective date)	-.3	-.7	-.7	-.8	-.9	-1.0

BROADENED STOCK OWNERSHIP PLANS (BSOP)

Under BSOP, low and middle income individuals could deduct contributions of up to $1,500 for investment in common stocks. The BSOP program would be available to all workers and would enable them to hold a balanced portfolio of corporate stock for investment and retirement purposes. Withdrawals of funds from BSOPs would be taxed at capital gains rates.

Current law provides employee stock ownership plans (ESOPs) funded through a special investment tax credit. Under these ESOPs employees may acquire only the stock of their employers. Furthermore, these ESOPs are available only to those who work for corporations, and particularly benefit those working in capital intensive industries and for firms which have sufficient tax liabilities to avail themselves of the special investment tax credit. Since only the stock of the employing corporation may be held, ESOP investments are quite risky, particularly as a means of providing security for retirement.

The Administration's plan for eliminating the double tax on corporate dividends would also provide strong incentives for stock ownership. Thus, some of the objectives of both BSOP and ESOP would be achieved as a result of corporate integration.

	Fiscal Years					
	Billions of dollars					
	1977	1978	1979	1980	1981	1982
Effect on receipts........ (assumes 1/1/77 effective date)		-.4	-.5	-.6	-.7	-.7

ACCELERATED DEPRECIATION IN HIGH UNEMPLOYMENT AREAS

The Administration's proposal put forth in January of this year provides a tax incentive to encourage investment in plant and equipment in areas experiencing unemployment in excess of 7 percent. Buildings are allowed straight line depreciation over a period equal to one-half their useful lives and equipment is alloed 5-year amortization with a full investment tax credit.

The President has strongly supported this proposal during the election campaign, but it seems to have received very little public acceptance. This may be due to the fact that it is felt to have little impact on the most important aspectsif the current unemployment situation, namely, the high rate of unemployment in the central cities and among teenagers.

	Fiscal Years					
	Billions of dollars					
	1977	1978	1979	1980	1981	1982
Effects on receipts....... (assumes 1/1/77 effective date)	*	-.2	-.4	-.6	-.7	-.6

CORPORATE/INDIVIDUAL INCOME TAX INTEGRATION

Under the current two-tier system, income earned in the corporate sector is taxed once at that level and any portion of that income paid out as a dividend is taxed again at the shreholder level. Integration, first proposed to Congress by the Administation in July 1975, is designed to encourage capital formation by correctiing for some of the serious biases inherent in the two-tier system. The specific problems in the system that CITI addresses are: (1) the taxation of capital income; (2) the inhibition of the flow of savings to corporate equity investments; (3) the higher prices which consumers must pay for corporate products to provide a reasonable after-tax return to corporations; (4) the systematic bias against lower-bracket taxpayers' ownership of corporate stock; (5) the encouragement of high debt-to-equity ratios in corporate financing which make such businesses vulnerable to business cycle changes; and (6) the penalty against corporate decisions to distribute earnings which, by holding down dividends, keeps corporate earnings from the test of capital markets.

The integration proposal, by reducing the rate of tax on capital income and by providing more equal tax treatment of income from corporate capital compared to other income sources, will encourage additional savings and a more efficient use of all avilable capital.

Since July 1975, corporate integration has been strongly urged by the Administration in testimony before the congressional tax-writing committees. It has attracted broad and bipartisan support and has recently been under serious discussion by the Capital Formation Task Force of the House Committee on Ways and Means.

	Fiscal Year					
	Billions of Dollars					
	1977	1978	1979	1980	1981	1982
Effect on receipts........ (assumes 1/1/78 effective date)		-1.1	-3.1	-5.4	-9.2	-14.2

WRITE-OFF OF SILVER CERTIFICATES

The Administration has urged the Congress to enact legislation to write-off discontinued silver certificates which have been determined to have been lost or destroyed. This proposal has been transmitted to every Congress since 1970. The Senate passed the bill in the 91st and 92nd Congresses, but neither House acted on it during the 93rd or 94th Congress. The proposal recognizes that these Federal Reserve bank notes and National bank notes will not be redeemed. The value of the certificates would be credited to a governmental receipts account, thus reducing the deficit in the year of receipt.

	Fiscal Years					
	Billions of dollars					
	1977	1978	1979	1980	1981	1982
Effect on receipts........ (assumes 9/15/77 effective date)	.2					

NUCLEAR REGULATORY COMMISSION FEES
(MISCELLANEOUS RECEIPTS)

The 1977 budget included a proposal to allow the Nuclear Regulatory Commission to collect annual fees to cover the costs of its licensing services and its reactor safety research program in support of licensing. Legilsation submitted to the last session of the Congress never got out of the Joint Committee on Atomic Energy. The proposal is still thought to be a desirable one, and is consistent with OMB Circular A-25 on user charge policy.

	Fiscal Years					
	Billions of dollars					
	1977	1978	1979	1980	1981	1982
Effect on receipts......... (January budget estimate)	.1	.1	.1	.1	.1	.1

WATERWAY USER CHARGES (MISCELLANEOUS RECEIPTS)

The 1977 budget included a proposal to collect inland waterway user charges to help offset the federal subsidies presently dedicated to this mode of transportation. However, legislation was never submitted to the Congress, in part because of a disagreement between OMB and the Department of Transportation on the proper collection mechanism. It was finally decided that the issue should be resolved as part of a study being conducted by the Water Resources Council.

	Fiscal Years					
	Billions of dollars					
	1977	1978	1979	1980	1981	1982
Effects on receipts....... (January budget estimate)	.1	.1	.2	.2	.2	.2

WITHHOLDING ON FOREIGNERS

During consideration of the 1976 Tax Reform Act, the Treasury strongly recommended eliminating U.S. withholding taxes on dividends and interest payments to foreign investors in the United States. In its final form the Act eliminated withholding for bank interest payments only.

	Fiscal Years					
	Billions of dollars					
	1977	1978	1979	1980	1981	1982
Effect on receipts........ (assumes 1/1/77 effective date)	-.1	-.2	-.3	-.3	-.3	-.3

CHARITABLE DEDUCTIONS UNDER THE MINIMUM TAX

Under the Tax Reform Act of 1976, the charitable deduction is one of the itemized deductions which, to the extent they exceed 60 percent of the taxpayer's adjusted gross income, constitute items of tax preference. Treasury has opposed making the charitable deduction an item of tax preference in any form.

	Fiscal Years Millions of dollars					
	1977	1978	1979	1980	1981	1982
Effect on receipts......... (assumes 1/1/77 effective date)		-55	-60	-67	-73	-81

AUDIT FEE TAX ON PRIVATE FOUNDATIONS

Private foundations currently pay a 4 percent excise tax on their net investment income. Treasury has consistently supported a reduction in the rate of that tax from 4 percent to 2 percent, since a 2 percent tax will produce sufficient revenue to cover the cost of auditing all exempt organizations.

	Fiscal Years Millions of dollars					
	1977	1978	1979	1980	1981	1982
Effect on receipts......... (assumes 1/1/77 effective date)		-30	-30	-30	-30	-30

SLIDING SCALE FOR CAPITAL GAINS AND LOSSES

The sliding scale would reduce taxes on capital gains with longer holding periods. As at present, 50 percent of the gain would be taxed for assets held between 1 and 5 years. For each year between 5 and 25 years, the percentage of gain included in AGI would be reduced by 1 percentage point so that for assets held over 25 years, only 30 percent of the gain would be included in AGI. Capital losses as well as capital gains would be subject to the sliding scale in line with the symmetry in present law.

In recent congressional deliberations on the Tax Reform Act, the sliding scale provision was defeated on the Senate floor.

The sliding scale proposal would lower tax burdens on income from capital and, in particular, would stimulate demand for corporate stock as a financial investment. These same objectives are accomplished through corporate integration. The proposal would also serve as a rough offset to the taxation of inflationary appreciation.

	Fiscal Years					
	Billions of dollars					
	1977	1978	1979	1980	1981	1982
Effect on receipts......... (assumes 1/1/77 effective date)	0.1	-0.6	-0.9	-1.1	-1.2	-1.3

MUNICIPAL BOND OPTION

In past legislative and administrative actions, the Treasury and Congress have sought to improve the efficiency of the municipal market and prevent overloading that market with private credit, which drives up borrowing costs and increases the revenue loss to the Federal Government.

To further improve the efficiency of this market, Treasury this year proposed a taxable municipal bond option with a 30 percent subsidy. A 35 percent subsidy was narrowly approved by Ways and Means Committee, but was never taken to the House floor.

Improved efficiency of the tax-exempt market, reductions in state and local borrowing costs, and a more rational Federal credit policy can be achieved through a combination of the taxable bond option and the requirement that IDB financing and federally-guaranteed financing be limited to the taxable market.

A separate question is whether it is necessary to provide explicit interest rate subsidies to compensate IDBs for their removal from the tax-exempt market.

Reproposal should require that municipal bonds for industrial development purposes and those issued with a federal guarantee or other Federal subsidy be excluded from the tax-exempt market. As an additional proposal, KDBs currently eligible for tax exemption could be required to be issued in the taxable market with a federal interest subsidy not exceeding 20 percent of interest costs.

	Fiscal Years					
	Millions of dollars					
	1977	1978	1979	1980	1981	1982
Effect on outlays and receipts (assumes 1/1/78 effective date)						
TBO outlays		13	31	37	40	42
TBO receipts		2	16	30	31	32
IDB subsidy outlays		20	50	58	62	66
IDB subsidy receipts		5	40	71	75	78

RESIDENTIAL INSULATION

Included in the 1976 Budget and reiterated in the President's 1976 Energy Message was a proposal for a 15 percent tax credit for the cost of "certain improvements in thermal efficiency in residences". This credit would apply to the first $1,000 of expenditures and could be claimed during the 3 years following enactment. In the last session of Congress, the credit proposal passed both the House and Senate in actions on separate bills but never became law.

Questions have been raised as to the cost effectiveness of this proposal as an energy-saving device and also the administrability of distinguishing between expenditures for genuine insulation and those which are primarily decorative.

	Fiscal Years					
		Millions of dollars				
	1977	1978	1979	1980	1981	1982
Effect on receipts......... (assumes 1/1/77 effective date)		-193	-200	-212		

IRA ACCOUNTS FOR EMPLOYEES WITH LIMITED EMPLOYEE PLANS

Under current law, an active participant in a qualified retirement or similar plan maintained by his employer may not make a deductible contribution to an individual retirement account (IRA). This proposal would allow such an individual (including a public employee) to deduct the difference between the amount of the IRA deduction limitation for the year (the lesser of 15 percent of compensation or $1,500 ($1,750 in certain cases)) and the amount of employer contributions and forfeitures on his behalf under the employer's qualified plan and would also allow an employee to take as a tax deduction his contributions to such an employer plan. The Administration supported this proposal during congressional deliberations on the Tax Reform Act.

In many cases, an individual is denied the opportunity of making a deductible IRA contribution because his employer makes a very small contribution on his behalf to a qualified plan, and the individual may not refuse to participate in the plan. Conversely, where employees are given the option of participating in an employer's plan, the plan may face disqualification because lower-paid employees who would receive relatively small contributions withdraw from the plan in favor of making their own IRA contributions. This proposal would alleviate both problems.

	Fiscal Years					
	Billions of dollars					
	1977	1978	1979	1980	1981	1982
Effect on receipts......... (assumes 1/1/77 effective date)	-.1	-.4	-.5	-.5	-.6	-.6

EDUCATION TAX CREDITS

A simple tax credit for tuition paid to church-related elementary and secondary schools would probably be unconstitutional. Any new proposal should be based on a method that could reasonably be expected to survive a court challenge.

The tax credit for expenses of higher education was initially, attached to the Tax Reform Bill of 1975 on the Senate floor (the Roth Amendment), but was dropped by the Conference Committee.

The basic issues raised by the Roth Amendment are (1) the extent to which a credit is to be given for "first dollar" costs--thus predominately aiding public institutions--or (2) for a percentage of total costs up to some limit--thus predominately aiding private institutions. There is also the question of whether or not the credit should phase-out above some level of income.

A compromise proposal would provide:

- a maximum credit of $250, phased-in over a 4-year period in $50 increments, with an initial maximum of $100 in 1977.
- a variable credit rate which gives no credit for the first $100 of expenses, a 25 percent credit for the next $600 and a 10 percent credit for the next $1,000 of expenditures for higher education.
- an eligibility phase-out for adjusted gross income so that those with incomes between $20,000 and $40,000 receive reduced credits and those over $40,000 are are ineligible.
- an effective date of 7/1/77.

	Fiscal Years					
	Billions of dollars					
	1977	1978	1979	1980	1981	1982
Effect on receipts......... (assumes 1/1/77 effective date)		-.3	-.4	-.5	-.6	-.6

HIGHWAY TRUST FUND TAXES

Highway trust fund taxes are scheduled to expire in September 1979. The January budget and the Mid-Session Review both assumed that the highway taxes would be extended indefinitely.

The Administration is required to submit authorizing legislation to the Congress in CY 1977 relating to the extension of the Federal-aid Highway program in FY 1979 and subsequent years. The development of the Administration's legislative proposal will be dependent upon the completion of selected studies over the next 6 months. The legislative proposal will presumably include some type of modifications of the turst fund, but the exact form which this may take is unknown at this time.

	Fiscal Years Millions of dollars					
	1977	1978	1979	1980	1981	1982
Effective on receipts....... (assumes 10/1/79 effective date)				4486	4710	4946

TAB E

Table E-1

Revenue Loss of Investment Stimulus Options

($ billions)

	Fiscal Years 1977	1978	1979
I. Variation in schedule of corporate integration:			
A. Advance integration by speeding dividend deduction at the corporate level only	2.1	4.9	5.2
B. Advance entire integration schedule by one year.	0.7	2.5	5.1
II. Restructure investment tax credit, including basis adjustment, additional 2 percent for assets with lives of 12 years or more, and increase in basic credit to 12 percent:			
Total	1.9	4.3	4.0
Restructure plus 2 percent for long lives ..	0.9	2.4	2.0
Increasing basic credit	0.9	1.9	2.1
III. Reduce top corporate rate 2 percentage points (from 46 percent to 44 percent)	0.9	2.1	2.5

Office of the Secretary of the Treasury
Office of Tax Analysis

December 10, 1976

Note: Details may not add to totals due to rounding.

Table E-2

Summary List of Small Business Proposals
(with revenue estimates where available)

Impact on Liability in Calendar 1977

($ billions)

1. Adjustment of depreciation schedules:	
Total	
Plant and equipment	-12.0
Land	
2. Adjustment of corporate rates:	
A. Revised rate structure	-4.9
B. Increase surtax exemption to $100,000	-2.7
3. Transfers of stock in qualified small business corporations	
4. Raise accumulated earnings tax ceiling to $500,000	*
5. Limit tax payments to 125 percent of prior year liability (with deferred liability accruing interest at the late payment rate)	
6. Carryover and carryback of unused corporate surtax exemptions ...	
7. Support COSIBA tax bill (H.R. 13687)	-34.0
8. Working capital investment credit:	
Total	
Corporations	-3.7
Noncorporate business	
9. Support partial deduction for cost of equity	--
10. Study the "employment tax credit"	--

Office of the Secretary of the Treasury
Office of Tax Analysis

December 10, 1976

Note: Revenue costs are estimated independent of each other and thus are not additive. All estimates are tentative.

*Under $50,000,000.

TAB F

Treasury Department Basic Tax Reform Report

This paper discusses the study conducted by the Treasury Department on Basic Tax Reform (BTR). A more extended discussion is attached.

The Treasury report presents proposals representing two approaches to broadening the tax base. The first, comprehensive income taxation, includes elimination of the corporation income tax and full allocation of corporate income to shareholders, along with an inflation correction for capital gains and depreciation. The second approach, a cash flow tax, would replace the individual and corporation income taxes with a consumption based tax.

The report, which will be ready for release by the middle of next month, represents a thorough review of the basic fundamentals of taxation. It considers, for example, the concept of income and how it should be defined theoretically, and measured practically. The report develops a tax system which is simpler, more equitable and easier to understand and justify. It would make the operation of the private economy more efficient, and could achieve any degree of progressiveness desired. The report finds that even a revised, comprehensive income tax would be inferior, in many respects, to a consumption based tax.

The Present System

The present system is viewed as unnecessarily complex: a system designed for the benefit of accountants and tax lawyers. It is seen as inequitable: designed to favor the rich and provide loopholes for special interests with political muscle. It is viewed (mostly by economists) as inefficient: misallocating resources in socially undesirable and sometimes unintended directions.

The BTR report begins by sketching an "ideal base" for a tax system and then modifies this ideal base in ways which make implementation possible. Two bases are considered: income and consumption.

The Comprehensive Income Tax

The most important features of the comprehensive income tax are:

1. Integration of the Corporate and Personal Income Taxes.

A corporate tax is inappropriate because there is no such thing as "corporate income" which does not accrue to individuals. That is, all corporate net receipts belong to individuals, either through being paid out as dividends or being retained as retained earnings and thus increasing the value of shareholders' stock. The present system of taxation provides a rate which is too high for some of these shareholders and too low for others. In the case of dividends, of course, the corporation tax simply adds to the burden imposed by the individual tax, and this means the total tax is too high. Earnings which are retained may be effectively taxed only once. For individuals in the highest tax brackets on the other hand, the 48 percent rate applied to retain earnings is lower than the rate on their ordinary income. Further taxation of retained earnings will generally be at capital gains rates and will be deferred, perhaps forever.

Under the BTR proposals, the corporation income tax would be eliminated and all corporate income would be allocated to individual shareholders with an accompanying step-up in basis. Dividends to shareholders would not be separately taxed but treated as a reduction in basis. Thus, integration would (1) end the double taxation of dividends, (2) key the effective tax rate on all income to the circumstances of individual taxpayers, and (3) provide a practical method for accrual taxation of this form of capital gains.

2. Base Broadening.

Improved equity and lower tax rates would be achieved by broadening the base of the income tax. This would be done both through expanding the types of income which are taxable and through reducing the types of deductions which are allowed. The report goes into these matters in considerable detail, discussing the theoretically best approach and indicating where administrative or practical considerations impel different decisions.

The report proposes significant changes in the handling of capital gains income. Under an "ideal" tax base, capital gains would be taxed as accrued, not just when realized through sale or exchange of the asset. However, this would necessitate annual asset valuations, and the practical problems raised by this led the BTR report to recommend against accrual taxation. Thus, the tax benefit from deferring realization of capital gains would be retained, though the proposed corporate integration would considerably reduce the scope of this deferral. While the proposal calls for full taxation of capital gains (abolising the 50 percent exclusion), it would end the taxation of purely inflationary gains by providing an inflation adjustment, discussed below.

Some other forms of income currently excluded from the tax base would become fully taxable. These include state and local bond interest, social security benefits (though employee contributions would become deductible), private pension benefits and interest earnings thereon, and unemployment compensation payments.

3. Inflation Correction.

The BTR report calls for an inflation correction for capital gains and for depreciation allowances. That is, assets which are held over a period of time would have their cost basis adjusted upward to take account of the depreciation of the currency during the holding period. While under an "ideal" tax system, this inflationary correction would also apply to debts, e.g., adjusting upward the principal of a home mortgage, the BTR recommendation stops short of such a complex step.

The Cash Flow Tax

The most significant aspect of the BTR report is its recommendation of consideration of a cash flow, consumption based tax to replace the present individual income tax. In the past, such a tax has usually been viewed as not worthy of consideration because it would be:

- Regressive (like a sales tax)
- Radical (a complete change from the present income tax system)
- Difficult to administer (who can keep track?)

The BTR report examines these criticisms and finds them invalid.

Regressive -- While a consumption tax is viewed as bearing heavily on the poor (who spend) and not on the rich (who save), in reality through the use of exemptions and progressive rates, a tax on spending can be just as progressive or regressive as the Congress wishes to make it.

Radical -- While it would appear that changing from the present income tax to a cash flow, consumption base tax would be a radical move, the BTR report finds that the present system is closer to a cash flow tax than to a comprehensive income tax in its treatment of many forms of income from capital. In particular, two important sources of saving for many Americans -- home ownership and contributions to retirement annuities (employer contributions, Keogh Plans, and IRA's) -- are treated under the current law almost exactly the same way they would be treated under a cash flow tax.

Difficult to administer -- When the term "consumption tax" is used, most people think of a sales tax and imagine that such a tax would require keeping records on every bit of expenditure throughout the year. In actual implementation, however, a cash flow consumption base tax would involve tax forms very similar to the present ones with the significant change that net additions to savings would be subtracted from income in arriving at the tax base. Indeed, a cash flow consumption base tax would actually be easier to administer in many respects, primarily in the area of capital income. For example, problems in the measurement of depreciation, in the evaluation of capital gains, and in the allocation of undistributed corporate income could be avoided because changes in net worth (savings) would not be included in the tax base.

Even more significantly, the cash flow tax, by taxing consumption, eliminates disincentives to savings and thus encourages capital formation. This would lead to more capital per worker and higher before tax wages in the long run. Thus, the allocative effect of a cash flow consumption base tax makes it very attractive as an alternative to eithr the present income tax or even to an improved comprehensive base income tax.

Tax Rates

The advantage of base broadening, of course, is that it makes possible the use of much lower tax rates to raise the same total revenue. For example, the "comprehensive income" concept developed by the BTR report is approximately 20 percent higher than the AGI (Adjusted Gross Income) of individuals, so even after making up for the abolition of the corporate tax, individual tax rates could be cut almost one-fifth across the board and still raise the same revenue. (Of course, the distribution of taxes across income classes would be quite different.) The BTR report presents alternative rate structures. The exact rate schedules remain to be worked out, but it appears that both individual and corporate income tax receipts could be replaced by structures ranging from a proportional 15 percent tax with no exemptions to systems with exemptions and various tax brackets up to a top rate of 40 percent. All of these yield the same total revenue; the graduated structure is required to preserve the present progressivity of the Federal tax system.

Bombshells, Boobytraps, and Pitfalls

There are certain aspects of the BTR report which you should be aware of because they will arouse comment and criticism. These include the following proposals:

- Social security benefits and other retirement benefits would be taxed when they are received. (For the most part, they are now exempt.)

- The earnings on retirement and pension funds would be taxed as they accrued. (They are now mostly exempt.)

- Capital gains would be taxed at full rates. (They would be adjusted for inflation, and those arising from corporation earnings would be relieved of double taxation.)

- Unemployment compensation would be taxed. (It is now exempt.)

- Interest on state and local bonds would be taxed.

- The aged and blind exemptions would be abolished.

- The deduction for local taxes on personal property would be abolished.

- The consumption tax proposals will, in spite of the points made above, be viewed by many as a radical, regressive, and impractical proposal.

- Many of what the report regards as minor and noncontroversial loophole closings will produce cries of outrage from small, but vocal, special interests.

Is the Report a Radical One?

While the report urges some significant changes in the income tax base and calls for at least studying a consumption based tax, it should be emphasized that many characteristics of the present tax system would be retained, and some of the changes are presented as options. Specifically, charitable deductions and medical deductions are included as options, although the basic model plans assume they are eliminated. While there is a new "secondary worker" exemption permitted for couples in which both husband and wife work, the basis for taxation remains the family unit as it is today.

Use of the BTR Report

In its present form, the BTR report provides the research and background information necessary for considering fundamental changes in U.S. tax policy. While it provides two models, a comprehensive income tax and a consumption tax, it does not attempt to "sell" or even to recommend these particular models. There are many details (e.g., deduction items) which are presented on an optional basis rather than a recommended basis. Thus, the present report would not be appropriate, for example, for inclusion in your budget for FY 1978.

Your Tax Message will contain a number of specific proposals. The BTR report is really a drastically different approach, an alternative to piecemeal, patching up of the system. To avoid getting bogged down in details, it sketches its proposals in more general terms, and there are not in the form appropriate for legislative recommendations to the Congress at this time. They are an attempt to describe the tax system of the future. There will be much work and many debates within and between the executive branch, the legislative branch, and the academic community before a new system becomes law. The BTR is designed to get the debate started.

Probably the best use you can make of the report would be to allude to it in your Tax Message and then issue it as a legacy to future tax policy. You would not have to "endorse" it but could say that the work represented in it will provide the basis for future Congresses to develop an improved tax system for the U.S.

December 11, 1976

Summary of Preliminary BTR Report

I. Overview

The report presents two proposals for broad-based reform of the individual and corporate income taxes. The proposals embody practical applications of two different conceptions of ideal tax systems. In so doing, they show how the tax system can be made simpler, more equitable, easier to understand and justify, and more conducive to the efficient operation of the private economy within a framework that permits maintenance of the vertical progressivity of the current rate structure.

Development of the plans for radical tax reform were motivated in part by the widespread dissatisfaction with the current tax system. In particular, criticisms of the current system have focussed on the appropriateness of current provisions on what items belong in the tax base. Numerous special features of the current law, relating both favorably and adversely to different sources and uses of income, introduce complexity into the system and raise questions about its fairness. In addition, many provisions of the code provide subsidies for special industries and for some forms of investment and consumption which are rarely justified explicitly and which may, in some cases, be unintentional. These subsidies, in many instances, tend to alter the pattern of economic activity in ways which may lower the social value of total output produced in the private sector. Further, although broadly speaking the present Federal tax system relates tax burdens to individual ability to pay, many details of the tax code do not reflect any consistent philosophy about the objectives of the system. The resulting confusion and complexity in the current tax code has led Secretary Simon to suggest that we should "have a tax system which looks like someone designed it on purpose."

Towards that end, the report presents two alternative model proposals for broad-based tax reform: (1) a comprehensive income tax, and (2) a cash flow, consumption based tax. Both proposals seek to treat individual items in the tax code in ways which would achieve consistency with an ideal base, departing from the ideal only where necessary for administrative feasibility, simplicity or what seems to be compelling social policy reasons. Where subsidies are maintained in the proposals, they are identified explicitly as such and justification is provided. The difference between the proposals is in the definition of the ideal base. The comprehensive income tax proposal uses as the conceptual tax base an accretion concept of income, where income in any year is defined as the sum of the individual's consumption and change in net worth. The cash flow tax uses consumption as the ideal base, excluding all positive and negative changes in net worth from tax.

Both proposals cover all of the major individual areas where changes from the current tax code merit consideration. In all cases where there are ambiguities about defining either the consumption or change in wealth components of income or where social values embodied in exclusions or deductions from income under the current law appear to merit continued consideration, specific policy judgments are made in the report for the purpose of presenting complete proposals. The report identifies those features of the proposal which are essential for definition of the ideal tax base, distinguishing them from the parts of the proposal which can legitimately be handled in different ways and still remain consistent with a reasonable definition of either the accretion or consumption ideal.

The following table compares the major features of the model tax reform plans with the current tax system. The items marked with an asterisk (*) in the table are optional in the sense that alternative treatments are possible under the comprehensive income tax and/or the cash flow tax.

The report shows that it is feasible to have a broad-based tax reform which departs in major ways from the current tax law. By providing two specific alternative plans -- even if preliminary -- it sets out a guide for possible future tax legislation aimed at sweeping reform, and also points out some of the main issues which remain to be resolved where social policy judgment, ultimately based on political and other considerations, must supplement technical analysis. Finally, in presenting a plan for a tax system based on the consumption ideal, the report points towards a promising alternative approach to tax reform which merits strong consideration.

II. Comprehensive Income Tax (Accretion Base)

Adoption of a more comprehensive definition of income in the tax base has received the most attention from reformers.

Comparison of Model Tax Plans

Item	Current Tax	Model Comprehensive Income Tax	Model Cash Flow Tax
Corporate income a. Retained earnings	Separately taxed to corporations	Attributed to individuals as income and included in tax base	No tax until consumed
b. Dividends	Separately taxed to corporations, included in individual tax base with $100 exemption		
Capital gains	50% of long-term gains included when realized; alternative tax available	Fully included in tax base on realization; no partial exclusion	Excluded from tax
Depreciation	Complex set of depreciation rules for different types of equipment and structures	Reformed rules for depreciation; depreciation to approximate actual decline in economic value	No depreciation; expensing of all business outlays
State and local bond interest	Excluded from tax base	Fully included in tax base	Excluded from tax base until consumed
Other interest received	Included in tax base	Included in tax base	Excluded from tax base until consumed
Interest paid on loans	Deducted from tax base	Deducted from tax base	No deduction
Rental value of owner-occupied homes 1/	Excluded from tax	Excluded from tax*	Excluded from tax
Local property taxes and gasoline taxes	Deducted from tax	Not deducted from tax	Not deducted from tax

Item	Current Tax	Model Comprehensive Income Tax	Model Cash Flow Tax
Medical expenses 2/	Expenses over 3% of adjusted gross income deducted from tax	No deduction; credit for expenses over 10% of adjusted gross income*	No deduction; credit for expenses over 10% of adjusted gross income*
Charitable contributions	Deducted from tax	Deducted from tax*	Deducted from tax*
Casualty losses	Uninsured losses deducted from tax	No deduction*	No deduction
State and local income taxes 4/	Deducted from tax	Deducted from tax*	Deducted from tax*
Child care expenses 5/	Limited tax deduction	Revised tax deduction*	Revised tax deduction*
Contributions to retirement pensions	Employer contributions untaxed, employee contributions taxed	All contributions excluded from tax	All contributions excluded from tax
Interest earnings on pension funds	Untaxed if employer-contributed or Keogh plan or IRA; taxed with deferral if employee contributed	Attributed to individuals and taxed in full as accrued	Untaxed
Retirement income from pension funds	Return of capital taxed only if contribution was deducted	Included in tax base	Included in tax base unless saved
Social security contributions	Employer contributions untaxed; employee contributions taxed	All contributions excluded from tax	All contributions excluded from tax
Social security retirement income and unemployment compensation	Excluded from tax base	Included in tax base	Included in tax base unless saved
Wage and salary income 6/	Included in tax base	Included in tax base for primary earner; for secondary earners 75% of wages under $10,000 and all wages over $10,000 included*	Included in tax base for primary earner; for secondary earners 75% of wages under $10,000 and all wages over $10,000 included*

Item	Current Tax	Model Comprehensive Income Tax	Model Cash Flow Tax
Deposits in qualified investment accounts	No tax consequences	No tax consequences	Deducted from from tax base
Withdrawals from qualified investment accounts	No tax consequences	No tax consequences	Included in tax base
Standard deduction	Available to non-itemizers only; \$1,600 or 16% of adjusted gross income up to \$2,400 for single taxpayer \$1,900 or 16% of adjusted gross income for married couple filing jointly	No standard deduction	No standard deduction
Personal exemptions 7/	\$750 per individual; extra exemptions for aged and blind	\$1,000 per individual and an additional \$2,000 per return*	\$1,000 per individual and an additional \$2,000 per return*

Office of the Secretary of the Treasury
Office of Tax Analysis

December 10, 1976

* Indicates alternative treatments possible.
1/ Under model comprehensive income tax, imputed rental income from owner-occupied homes may be included in tax base.
2/ Medical deduction optional under model tax plans. Alternative ways of structuring deduction or credit possible.
3/ Charitable deduction optional under model tax plans. Other alternatives possible, including limited credit.
4/ Deduction optional under model tax plans.
5/ Child care deduction and its form and limits optional under model tax plans.
6/ Treatment of secondary earners optional under model tax plans.
7/ Structure of personal exemptions under model tax plans subject to possible revision.

Income is defined by tax specialists as the sum of consumption and change in net worth in a given time period. Though income is defined conceptually in terms of uses of resources, it is not practical to measure an individual's annual income by adding up all of his individual purchases of consumer goods and the change in value of all the items on his balance sheet. Rather, income is measured by using the simple accounting concept that the sum of receipts from all sources within a given time period must equal the sum of all uses. To compute income, it is simply necessary to subtract from sources some expenditures which represent neither consumption nor additions to net worth. These expenditures for an individual include costs of operating his business (payment of salaries, rent, interest, etc.). They may also include direct costs of earning labor income (union dues, work clothing, etc), and perhaps some other expenditures such as interest, charitable contributions, State and local income, and sales taxes. For some items, e.g., large non-discretionary medical expenditures, there is some ambiguity as to whether or not they should be regarded as consumption and included in income (i.e., not deductible).

The tax base under current law departs from an ideal comprehensive tax base both in its measurement of sources of receipts and in its exclusion of some uses. Examples of the former are the exclusion of State and local bond interest and the double taxation of dividends of corporations. Examples of the latter include tax depreciation schedules which do not approximate actual changes in asset values, inclusion of only one-half of realized capital gains in the tax base and deferral of unrealized gains, and deductions for some types of consumption expenditures.

The comprehensive income tax proposal sets out a practical plan designed to approximate an accretion base as closely as possible. The major features of the comprehensive income tax are:

- integration of the corporate and personal income taxes

A separate tax on corporations does not fit into the ideal of a comprehensive tax base. Corporations do not "consume" or have a standard of living in the sense that individuals do; all corporate income can ultimately be accounted for either as consumption or an increase in the value of claims of individuals who own corporate shares.

The burden of the corporation income tax falls on individuals, but in ways which are difficult to determine. These burdens are almost certainly not systematically related to individual ability to pay.

Under the comprehensive income tax proposal the corporation income tax would be eliminated and all corporate income whether or not distributed would be allocated to individual shareholders. Corporate distributions to shareholders are not separately taxed.

The proposal contains a set of rules for allocating corporate income to individuals which are practically effective and come close to measuring annual income earned by shareholders as it accrues.

The advantages of integration are that 1) it ends the incentive to accumulate income within corporations by ending the double taxation of dividends, 2) it enables the effective tax rate on income earned within corporations to be keyed to the circumstances of individual taxpayers, and 3) it provides a practical method for accrual taxation of capital gains. Capital gains which result from retained earnings of corporations are automatically taxed under the proposal as they accrue, although capital gains resulting from changed expectations are only taxed when assets are sold.

The corporation income tax could be retained in the model system, with only after corporation tax income being attributed to shareholders. This would allow lower rates on individual income but would represent a significant departure from the principle of basing taxes only on individual circumstances.

. <u>treatment of capital gains</u>

Under an ideal comprehensive tax base, capital gains which represent an increase in real wealth should be taxed even though not realized by sale or exchange of the asset. The proposal moves in that direction by adopting the integration concept, and by advocating taxation of capital gains, though only upon realization, at full rates and allowing a step-up in basis for inflation. Thus, the proposal, while ending the current provision for exclusion of one-half of capital gains from the base, will also end the taxation of purely inflationary gains. Compared to present law, taxation of capital gains would be lower during periods of rapid inflation and higher during periods of relative price stability. The proposal does not recommend taxation of gains as accrued, i.e. prior to realization, because of the administrative cost of annual asset valuations. Thus, the tax benefits from deferring realization of capital gains are retained. However, the corporate integration proposal does enable a major fraction of individual income which was previously reflected in realized capital gain to be taxed as it accrues.

- <u>depreciation rules</u>

The proposal defines some general principles for measuring depreciation of assets for tax purposes. It is recommended that ADR be made mandatory for machinery and equipment. New rules for calculating depreciation are recommended for structures. Cost depletion is recommended in place of percentage depletion for mineral deposits.

- <u>state and local bond interest</u>

The proposal recommends that interest from state and local bonds be included in the computation of the tax base on the grounds that those receipts can be used for consumption or increases in net worth as well as receipts from any other source. The report mentions some alternative and less costly ways of providing the same subsidy to state and local governments as is presently provided by the interest exemption if such subsidization is viewed to be socially desirable.

- <u>imputed income from consumer durables</u>

Under an ideal comprehensive tax base, the imputed return in the form of the rental value of consumption services from ownership of consumer durables would be taxed. The exclusion of imputed income from tax provides an especially large subsidy to owner-occupied homes. This proposal does <u>not</u> recommend taxation of the imputed interest from homes and consumer durables, both because of difficulties of measurement and because the subsidization of home ownership appears to be a valid social policy. However, it is recommended that the deductibility of local taxes on personal property, including homes, be ended.

. itemized deductions

The report considers options for the treatment of major deductions, including deductions for medical expenses (replace with a catastrophic insurance program), charitable contributions (continue the deduction), state and local sales and income taxes (deductible), and casualty losses (will be eliminated in revision of the report). The major issues in deciding whether, and in what form, major personal deductions should be maintained concern whether or not a particular item of expenditure should be viewed as consumption and whether or not particular types of economic activities ought to be subsidized. While the report sets up specific proposals for treatment of all of these categories, it is noted that other rules are also consistent with the general ideal of a comprehensive income base. The deduction of interest is maintained, as is, in modified form, the deduction of child care expenses. The report recommends elimination of the standard deduction, which will be replaced in part by more generous personal exemptions.

. retirement income

Under a comprehensive income tax, both contributions to retirement pensions and the interest earned on such contributions should be included in the base. However, a roughly equivalent result is achieved by taxing retirement income and currently accrued earnings on pension funds and allowing employer and employee contributions to pensions to be deducted from the tax base. This procedure is preferable because it minimizes income averaging problems. Rules for making different types of pension accounts conform to this principle are outlined in the report. In contrast, social security taxes are not viewed as a purchase of a retirement annuity because of the looser connection between contributions made and retirement benefits received. For social security, it is proposed to allow deduction of both employee and employer contributions and to include all social security retirement income in the tax base.

The proposal also recommends that unemployment compensation payments be included in the tax base.

. choice of a filing unit and exemptions for family size

The report recommends family filing with rate brackets slightly less than twice as wide as the brackets for individual taxpayers. The decision on the appropriate filing unit represents a compromise between two objectives which cannot be met simultaneously when the rate structure is progressive: a system in which families with equal size with equal incomes should pay equal taxes and a system in which the total tax liability of two individuals is not altered when they marry. To reduce the work disincentive features caused by taxation of secondary earners at marginal rates to determine the income of a spouse, the plan also proposes that only 75 percent of the first $10,000 of earnings of secondary workers be included in the tax base. Alternative possible treatments of the filing unit which are also consistent with the general principles of an accretion base are presented.

The report discusses the issues in the choice between exemptions and tax credits for family size, and recommends a per-member exemption. Again alternative methods of adjusting for family size described in the report may also be viewed as consistent with the accretion base.

The report shows how adoption of the recommended changes in the tax base would change tax rates. With an exemption of $1,000 per taxpayer and an additional $2,000 per tax return, it is possible to raise the same revenue with roughly the same burden distribution by income class as under the present income tax with a rate structure ranging from 21 percent in the lowest bracket to 39 percent in the highest bracket. Alternatively, it is possible to raise the same revenue with a flat rate of 23.9 percent on all income above the exemptions. With exemptions limited to $1,000 per taxpayer, it would be possible to lower the rate to 19.1 percent. With no exemptions, the same revenue could be raised with a rate of 14.9 percent.

If all of the deductions viewed as optional in the proposal were eliminated, the rates could be much lower. The rates could also be lower if the plan for partial corporate integration were adopted instead of the corporate integration plan included in the proposal, which recommends complete elimination of the separate tax on corporations.

In summary, the comprehensive income tax proposal is a complete plan for radical alteration of the tax system which eliminates many of the inconsistencies of the present law. Some provisions of the plan fall short of the accretion ideal because of practical considerations. However, the plan demonstrates the feasibility of major improvements in the simplicity, efficiency, and fairness in the income tax.

III. Cash Flow, Consumption Based Tax

A cash flow, or consumption base tax, is less widely advocated in discussions of tax reform but deserves serious consideration as an alternative ideal for the tax base. The cash flow tax differs from the comprehensive income tax by excluding changes in net worth from the tax base. In practical terms, this means that net saving, as well as gifts and current purchases which are not regarded as consumption, are subtracted from gross receipts to compute the tax base.

The report shows that a cash flow tax has a number of advantages over a comprehensive income tax on simplicity grounds. A cash flow tax avoids the most difficult problems of measurement under a comprehensive income tax, such as depreciation rules, inflation adjustment, allocation of undistributed corporate income, and measurement of unrealized capital gains. These can be avoided because changes in net worth are not included in the tax base. In addition, the report demonstrates that the cash flow tax is more equitable because, unlike a comprehensive income tax, it treats individuals beginning their working years with equal wealth and the same present value of future labor earnings the same. They are treated differently under an income tax, depending on the time pattern of their earnings and the way they choose to allocate consumption expenditures among time periods. The cash flow tax, by eliminating disincentives to savings by taxing consumption, would encourage capital formation, leading to higher growth rates in the short-run and more capital per worker and higher before-tax wages in the long-run.

The report also points out that the current tax system, though riddled with inconsistencies, is in many ways closer to a cash flow tax than a comprehensive income tax in its treatment of many forms of income from capital. In particular, two important sources of saving for many Americans--homeownership and employer contributions to retirement annuities (or contributions of individuals to Keogh Plans and IRA's)--are treated under the current law almost exactly the same way they would be treated under a cash flow tax.

One way of designing a cash flow tax is to have an individual compute his tax base by including all monetary receipts in a given time period in the tax base and subtracting purchases of assets, itemized gifts, and certain itemized expenditures also allowed as deductions under the comprehensive income tax. Sales of assets would be taxed if not used for purchases of other productive assets. Inclusion of asset sales in the tax base, combined with deduction of asset purchases from the tax base makes it possible for the tax base to measure an individual's annual consumption without observing his purchases of goods and services directly.

An alternative way of computing the base for a cash flow tax is to exempt all income from capital from tax. In this version of the cash flow tax, dividends interest, capital gains, and profit from a personal business would be excluded from an individual's tax base and deduction of interest payments on loans would not be allowed. Purchases of productive assets would not be deductible.

The report shows that the exclusion of capital income from tax under the framework of the present tax system is in an important sense equivalent to allowing deduction of savings and including principal and interest in the tax base upon withdrawal for consumption. The two alternative ways of treating assets do not alter the present value of the tax base; deferral of tax in the present leads to payment of the same tax plus interest at the time the asset is sold for consumption. However, the payment of taxes does occur later under the method which allows a savings deduction than under the method which allows an interest exemption.

Under an income tax the purchase of an asset is not deductible and interest earnings are subject to tax. In contrast to a cash flow tax, an individual's tax burden rises if he chooses to defer consumption by purchasing a productive asset.

The report develops a practical plan to enable individuals to choose between the two essentially equivalent ways of treating investments under a cash flow tax. Purchases of assets are eligible for deduction only if made through qualified accounts. The qualified accounts would keep records of an individual's net investment balance so that annual saving and dissaving can be measured. Each year net contributions to qualified accounts would be computed and subtracted from the tax base. If withdrawals exceed contributions in any year, the difference would be added to the tax base as the additional source of consumption expenditure. Thus, the proceeds from an investment made through a qualified account would be subject to tax only when withdrawn for the purpose of consumption.

Savings not deposited in a qualified account would not be eligible for deductions but the interest and capital gains from investments financed by such saving would not be included in the tax base. There would be no need to monitor the flow of investments or the investment income made outside of qualified accounts because it has no tax consequences.

The report spells out the consequences of allowing a taxpayer to choose at will between two alternative ways of being taxed on income from assets, providing specific examples of how the tax would work. It is shown how allowing two alternative treatments for both assets and loans provides a simple device for the taxpayer to average the tax base over a number of years, thus avoiding the inequities associated with applying a progressive rate system to individuals with different annual variation in the level of consumption expenditures. The report also shows how allowing alternative treatment of assets and loans simplifies the measurement of the tax base.

Under the proposal, all consumer durables would be treated as tax prepaid assets. No deductions would be allowed for the purchase of a consumer durable and receipts from the sale of a consumer durable would not be included in the tax base.

Gifts would be treated differently under the cash flow tax than under both the comprehensive income tax and the current tax system. In the cash flow tax proposal, gifts and inheritances received are included in the tax base while gifts given are deducted. It is assumed that the cash flow tax would be supplemented by a separate tax on transfers of assets by gift or bequest.

The proposal describes in detail how specific items of capital income, including dividends, interest, capital gains, income from personal business, and accumulation of retirement pensions would be treated in accordance with the principles outlined above. The corporate income tax would be eliminated because there would no longer be a need to tax undistributed corporate income. Purchases of corporate stocks through qualified accounts would be tax deductible while all withdrawals from qualified accounts would be included in the tax base. Sale proceeds of corporate stock, dividends, and interest, if remaining in the qualified account, would not be taxed.

The cash flow tax, like the comprehensive income tax, would move towards neutrality in the tax treatment of different kinds of investments. By doing this, both proposals would have the effect of encouraging the best use of available capital. In addition, however, the cash flow tax eliminates the discouragement to capital formation inherent in the accretion concept.

The cash flow tax proposal treats definition of the filing unit, exemptions for family size, and deductions of personal consumption items the same way as the comprehensive income tax proposal. The only differences between the two proposals are the difference in the treatment of items which represent a change in net worth, and the difference in the treatment of gifts and inheritances.

IV. Transition Problems

Reforming the existing tax system poses a different set of problems than designing a new tax system from scratch. While the report concentrates on the design of approximations to ideal tax systems, the problems of transition have also been examined and embodied in specific proposals.

Transition to a new set of tax rules poses two separate, but related problems. First, changes in rules for taxing income from capital will lead to changes in relative asset values. Problems of fairness exist when investors who have purchased a particular type of asset in light of the present tax system would be subjected to losses by rapid and major changes in tax policy. Similarly, changes in tax policy may provide some investors with windfall gains. Second, changes in the tax law raise questions of what to do about income earned before the effective date, but not yet subject to tax. For example, the comprehensive income tax, which proposes full inclusion of capital gains in the base, requires a transiton rule for taxing capital gains accumulated before, but realized after the effective date.

The report outlines a series of specific transition proposals for handling income earned before the effective date, but not yet taxed. It also describes two methods for moderating the wealth effects of tax reform--"grandfathering", or exempting existing assets from the new tax provisions and phasing-in the new rules. Specific proposals for use of these instruments for different projected changes in the tax code are presented. The report also presents a transition proposal for phasing-in a cash flow tax.

Transition will be a major problem in any significant reform of the tax system. The analysis of transition issues, and the rules proposed for specific changes in the code in this report can be applicable to a number of alternative plans for future changes in the tax system.

V. How An Individual Would Calculate Tax Liability Under the Reform Plans

The method of calculation of tax liabilities under the broad-based reform plans is basically similar to the method under the current personal income tax. A form similar to a Form 1040 with boxes indicating family status and number of exemptions will be filled out. There will, however, be no standard deduction under either plan; any taxpayer with any positive amounts of eligible deductions would choose to itemize. To reduce the number of itemizers generally deductions would be subject to floor amounts.

Taxable income would be calculated on the form, and the relevant tax rate schedule, determined by the status of the filing unit (*i.e.*, single, married, head of household), would be applied to taxable income to compute tax liability. Taxes owed, or refunds due, would depend on the difference between tax liability and taxes withheld as reported on W-2 statements.

The wages and salaries of the primary wage-earner would remain the biggest item in computing taxable income of most households and would be entered into the calculation of income the same way as under the current system.

Some items in the computation of tax would change under both reform plans. The first $10,000 of wages and salaries of *secondary* wage-earners in any family would be multiplied by .75 before being added into the computation of taxable income. The rules for calculating some deductions (*e.g.*, child care) would be changed and other deductions (*e.g.*, property and gasoline taxes) would be eliminated.

Under the comprehensive income tax, some additional items would be added to the computation of taxable income. Corporations would supply to all stockholders a statement giving the amount of profit attributed to that stockholder in the previous year, and an adjustment to basis which would rise with earnings and fall with distributions. (The integration proposal includes procedures for handling changes in shareholders during the year and audit adjustments to the corporation's income.) Similar statements of attributions of earnings would be supplied by pension funds and insurance companies. The individual would include the income reported in those statements in his computation of taxable income. Also, interest income from state and local bonds, unemployment compensation, and social security retirement income would be included in the computation of taxable income.

All capital gains (or losses) would be entered in full in the computation of taxable income. In computing capital gains, the individaul would be allowed to adjust his basis for inflation. A table of allowable percentage basis adjustments would be provided in the tax form. In addition, the individual would use statements received from corporations to adjust his basis upward for corporate profits attributed to him and downward for distributions received.

The major change under the cash flow tax is that the taxpayer would receive each year statements from all of his qualified accounts on net withdrawals or deposits in the previous year. The source of an individual's deposits to qualified accounts are current savings and past accumulated capital and the source of withdrawals are past deposits and interest, capital gains and dividends received on investments made through the qualified accounts. The sum of all withdrawals and deposits would be recorded on a separate form. If deposits exceed withdrawals, the difference between deposits and withdrawals will be subtracted from other items included in the computation of taxable income. If withdrawals exceed deposits, the difference between withdrawals and deposits will be added to other items in the computation of taxable income.

Loans may also be made using qualified accounts. All funds borrowed from a qualified account would be included in the computation of taxable income in the year the money is received. All repayments of loans to qualified accounts, including interest and amortization, would be subtracted from the tax base in the years the payments are made.

Interest, dividends, and capital gains realized on investments made outside of qualified accounts would not be reported on the tax form and would not be included in taxable income. Deductions would not be allowed for interest paid on loans outside of qualified accounts.

Gifts and inheritances received would be included in taxable income (but if deposited in a qualified account would have an offsetting deduction), and separate lines will be provided for them on the tax form. A deduction would be allowed for gifts given. On the form for itemized deductions, the identity of the recipient of all deductible gifts and his social security number would be recorded.

VI. Chapter-by-Chapter Outline of Tax Reform Report

Chapter 1--Introduction

Chapter 1 sets out the objectives of a reformed tax system: equity, efficiency, and simplicity. The scope of the study is defined to include only the Federal income tax and the corporation tax. The relationship of the income and corporation taxes to other taxes in the system, notably the payroll tax and estate and gift taxes, and to means-tested grant programs is briefly explored. The content of the remainder of the report is outlined.

Chapter 2--What is to be the Tax Base?

Chapter 2 reviews the main issues in choosing an appropriate tax base, and presents the case for considering a cash flow tax based on consumption as a serious alternative to a reformed comprehensive income tax. General issues of equity in design of a tax system are discussed and the concepts of consumption and income are explained in detail. It is shown that the current tax system contains some elements of a consumption base and some elements of a comprehensive income base. The alternative tax bases are then compared on the grounds of equity, simplicity, and effects on economic efficiency.

Chapter 3--A Model Comprehensive Income Tax

A plan for a model comprehensive income tax is presented in Chapter 3. The major innovations in the plan relate to integration of the corporation and personal income taxes, tax treatment of capital gains, treatment of State and local bond interest, taxation of income accumulated in pensions and life insurance funds, and treatment of retirement income and unemployment compensation. Suggested changes in many personal deductions are presented, and are related to the concept of income. Important recommendations for changes in the filing unit, adjustment for family size, and taxation of secondary wage earners are set forth. International considerations in income taxation are briefly discussed. The

Chapter concludes with a description of a sample form for an individual's tax calculation under the comprehensive income tax.

Chapter 4--A Model Cash Flow Tax

In Chapter 4, a plan for a model cash flow tax based on consumption is presented. The major innovation in the cash-flow tax is that savings may be deducted from the tax base. A plan for using the device of qualified accounts to measure the flow of saving and consumption is presented. The equivalence between deductibility of saving and exclusion of capital earnings from tax is explained, and a plan for alternative treatment of assets following from this equivalence is presented. Treatment of specific items under the model cash flow tax is proposed in detail, and compared with treatment of the corresponding items under the comprehensive income tax. Arguments against the cash-flow tax on grounds of progressivity and effect on the wealth distribution are evaluated, and the possible use of a supplementary wealth transfer tax is explored. The Chapter concludes with a description of a sample individual tax form under the cash flow tax.

Chapter 5--Transition Rules Under Basic Tax Reform

Chapter 5 proposes a set of transition rules to accompany introduction of each one of the model tax plans. Problems which may arise in changing tax laws are explained, and some instruments to ameliorate adjustment problems, including exempting existing assets from the tax change and phasing-in the new rules, are described and evaluated. Specific proposals are presented for transition to both a comprehensive income base and a cash flow base which cover the timing of the application of the new rules to specific proposed changes in the tax code.

Chapter 6--Quantitative Analyses

Chapter 6 presents preliminary simulations of the effects of adoption of the proposed model tax reform plans on the tax liability of different groups of taxpayers. The Chapter includes examples of how taxpayers in different categories would calculate their taxes under the model plans.

THE WHITE HOUSE

WASHINGTON

December 13, 1976

MEMORANDUM FOR THE PRESIDENT

FROM: L. WILLIAM SEIDMAN LWS

SUBJECT: Tax Policy Issues

This memorandum supplements my memorandum of December 11 by providing the recommendations of your advisers on the tax policy issues scheduled for discussion at your meeting today with the Economic Policy Board Executive Committee.

Issue 1: Level of personal income tax reductions

Decision

Option 1 ___ Reduce tax revenues by approximately $11 billion in FY 1979 by increasing the personal exemption to $1,000, lowering marginal tax rates, and raising the low income allowance levels of the current law to the flat standard deduction levels you originally proposed ($1,800 for single returns and $2,500 for joint returns).

Supported by: OMB, Treasury, Commerce, Labor, Domestic Council, CEA

Option 2 ___ Reduce tax revenues by approximately $8 billion in FY 1979 by increasing the personal exemption to $1,000 and lowering marginal tax rates.

Supported by:

Issue 2: Social Security Tax Increases

Recommendation: That you propose increasing the combined employer-employee social security tax 0.6 percentage point on January 1, 1978, a further 0.6 percentage point on January 1, 1979, and a further 0.3 percentage point on January 1, 1980.

a strong statement to include decoupling

Issue 2: Social Security Tax Increases

Approve ______ Supported by: OMB, Treasury, Commerce, CEA, Domestic Council

Disapprove ______ Supported by: Labor*

Issue 3: Modifying Other Outstanding Proposals to Increase Tax Revenues

	Effects on Fiscal Year Receipts ($ billions) 1977	1978	1979
Accelerated depreciation in high unemployment areas	*	0.2	0.4

Retain ______ Supported by: OMB, Treasury, CEA, Commerce, Labor, Domestic Council

Delete ______ Supported by:

	1977	1978	1979
Utility relief package reductions	0.2	0.8	1.1

Retain ______ Supported by:

Delete ______ Supported by: OMB, CEA, Treasury, Domestic Council, Commerce**

No Comment: Labor

48 to 46

	1977	1978	1979
2 percentage point surtax rate reduction	1.1	2.6	2.8

Retain ______ Supported by: OMB, CEA, Labor

Delete ______ Supported by: Commerce,** Domestic Council

* Labor recognizes the need for some tax increase beyond the 0.4 mandated by law in 1978.

** Commerce feels should be tied to integration.

	Effects on Fiscal Year Receipts ($ billions)		
	1977	1978	1979
<u>Financial institutions reform</u>	0.3	0.7	0.7

Retain ________ Supported by: Commerce

Delete ________ Supported by: OMB, CEA, Domestic Council

No comment: Labor

	1977	1978	1979
<u>Broadened stock ownership (BSOP)</u>	*	0.4	0.5

Retain ________ Supported by: Commerce

Eliminate ESOP Too

Delete ________ Supported by: OMB, CEA, Domestic Council

No comment: Labor

	1977	1978	1979
<u>Proposal to end withholding on dividends to foreigners</u>	0.1	0.2	0.3

Retain ________ Supported by: OMB, Treasury, Commerce, Domestic Council

Delete ________ Supported by: CEA

No Comment: Labor

	1977	1978	1979
<u>Sliding scale capital gains tax</u>	-0.1	0.6	0.9

Retain ________ Supported by: CEA, Domestic Council, Treasury

Delete ________ Supported by: OMB, Commerce**

No Comment: Labor

** Commerce feels should be tied to integration.

	Effects on Fiscal Year Receipts ($ billions)		
	1977	1978	1979
Home insulation credit		0.2	0.2

Retain ________ Supported by: OMB, Commerce

Delete ________ Supported by: Treasury, CEA, Domestic Council

No Comment: Labor

Limited Employee Retirement Accounts	0.1	0.4	0.5

Retain ________ Supported by: OMB, Domestic Council

Delete ________ Supported by: CEA

No Comment: Commerce, Labor

Education Tax Credit Proposal	*	0.3	0.4

Retain ________ Supported by: Treasury, Labor, Domestic Council

Delete ________ Supported by: CEA

No Comment: Commerce

Exclusion of charitable contributions from minimum tax	*	0.1	0.1

Retain ________ Supported by: OMB, Treasury

Delete ________ Supported by: CEA, Domestic Council

No Comment: Commerce, Labor

Issue 4: Possible Stimulative Investment Measures

Decision

Option 1 ________ Advance the dividend deduction feature of the integration proposal.

Supported by:

Option 2 ________ Increase the benefits provided by the investment tax credit.

Supported by: CEA, Commerce, Labor

Option 3 ________ Reduce the corporate income tax rate from 48 percent to 44 percent or 2 percentage points more than your original proposal.

Supported by:

Option 4 ________ Do not propose additional stimulative investment measures

Supported by: OMB, Domestic Council

Treasury supports some additional measures to stimulate investment but has no preference for the method of stimulation except that it should include measures to benefit small business. Treasury supports preparing a package of the above stimulative measures at a level of approximately $4 billion annually.

[illegible]

THE WHITE HOUSE

WASHINGTON

December 13, 1976

MEMORANDUM FOR THE PRESIDENT

FROM: L. WILLIAM SEIDMAN LWS

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Supported by: OMB, Treasury, Commerce, Labor, Domestic Council, CEA

Option 2 ___ Reduce tax revenues by approximately $8 billion in FY 1979 by increasing the personal exemption to $1,000 and lowering marginal tax rates.

Supported by:

Issue 2: Social Security Tax Increases

Recommendation: That you propose increasing the combined employer-employee social security tax 0.6 percentage point on January 1, 1978, a further 0.6 percentage point on January 1, 1979, and a further 0.3 percentage point on January 1, 1980.

A strong statement to include decoupling

Issue 2: Social Security Tax Increases

Approve ______ Supported by: OMB, Treasury, Commerce, CEA, Domestic Council

Disapprove ______ Supported by: Labor*

Issue 3: Modifying Other Outstanding Proposals to Increase Tax Revenues

	Effects on Fiscal Year Receipts ($ billions) 1977	1978	1979
Accelerated depreciation in high unemployment areas	*	0.2	0.4

Retain ______ Supported by: OMB, Treasury, CEA, Commerce, Labor, Domestic Council

Delete ______ Supported by:

	1977	1978	1979
Utility relief package reductions	0.2	0.8	1.1

Retain ______ Supported by:

Delete ______ Supported by: OMB, CEA, Treasury, Domestic Council, Commerce**

No Comment: Labor

	1977	1978	1979
2 percentage point surtax rate reduction	1.1	2.6	2.8

48 to 46

Retain ______ Supported by: OMB, CEA, Labor

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** Commerce feels should be tied to integration.

	Effects on Fiscal Year Receipts ($ billions) 1977	1978	1979
Financial institutions reform	0.3	0.7	0.7

Retain ________ Supported by: Commerce

Delete ________ Supported by: OMB, CEA, Domestic Council

No comment: Labor

	1977	1978	1979
Broadened stock ownership (BSOP)	*	0.4	0.5

Retain ________ Supported by: Commerce

Eliminate ESOP Too

Delete ________ Supported by: OMB, CEA, Domestic Council

No comment: Labor

	1977	1978	1979
Proposal to end withholding on dividends to foreigners	0.1	0.2	0.3

Retain ________ Supported by: OMB, Treasury, Commerce, Domestic Council

Delete ________ Supported by: CEA

No Comment: Labor

	1977	1978	1979
Sliding scale capital gains tax	-0.1	0.6	0.9

Retain ________ Supported by: CEA, Domestic Council, Treasury

Delete ________ Supported by: OMB, Commerce**

No Comment: Labor

** Commerce feels should be tied to integration.

	Effects on Fiscal Year Receipts ($ billions)		
	1977	1978	1979
Home insulation credit		0.2	0.2
Limited Employee Retirement Accounts	0.1	0.4	0.5
Education Tax Credit Proposal	*	0.3	0.4
Exclusion of charitable contributions from minimum tax	*	0.1	0.1

<u>Home insulation credit</u>

Retain ________ Supported by: OMB, Commerce

Delete ________ Supported by: Treasury, CEA, Domestic Council

No Comment: Labor

<u>Limited Employee Retirement Accounts</u>

Retain ________ Supported by: OMB, Domestic Council

Delete ________ Supported by: CEA

No Comment: Commerce, Labor

<u>Education Tax Credit Proposal</u>

Retain ________ Supported by: Treasury, Labor, Domestic Council

Delete ________ Supported by: CEA

No Comment: Commerce

<u>Exclusion of charitable contributions from minimum tax</u>

Retain ________ Supported by: OMB, Treasury

Delete ________ Supported by: CEA, Domestic Council

No Comment: Commerce, Labor

Issue 4: Possible Stimulative Investment Measures

Decision

Option 1 ________ Advance the dividend deduction feature of the integration proposal.

Supported by:

Option 2 ________ Increase the benefits provided by the investment tax credit.

Supported by: CEA, Commerce, Labor

Option 3 ________ Reduce the corporate income tax rate from 48 percent to 44 percent or 2 percentage points more than your original proposal.

Supported by:

Option 4 ________ Do not propose additional stimulative investment measures

Supported by: OMB., Domestic Council

Treasury supports some additional measures to stimulate investment but has no preference for the method of stimulation except that it should include measures to benefit small business. Treasury supports preparing a package of the above stimulative measures at a level of approximately $4 billion annually.

[illegible]