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Revenue Options

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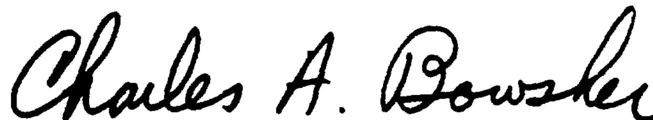
The President of the Senate
The Speaker of the House of Representatives
The Secretary-designate of the Treasury

This report is one of a series addressing major policy issues facing the next Congress and administration. The first in the series deals with what many consider the most important issue that must be addressed—the deficit.

This report describes the key points raised in our recent work, and in the work of others, concerning certain revenue options frequently proposed: raising income tax rates, broadening the income tax base, enacting a consumption tax, increasing revenue from federal excise taxes, and strengthening IRS enforcement. A combination of these options could emerge because each option alone has some drawbacks.

Based on past experience it will be extremely difficult to bring down the deficit solely through management efficiencies and spending cuts. Many people, including those involved in our domestic and overseas financial markets and institutions, would not view any deficit reduction effort as credible without some revenue increases. Therefore, the Congress and the administration must carefully consider the advantages and disadvantages of various revenue options available to deal with the deficit.



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Raise Income Tax Rates

At first glance, raising income tax rates appears to be the least complicated way to raise additional revenues. A small rate increase would generate a significant amount of revenue. IRS would not have to change any of its current administrative procedures and Treasury would begin to receive the additional revenue relatively quickly, as soon as the adjustment could be made to withholdings and estimated tax schedules.

Revenue Gains Are Potentially Large

Tax rates could be raised in various ways. Experts have estimated that a single percentage point increase in the two individual tax rates and the corporate rate would increase revenues by about $30 billion annually. The Congressional Budget Office (CBO) estimated that an increase in the lower individual tax rate from 15 to 16 percent and the upper statutory rate from 28 to 30 percent would raise revenues by about $30 billion per year. CBO also estimated that a 5-percent surtax applied to tax liability after credits would raise almost $23 billion annually.

But Many Are Reluctant to Raise Rates After Tax Reform

Even though increasing income tax rates would be technically simple, many Members of Congress believe that they have a tacit agreement with the public, through the Tax Reform Act of 1986, not to raise

tax rates. This act represents the most significant change in federal tax policy during the postwar era. It lowered the rates, broadened the base, and removed many of the Nation's poor from the tax rolls. But lowering the rates, which improved incentives to work and save, is viewed as the quid pro quo for the base broadeners in the act. Also, raising the rates might rekindle the debate over preferential treatment of income from capital gains. If this were to occur, there is a possibility that several of the reforms achieved in the act would begin to unravel.

Broaden the Income Tax Base

While the Tax Reform Act of 1986 significantly broadened the tax base, close to $300 billion in tax expenditures, over 120 separate tax preference items, still remain in the tax laws. Most of these preferences were originally justified as fostering some socially desirable goal, such as improving equity or reducing burdens on a particular activity, like owning a home. But the proliferation of tax expenditures has been criticized because they complicate the tax laws and are frequently less efficient than direct expenditures.

A small number of the 120 items comprise a relatively large share of total tax expenditures. The largest tax expenditure is in the area of employer-provided fringe benefits (e.g., pension contributions, health insurance). Deductions for mortgage interest payments and state and local taxes rank second and third. Other significant tax expenditures are in the areas of accelerated depreciation, nontaxed capital gains, tax-exempt bonds, nontaxable social security benefits, charitable contributions, and various types of individual retirement accounts.

Each Tax Preference Item Has Strong Backing

Each tax preference has a strong vested interest group arguing for continuation or expansion of its particular preference. For example, most retirees would be affected if Social Security benefits were taxed in the same way other pension programs are taxed. Moreover, any revenue increase from such an option would not help reduce the federal funds deficit unless Congress reconsidered its decision to place the proceeds from any taxation of Social Security benefits into the Social Security trust fund.

Two other examples in the areas of tax-exempt bonds and insurance further illustrate the support for tax preferences. The National Council of State Housing Agencies and the Association of Local Housing Finance Agencies have lobbied aggressively on behalf of tax-exempt mortgage revenue bonds. They have urged that state and local government issuance authority for these bonds be extended beyond their expiration date. The insurance industry has given strong backing to a preference item that excludes taxation of investment income earned by life insurance policyholders. We have issued reports on these two items and Congress deliberated this year whether to restrict or eliminate these tax expenditures in the technical corrections tax bill.

But Some Tax Preferences Could Be Made Less Costly Through Narrower Targeting

We have argued that the 1989 estimated tax expenditure of $1.7 billion for all outstanding mortgage-revenue bonds is costly and not well-targeted to the intended beneficiaries, low- and moderate-income home owners. Congress in the Technical Corrections Act of 1988 voted to extend bond issuance authority but placed greater targeting restrictions on bond-financed mortgages. The Joint Committee on Taxation estimated these restrictions would result in a 60-percent savings on new bond issues over what the tax expenditure would have been if issuance authority were extended without restrictions. In dollar terms this represents an average reduction in tax expenditure of almost $50 million annually for the next 3 years.

Single premium life insurance policies provide a device for capturing investment income without reflecting it on an income tax return. In a recent report, we recommended that this preference item be restricted and presented two alternatives to change the tax status of single premium life insurance products. Congress voted to somewhat restrict this tax expenditure, raising about $100 million annually.

Two other examples of tax preferences that could be more narrowly targeted are the mortgage interest deduction and the

state and local tax deductions. The mortgage interest deduction is a tax expenditure valued at over $30 billion per year. While it may not be possible to repeal the deduction, it may be possible to narrow the target group.

Under the current mortgage interest deduction cap, a taxpayer may not deduct interest on "acquisition debt" over $1 million and "equity debt" over $100,000. If the overall debt on a principal and second home exceeds $1.1 million, interest on the excess debt becomes personal interest and is only partially deductible. It may be possible to lower this cap or lower the value of the deduction by some amount. To illustrate the revenue potential of this approach, CBO estimated that, if the value of the deduction were limited to the lowest marginal tax rate, currently 15 percent, nearly $12 billion more could be raised per year.

Similarly, it may be possible to narrow the target group that benefits from the deduction for state and local taxes. This deduction reduces federal tax liability for itemizers only and the value of the deduction is worth more to taxpayers in higher brackets. To illustrate the revenue potential associated with this approach, CBO estimated that revenues would increase by

almost $5 billion annually if the deduction were restricted by a ceiling of 7.5 percent of adjusted gross income (AGI). In other words, a taxpayer would not be able to deduct state and local taxes above 7.5 percent of AGI. CBO also estimated that completely eliminating state and local tax deductions would raise over $25 billion per year in revenues.

Enact a New Consumption Tax

A consumption tax is levied on a taxpayer's expenditures for goods and services rather than on a person's or firm's income. Hence, saving is not taxed. There are generally three types of broad-based consumption taxes: (1) a personal expenditure tax, (2) a national retail sales tax, and (3) a value-added tax (VAT).

Under a personal expenditure tax, which would replace the individual income tax, individuals would pay tax only on their consumption. Withholding would continue and individuals would be required to file an annual form with IRS similar to the form filed for income tax purposes.

The other two types of consumption tax could be added to the current income tax system. Under a national retail sales tax, the compliance burden to file the appropriate form and pay the collected tax would be placed on retail businesses. A VAT, on the other hand, would not be collected solely at the retail stage of the production process. Instead, a VAT would distribute the tax collection burden across various stages of production. Of the three consumption tax options, the VAT is discussed most frequently, in part because it is used by most other industrialized nations.

The Potential for Revenue Gains Would Be Substantial

Interest in the VAT has grown considerably in recent years. If substantial sums are needed to close the deficit, the VAT offers that potential at a reasonably low rate. CBO estimated that a comprehensive 5-percent VAT could bring in almost $117 billion annually, while one that exempted food, housing, and medical care could yield about $67 billion annually.

How the Value Added Tax Works

The VAT, a multistage tax, can best be seen as a particular means of collecting a general sales tax on consumer goods and services. Tax is collected at each stage in the production-distribution process on the value that firms add to goods and services bought from suppliers. We are currently reviewing two different methods of collecting a VAT—the subtraction method and the tax-credit or invoice method.

The two methods differ in the information used to calculate tax liability and in their ability to accommodate various design features that have direct tax policy implications. Under the subtraction method the statutory tax rate is applied directly to the firm's value added, which is calculated by subtracting purchased inputs from sales. The subtraction VAT does not require the taxpayer to keep additional records, but the tax rate must be uniform because the

taxpayer does not calculate the tax on each separate transaction.

Under the tax-credit method, the firm must first calculate its gross tax liability by applying the statutory rate to its sales, then calculate its net liability by deducting the amount of tax it has paid on its purchases. This method requires a separate invoice for each transaction, placing additional record-keeping burden on some taxpayers. But separate invoices allow greater flexibility in the design of a VAT. The policymaker can, for example, reduce the VAT's regressivity by creating different tax rates for luxuries and for necessities, such as food or medicine.

Would a VAT Improve Our Domestic and International Economic Position?

Advocates believe that an increase in federal revenues through a VAT would have less of an adverse effect on long-run economic growth, investment, and savings than a similar-sized revenue increase using the income tax. They also believe that a VAT, if substituted for a corporate income tax, would improve our international competitive position by increasing corporate profit, reducing the cost of capital, and improving our balance of trade. Other experts, however, doubt that balance of trade improvements could be maintained because adjustments to currency exchange

rates would nullify any initial improvements.

One additional aspect often mentioned by VAT proponents is that a VAT would help harmonize the U.S. tax structure with many of its trading partners. While the European Economic Community uses a VAT that taxes imports but not exports, two of our major trading partners, Japan and Canada, currently do not impose a VAT. However, both countries are considering consumption tax proposals of the VAT or national sales tax variety. If they both enact a VAT, the U.S. will be one of the few major industrialized nations in the world without a VAT.

Basic Concerns in Designing a VAT

The regressivity issue is one major concern in designing a VAT. Without any adjustment for taxes paid, a VAT would cause low-income persons to incur substantial tax liabilities, paying a higher percentage of their income in this tax than those earning higher incomes.

Because the revenue estimates are so large, another concern is that a VAT could become a "money machine" encouraging more, rather than less, government spending. Some restrictions on rate increases would have to be part of the design before those who worry about the "money

machine" problem would support a VAT. Critics of a VAT also worry about an adverse effect on the inflation rate and federal intrusion into a revenue base that has traditionally belonged to state and local governments. We are currently doing a study on this latter concern.

What Would It Cost to Administer a VAT?

Due to lack of U.S. experience with a VAT, much of the empirical evidence and analyses necessary to make fully informed decisions on the administration of this type of tax in the United States does not exist. To assist Congress in debating this issue and to be prepared to implement such a tax, were it to pass, IRS needs to study how it would implement various types of VATs and reevaluate the costs associated with administering them.

In the only published evaluation, made in 1984, IRS estimated that it would need at least 18 months after enactment before it could begin to administer a VAT. It also estimated that a VAT, when fully phased in, would cost about $700 million per year to administer and require about 20,000 additional employees. However, these estimates were based on a set of broad assumptions. For example, IRS assumed that all firms would be subject to a VAT. The estimates could vary substantially under different assumptions.

Increase Revenue From Federal Excise Taxes

The federal government currently imposes over 100 excise taxes on various goods and services. While accounting for a small share of revenues, an estimated $35.3 billion or 3.9 percent in 1988, these taxes are receiving increased attention as a means of reducing the federal deficit.

An argument for increased reliance on these taxes is that the cost of consuming many of these items spills over onto society as a whole. For example, the full cost of smoking includes the smoke-related medical costs borne by both smokers and nonsmokers. However, excise taxes are criticized as being generally regressive, resulting in increases that could offset the gains in equity achieved by tax reform when many of the poor experienced substantial reductions in their taxes.

A package of all the various options to raise revenues through excise taxes could not be put together without substantial effort. A Brookings tax expert estimated that "with an heroic effort, Congress might increase excise taxes by perhaps $30 billion." But to achieve such an increase would entail almost doubling current excise tax revenue, which we think would be very difficult.

Restore Erosion From Inflation

We are currently studying how past inflation has eroded the potential revenue that could have been realized from various excise taxes that are imposed in per unit terms rather than per dollar value of the respective product. Taxes on beer, wine, certain tobacco products, and certain weapons have been imposed at their current rate for over 30 years. Since 1965, the last time Congress undertook a comprehensive examination of excise tax rates, the Producer Price Index has risen by almost 220 percent. If excise tax rates on the above items, in addition to the tax on distilled spirits and occupational wagering, had been indexed since 1965, they would have at least doubled, producing substantially more annual revenue.

Raise the Rates or Equalize Them Among Similar Products

The current federal tax on gasoline is 9.1 cents per gallon; the tax on diesel fuel is 15.1 cents per gallon. Some observers argue that the tax is not adequate to encourage conservation and it is too low relative to what Europeans pay. They also argue that people who use the roads or buy goods shipped by road cause "negative externalities"—pollution, congestion, and noise—and should pay for them. To illustrate the revenue potential, CBO estimated that, if these tax rates were raised an additional 12 cents per gallon, revenues

would increase by about $11 billion annually. However, motor fuel tax revenues and revenues from certain other excise taxes are earmarked to trust funds. If Congress wants to reduce the deficit with additional revenues from earmarked taxes, it will have to allocate those revenues to the general fund.

Some excise taxes have been criticized because the tax rates on similar products are not equal. The tax rates on beer and wine are much lower than the tax rate on liquor when computed by alcoholic content—about a penny per ounce of alcohol in wine, a nickel in beer, and a dime in whiskey. CBO estimated that increasing rates to the alcohol-equivalent rate on distilled spirits would raise roughly $4 billion per year.

Broaden the Base

The excise tax base could also be broadened by eliminating exemptions on certain goods and services. In our review of excise taxes we found that current law taxes some types of gambling activity while exempting other types such as state-licensed parimutuel wagering, most tax-exempt organization activities, and activities that require winners to be present. For example, bingo, keno, and casino gambling are generally exempt.

Enact New Excise Taxes

Another revenue option would be to enact new excise taxes. Congress recently enacted new excise taxes on certain fishing equipment—electric outboard motors and sonar fish finders. But it is not easy to impose a tax on a commodity or service that is no longer taxed or was not previously taxed. For example, last year Congress considered a proposal to tax transactions on the stock market. This proposal, called a stock transfer tax, met stiff opposition. This opposition argued that the tax would result in lower share prices and lower trading volume, thus reducing the efficiency of the market. A similar but more recent proposal is a tax on financial transactions that would have a low rate but a very large base.

Increase Internal Revenue Service Enforcement

Several actions, summarized below, are also discussed in our transition series report on IRS (GAO/OCG-89-26TR).

Reduce the Tax Gap

IRS estimates individuals and corporations will not pay $87.1 billion in income taxes owed the government for 1988 and that this amount will grow to $113.7 billion by 1992. The 1988 estimate of the tax gap consists of $64.3 billion in unpaid income taxes by individuals and $22.8 billion unpaid by corporations. The tax gap estimates show that unpaid taxes remain substantial and that IRS can more vigorously seek to collect specific pockets of unpaid taxes through enforcement programs.

Increase Examination Resources

IRS figures show that it audited 2.29 percent of taxpayer returns 10 years ago; by 1987 that figure dropped to 1.1 percent. With more examination resources IRS could expand audit coverage and generate additional tax revenue from taxpayers who have overstated deductions or understated income. This revenue, however, would not be realized immediately because of the time it takes to recruit and train new revenue agents. CBO estimated that an additional 3,302 staff positions in examinations would yield between $0 and $160 million in the first year and $588 million the first fiscal year in which all new

hires were employed for the complete year.

Improve Collection Activities

In addition to tax gap estimates, IRS recently reported a total accounts receivable balance of about $56 billion. Such taxes owed the federal government have grown at a steady pace and we expect the trend to continue. IRS' Internal Audit Division estimated that about $33 billion of the balance is collectible, but IRS has little detailed information on how much of the accounts receivable inventory can be collected and does not know what collection tools are most effective. As a result, IRS has not been able to effectively reduce the growth of accounts receivable and collect delinquent taxes, thus depriving the government of a significant source of revenue to reduce the budget deficit.

Increase Non-Tax Revenue Sources

Increase Reliance on User Charges

It is appropriate to explore opportunities to expand and improve the application of user charges. When federal agencies provide goods, services, and privileges that benefit identifiable recipients, charging recipients for these benefits deserves consideration. Charging for the benefits from these publicly provided goods is equitable because it assures that costs are directly borne by the beneficiaries, rather than taxpayers in general. Also, charging is efficient because it helps to better allocate scarce government resources.

However, some prices could be set below full government expenses to account for external costs or to permit access by those with low incomes. There is a need for an overall review of current federal user charge policies. The user charge option could be regularly considered in designing future federal programs, even though revenues gained from user charges may not be significant relative to the deficit.

Selling Federal Assets

In January 1986, the administration initiated a proposal to improve federal credit management and to generate budgetary receipts through the sale of $4.4 billion in loan assets. This initiative expanded to $6.8 billion of sales in the 1986 Budget Reconciliation Act, and to $12.6 billion in the President's fiscal year 1988 budget.

We found, however, that the government had to provide credit enhancements—indemnification to private investors against loan losses after the sale—for it to maximize net sale proceeds. Sales without recourse would have significantly lowered the price received. Thus, investors who purchased these loans did not assume the full risk of loss, as OMB had initially required. Also, we found these sales simply shift future cash receipts to the budget year in which the sales are completed.

An overall decrease in the structural budget deficit would occur only if the proceeds from a loan sale or prepayment were more than the present value of foregone loan principal and interest payments. This did not occur in the loan sales we analyzed. Thus, we believe a change in budgetary accounting for loan programs and loan sales should be made to more properly reflect the true nature of loan programs and sales.

Gains Through Economic Growth

Although not directly controlled by policymakers, economic growth can result in significant increases in federal receipts. One Brookings economist estimated that federal individual income tax receipts would increase by 1.5 percent for every 1.0 percent increase in adjusted personal income, under 1988 tax rates. In other words, an

additional 1 percent or about $34 billion in 1988 personal income would result in an additional 1.5 percent or $6.1 billion in individual income tax revenue.

Related GAO Products

The Congress Should Consider Exploring Opportunities to Expand and Improve the Application of User Charges by Federal Agencies (GAO/PAD-80-25, Mar. 28, 1980).

Tax Policy: Choosing Among Consumption Taxes (GAO/GGD-86-91, Aug. 1986).

Tax Policy: Taxation of Single Premium Life Insurance (GAO/GGD-88-9BR, Oct. 16, 1987). Testimony given on March 15, 1988, before the Subcommittee on Select Revenue Measures, Committee on Ways and Means, House of Representatives.

Loan Asset Sales: An Assessment of Selected Sales (GAO/AFMD-88-24, Feb. 19, 1988).

Home Ownership: Mortgage Bonds are Costly and Provide Little Assistance to Those in Need (GAO/RCED-88-111, Mar. 28, 1988).

The Budget Crisis: Hard Choices in the Real World. Excerpted from a presentation by the Comptroller General before the annual meeting of the National Association of State Comptrollers, May 18, 1988.

Tax Administration: Difficulties in Accurately Estimating Tax Examination Yield (GAO/GGD-88-119, Aug. 8, 1988).

Internal Revenue Service Issues (GAO/OCG-89-26TR).

Tax Policy: Subtraction VAT vs. Tax Credit VAT (forthcoming).

Tax Policy: The Potential for Increasing Federal Excise Taxes to Enhance Revenue (forthcoming).

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