

Research Department Federal Reserve Bank of San Francisco

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Lost Revenues?

Faced with ever-rising demands for new spending programs, Congress is anxiously searching for new ways to pay for such programs. In particular, it is now closely examining "tax expenditures"—at the House Ways and Means Committee's current hearings, and at other committee sessions as well.

Tax expenditures are revenues that the Treasury fails to receive because of special treatment granted to individual or corporate taxpayers. Specifically, they are defined as revenue losses attributable to a special exclusion, exemption or deduction from gross income, or attributable to a special credit, preferential tax rate or deferral of tax liability. Total "losses" of this type approximated \$75 billion in fiscal 1974 and \$81 billion in fiscal 1975, according to a table published (for the first time) in the current budget document. This new emphasis on tax expenditures reflects the pressure of tax reformers who believe that the entire tax system should justify itself in the same way the appropriations system does.

Critics and defenders

Each type of preference has its critics and defenders. For example, should we continue to subsidize farmers to the tune of almost \$1.0 billion a year because of specific tax provisions applicable only to farm income? Again, should we continue to subsidize homeowners to the tune of \$10.3 billion a year because of the tax deductibility of mortgage interest and

property taxes—a feature not available to renters? Or should we continue to subsidize small business with at least \$3.5 billion in preferences because of the reduced tax rates applicable to the first \$50,000 of corporate income?

Defenders of the present system claim that it should be retained because of its many benefits for ordinary taxpayers, put into law by Congressional decisions to support certain worthwhile activities. (Individuals account for about three-fourths of all such tax benefits, and corporations account for the rest.) In their view, the tax-reform tactic can be pushed to excess, because it would imply that all income covered by tax legislation rightfully belongs to the government, and that whatever the government decides not to collect (through exemptions) constitutes a suspect subsidy.

Tax reformers, in contrast, claim that a proper income-tax structure should include in the tax base all sources of income, allowing deductions for expenses incurred in obtaining that income. They add, however, that any special provision beyond that point is a subsidy which merits full Congressional scrutiny. Reformers admit that some tax expenditures largely benefit low-income taxpayers; for example, through the tax exemption of unemployment compensation, workmen's compensation and public-assistance payments. But they argue that the greatest benefits go to higher-income

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groups. In 1972, the average individual in the \$3-5,000 tax bracket received \$10 in tax-expenditure benefits, but average benefits rose to \$1,358 in the \$25-50,000 bracket and to \$29,264 in the \$100-500,000 bracket.

The estimates of total revenue "losses" prepared by the Office of Management and Budget are somewhat inexact, especially since they fail to take into account the interactions among different preference categories. OMB assumes that the tax structure, average taxpayer behavior and the general economic situation all remain unchanged in response to the hypothetical deletion of individual tax-expenditure categories. Such assumptions in many cases are unrealistic; for example, the deletion of the investment-tax credit presumably would harm the economy, and this in turn would affect other preference categories such as unemployment-insurance benefits.

Moreover, OMB deletes from its list certain preferences that it argues are normal features of the tax structure, such as rapid depreciation write-offs, failure to tax capital gains at death, and deferments of tax payments on foreign-source income—preferences which some critics claim should be included in its list. Again, the figures are inexact because only preliminary estimates are now available regarding the impact on tax preferences of the Tax Reduction Act of 1975.

How much involved?

Given these qualifications, tax expenditures as a group were estimated at \$81.4 billion for fiscal 1975. The OMB study broke the total into 15 major categories, but three of those categories accounted for 46 percent of the total amount involved. Income-security activities brought about a \$16.1 billion revenue loss, since such income benefits as social-security, pension and unemployment-insurance payments are all excluded from taxable income. Another \$16.0 billion was involved in tax-investment preferences available to holders of both real and financial assets; most of this came from the homeowner's ability to deduct from gross income both the mortgage interest and the property taxes on owner-occupied homes, although the favorable tax treatment of capital gains also fell under this heading. Another \$5.7 billion came from a third (health) category, reflecting the individual's ability to deduct medical expenses from gross income, and to exclude employer contributions to medical-insurance premiums from taxable income.

Two other categories, related mainly to Federal fiscal assistance to other levels of government and to nonprofit institutions, accounted for 26 percent of the overall revenue loss. These included the tax deductions for state-local taxes, charitable contributions and

consumer-credit interest, as well as the nontaxable status of state-local government debt. Three other categories, related to business investment and resources development, accounted for 20 percent more of the total. These included the investment tax credit, the corporate surtax exemption below \$25,000 income, and the special provisions for firms involved in the extraction of natural resources. The other seven categories were relatively minor in dollar terms, although they involved such popular programs as the tax exclusion of veterans' benefits, the special treatment of farmers' capital outlays, and the deductibility of child-care and dependent-care expenditures.

The Tax Reduction Act has affected tax expenditures in both directions, although no official estimate has yet been made of its overall impact. For individuals, the Act tends to reduce estimated tax expenditures because of the increase in the minimum standard deduction. But in the other direction, the Act increases certain preference items, especially through the tax credit of 10 percent of earned income for low-income wage earners, but also through the new-home purchase credit and the widening of eligibility for child-care deductions. For corporations, certain preferences are tightened—the elimination or reduction of the oil-depletion allowance and the

change in treatment of foreign-earned profits—but these are more than offset by the revenue loss caused by the increase in the investment tax credit and the reduction in tax rates on the first \$50,000 of profits.

What objectives?

In the main, tax expenditures are designed to achieve specific economic and social objectives through fiscal activities. Thus, they can be viewed as alternatives to other fiscal tools such as credit programs and direct outlays. Most such preferences either encourage certain activities—for example, the broadening of home-ownership, the operation of small businesses, or the financing of state-local governments—or they reduce the burden of those in adverse circumstances such as the blind, the aged, and low-income individuals.

As in other areas, however, our economic and social objectives change over time, and thus necessitate a review of our tax laws. The Ways and Means Committee, in its current deliberations, may tighten up on some tax expenditures while loosening others in an attempt to meet new national goals. But increased Congressional scrutiny of these preferences is clearly in the works. In fact, the Budget Reform Act of 1974 specifically enjoins the new budget committees to "devise methods of coordinating tax expenditures, policies and programs with direct budget outlays."

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 6/25/75	Change from 6/18/75	Change from year ago	
			Dollar	Percent
Loans (gross, adjusted) and investments*	85,168	- 945	+ 1,329	+ 1.59
Loans (gross, adjusted)—total	64,244	- 402	- 1,474	- 2.24
Security loans	1,022	- 411	- 223	- 17.91
Commercial and industrial	23,294	- 99	- 214	- 0.91
Real estate	19,585	+ 7	+ 116	+ 0.60
Consumer instalment	9,835	+ 22	+ 426	+ 4.53
U.S. Treasury securities	8,474	- 614	+ 3,388	+ 66.61
Other securities	12,450	+ 71	- 585	- 4.49
Deposits (less cash items)—total*	85,329	- 591	+ 6,096	+ 7.69
Demand deposits (adjusted)	23,147	- 400	+ 1,320	+ 6.05
U.S. Government deposits	445	- 637	- 595	- 57.21
Time deposits—total*	60,341	+ 499	+ 5,408	+ 9.84
States and political subdivisions	6,904	- 69	+ 229	+ 3.43
Savings deposits	20,276	+ 69	+ 2,311	+ 12.86
Other time deposits‡	29,399	+ 321	+ 1,923	+ 7.00
Large negotiable CD's	16,045	+ 336	+ 1,857	+ 13.09
Weekly Averages of Daily Figures	Week ended 6/25/75	Week ended 6/18/75	Comparable year-ago period	
Member Bank Reserve Position				
Excess Reserves	53	66	-	6
Borrowings	0	0		141
Net free (+) / Net borrowed (-)	+ 53	+ 66	-	147
Federal Funds—Seven Large Banks				
Interbank Federal fund transactions				
Net purchases (+) / Net sales (-)	+ 1,475.8	+ 2,374.5		+ 1,606.7
Transactions of U.S. security dealers				
Net loans (+) / Net borrowings (-)	+ 490.3	+ 940.7		+ 495.9

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

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