Order Code RL33088

CRS Report for Congress
Received through the CRS Web

Tax Policy Options After Hurricane Katrina

Updated October 23, 2006

Jane G. Gravelle
Senior Specialist in Economic Policy
Government and Finance Division

Tax Policy Options After Hurricane Katrina

Summary

The damage from Hurricane Katrina raised at least four issues that might be addressed by tax policy.

The first issue was that the effect of the disaster, particularly given the potential impact on energy prices, might contract the overall economy, suggesting some need for a fiscal stimulus. The Administration indicated that it would not propose a tax cut, but supports making the existing tax cuts permanent. Congress acted by appropriating $62.3 billion in direct assistance, followed by $6.2 billion in tax relief.

Preliminary indications were that the effect of the hurricane on the national economy would be limited, and in subsequent weeks, the economy has resumed its growth path. If Congress determined that an immediate stimulus were needed, timing would be an important factor. Relying solely on tax cuts (rather than spending or a monetary stimulus) raises issues related to timely delivery and the spending of those funds. Making the tax cuts permanent is unlikely to have much stimulative effect in the short term, since the tax cuts do not, in general, expire until 2011, and there would be no immediate effect on disposable income.

A second issue was whether the rise in energy prices should be addressed by some redistribution from energy producers to consumers, or some general relief. An initial proposal to suspend the gasoline tax would not have been expected to have an effect on prices in the short run due to the market mechanism allocating supply. Income tax rebates could be used to target benefits to poor people, but this approach would also face administrative difficulties. Proposals have been made for a windfall profits tax, which has some historical precedence, but the tax is difficult to administer.

A third issue was whether tax measures might be used to provide relief for the victims. In general, tax benefits cannot easily be targeted to lower-income individuals who have little or no tax liability. There are some current tax provisions and administrative actions already providing some relief. H.R. 3768 provided additional benefits to help with cash flow, employment, housing, and tax compliance issues of the victims, as well as incentives to increase charitable giving. While some of these proposals would aid the victims, or at least those who have tax liability, the tax benefits for charitable giving in the Senate bill would have been unlikely to do so. The final legislation included more focused charitable provisions.

A fourth issue is what role tax subsidies might play in the longer-term rebuilding of the area, and such incentives are in H.R. 4440 and S. 2020; this legislation was enacted in December of 2005. Geographically targeted subsidies exist in the current tax law for economically depressed areas and were enacted for lower Manhattan after the 2001 terrorist attacks. Empirical evidence suggests that these incentives might not be very effective in speeding up or increasing the degree of rebuilding but they may be desirable as part of the means of compensating victims for catastrophic losses. This report will be updated to reflect legislative developments.

Contents

Tax Cuts and Fiscal Policy Issues 1

Providing Relief from High Fuel Prices 4

Providing Relief to the Disaster Victims 5
- Pre-Existing Tax Provisions 6
- Administrative Actions of the Internal Revenue Service 7
- New Provisions and Their Development 7
  - Senate Proposal 8
  - House Proposal 9
- Discussion of Tax Provisions for Relief 9
- Further Legislative Action 11

Incentives for Rebuilding 12
- Prior Geographically Targeted Subsidies 13
- Justification for Subsidies 14

Conclusion 16

Tax Policy Options After Hurricane Katrina

The damage from Hurricane Katrina raised at least four issues that might be addressed by tax policy. This report provides an overview, beginning with national issues and then addressing local issues.

The first issue was that the effect of the disaster, particularly given the potential impact on energy prices, might contract the overall economy, suggesting some need for a short-term fiscal stimulus. A related nationwide fiscal policy concern was that the loss of income (and the taxes on that income) and the increased spending would increase the budget deficit and debt, and worsen pressures on the budget from a variety of factors (such as the Iraq War and the need to address issues such as the alternative minimum tax). A second issue was whether the rise in energy prices should be addressed by some redistribution from energy producers to consumers, or some general relief. A third was whether or not tax measures might be used to provide relief for the victims. The last section of this report discusses the role that tax subsidies might play in the longer-term rebuilding of the area.

In the time that has passed since the disaster, some of these issues have been resolved in part. The economy has continued to expand through the third quarter and forecasts are generally for a 3.5% growth rate during the year. Gasoline prices, which rose sharply, have since moderated significantly; although winter fuel costs were high.

Most of the legislative response to the disaster has been through spending in the region, with $62.3 billion in supplemental appropriations.[1] There has been no fiscal stimulus bill directed at overall national economic performance. Congress passed a tax relief bill, H.R. 3768, of $6.1 billion (over ten years) and H.R. 4440, a bill containing tax provisions to encourage rebuilding.

Tax Cuts and Fiscal Policy Issues

Hurricane Katrina had devastating effects in areas of Louisiana, Mississippi, and Alabama. It also had effects on the overall economy. These effects arise from two sources: from the direct losses in the area and from possible supply effects for the economy as a whole, mainly fuel costs. The extent to which Hurricane Katrina might adversely affect the overall national economy thus depended significantly on how energy issues were resolved. The loss of property from the disaster per se cannot be reversed and does not in itself imply a problem with unemployed resources, which

---

[1] See CRS Report RS22239, *Emergency Supplemental Appropriates for Hurricane Katrina Relief*, by Jennifer Lake and Ralph Chite, for a discussion.

is the reason for general economic contractions that might be addressed by a fiscal stimulus. Many residents of the affected region are displaced from their jobs. An option to address this problem would be to provide direct spending or regionally focused benefits (in the area of impact and the area that is housing refugees) to return these workers to their jobs. Lingering unemployment in the area will be offset in part by increased demand for workers due to the rebuilding efforts. Indeed, a current problem in New Orleans is that a labor shortage has developed in part because of the lack of housing.

Pressure on energy prices was a concern. An initial release by the Congressional Budget Office (CBO), however, indicated that the outlook was becoming somewhat more positive as the energy infrastructure was being restored.[2] This study estimated a small one-time reduction in economic output and a temporary slowing of growth (but not a recession) with growth projected to turn up in the first half of 2006 as rebuilding resumes. These losses are relatively small because the production in the affected area is small compared to the U.S. economy and because of the expected resolution of the energy shock.[3] Subsequent events support this outlook. Energy prices moderated; the economy continued to grow; and while the unemployment rate rose slightly in September of 2005, it declined in October and has since fallen slightly more.

The Internal Revenue Service (IRS) initially had undertaken some administrative actions that might ease the fuel situation (and some regulatory changes and a release of oil from the strategic reserve have also occurred). These administrative actions included allowing the sale of dyed diesel fuel for highway use (normally reserved for off-road or tax exempt use), suspending the tax penalty on failure to meet sulphur content regulations if the EPA waives the requirements, and allowing highway vehicles to remove aviation fuel from tax favored airport fueling terminals for certain airports in New Orleans, Memphis, Dallas and Houston. The IRS and Treasury had also announced that transporting fuel from the strategic oil reserve will not disqualify shipping operations for exemption from U.S. income tax under treaty agreements.

Federal spending already authorized or proposed constituted a regionally concentrated stimulus. As for broader tax policy, Treasury Secretary Snow indicated on September 2 that the Administration would not propose a tax cut to stimulate the economy. Rather, it continued to propose that Congress make the 2001 tax cuts permanent, arguing that this change would increase confidence in the future.[4]

If the objective was an immediate stimulus to the economy, timing was important. To stimulate the economy in the short run would require an increase in

---

[2] Congressional Budget Office, *Macroeconomic and Budgetary Effects of Hurricane Katrina*, Sept. 6, 2005.

[3] See CRS Report RS22260, *The Macroeconomic Effects of Hurricane Katrina*, by Brian W. Cashell and Marc Labonte, for a further discussion of the likely economic effects and a summary of forecasters' projections.

[4] See "IRS Offers More Relief for Katrina Victims, But Snow Says Tax Cut Package is Off the Table," *Bureau of National Affairs Daily Tax Report*, Sept. 6, 2005.

near-term spending. Extending or making permanent the tax cuts would generally take effect in 2011 when the rate reductions and other revisions expire (the lower rates on dividends and capital gains expire in 2009), and therefore would not increase *current* disposable income. Although there are theories that increases in permanent income will affect current spending, there is evidence that a substantial amount of current spending is related to current income. In addition, if individuals already believe the tax cuts will be permanent their behavior would not be affected. And much of the benefit will go to higher income individuals who, economic studies indicate, are less likely to spend income, especially the rate reductions, the estate tax repeal, and the lower taxes on dividends and capital gains. Extending the tax cuts so they would not expire in 2011 would not be expected in the short term to have much effect on demand.

Because short-run demand can only increase via fiscal policy if spending on goods and services increases, the most effective way to stimulate the economy through fiscal measures is via those measures that translate most fully into actual spending. A dollar spent by the government on goods and services will increase spending dollar for dollar and thus, other things equal, would be more effective, since a dollar of tax cut may not be entirely spent. For short-run tax stimulus measures, tax cuts directed at individuals who have a low marginal propensity to save will be most effective; these are likely to be lower- and moderate- income individuals.[5] (Monetary policy can also be used to stimulate the economy.) Since the lowest income groups do not pay income taxes, only measures directed at earned income tax credits or refundable child credits are likely to reach these individuals.

Moreover, even if the tax cut could be directed at taxpayers who are likely to spend it, the tax system has a number of constraints that prevent it from being an effective immediate fiscal stimulus tool. There is a lag in passing legislation and a lag in getting money to individuals. Tax rules generally cover an entire year, tax returns are filed with a lag, and the usual way to get tax cuts to individuals is through a change in withholding.

The difficulty arising from this route to delivering a tax benefit was illustrated by the 2001 tax cut, which provided for a new 10% rate bracket for 2001. Because the tax cut was adopted towards the middle of the year, reducing withholding in the normal way for the last half of the year would delay the stimulus until taxpayers filed returns the following year. Another option was providing a double reduction in withholding, but this approach would then require an increase in withholding at the beginning of 2002.[6] The solution adopted was to provide rebate checks, which were issued from July to October. There was, however, some concern among economists that lump sum amounts, such as the rebate checks, might not be spent because they

---

[5] See CRS Report RS21126, *Tax Cuts and Economic Stimulus: How Effective are the Alternatives?* by Jane Gravelle, for a further discussion of the savings and spending behavior of lower and higher income individuals and references to empirical evidence on this point.

[6] See CRS Report RS21171, *The Rate Reduction Tax Credit in the Economic Growth and Tax Relief Reconciliation Act of 2001: A Brief Explanation*, by Gregg Esenwein and Steven Maguire, for a discussion of the 2001 rebate and the reasons for it.

would be viewed as a one time effect on wealth.[7] One study of the rebate found that about 20% to 40% was spent on nondurable goods in the three months in which the check was received and another third in the following three months.[8] These results suggest that a significant amount was spent quickly (although well under the 100% of spending that would occur with a direct spending program). This study also found that spending was greater for those households that had low levels of wealth, consistent with other evidence that lower income (and wealth) individuals have a higher propensity to spend.

On the whole, therefore, it was not clear that a national stimulus was desirable, and recent economic performance appears to support that reservation. Even if a fiscal stimulus were desirable, tax cuts may not be the chosen approach, in part because of the administrative and timing difficulties described above.

Aside from short-run spending issues, tax cuts of any type that are not offset by spending reductions can worsen the long-run fiscal situation of the country by increasing the deficit. They can also offset — or more than offset — any potential growth effects from cutting marginal tax rates. Thus, in assessing the permanent effects of the tax cuts on the economy, the effects on the national debt are an important consideration.

Providing Relief from High Fuel Prices

Another issue is whether the tax system can be used to provide relief from high fuel prices. Proposals were made for gasoline tax reductions and windfall profits taxes.

The spike in gasoline prices was caused by a contraction in supply which in the short run is unlikely to be responsive to tax reductions. The higher prices were needed to equate supply and demand. With a more or less fixed supply, any reduction in fuel taxes was likely to increase the profits of suppliers rather than bring down prices. That is, the amount of gasoline consumers want depends on the price they pay, and only one price will equate that amount they wish to purchase to the fixed amount available to sell. If, given a tax repeal, sellers do not add on the tax, effectively lowering the price, consumers will want more than is available, gas stations will run out of gasoline to sell, and either raise the price again, or demand more from their suppliers (who will raise the supply price), and so forth. Economic analysis suggests that any attempt to provide relief through lower prices is likely to fail; relief can be provided in general to ease the circumstances of consumers, especially low income consumers, but not by price reduction. Therefore, one type of proposal that would probably not be effective would have been to reduce current excise taxes, such as the federal gasoline tax (which is currently 18.4 cents per gallon

---

[7] This issue was discussed in a Congressional Budget Office study, *Economic Stimulus: Evaluating Proposed Changes in Tax Policy*. Jan. 2002.

[8] David S. Johnson, Jonathan Parker, and Nicholas Souleles, *Household Expenditure and the Income Tax Rebates of 2001*, NBER Working Paper 10784, Cambridge, MA, National Bureau of Economic Research, Sept. 2004.

and therefore could have had only a partial offsetting effect, even if the reduction was passed on in price).

Transportation officials and lawmakers were also concerned about the loss in funding to federal highways if gasoline taxes were reduced.

Another approach was to target general relief to lower income individuals. The group that may be particularly burdened by higher gasoline prices are low income workers, who may need to drive to get to their jobs. They might be reached through a temporary increase in the earned income tax credit. As in the case of any tax rebate, the challenge would be to get money to these individuals quickly. It might have been possible to provide the rebate if it were based on the earned income credit claimed on 2004 tax returns, as was the case with the 2001 rebate, which depended on 2000 tax returns.

There were also proposals to impose a windfall profits tax that might be used to fund rebates. A windfall profits tax was imposed in the 1970s and was basically not a tax on profits but an excise tax on oil. It applied to crude oil prices in excess of a base. The tax was somewhat complicated to administer and was designed to impose the tax on existing oil supplies, without discouraging new drilling or marginal production. (A true excess profits tax that is based on profit or other measures as a percent of assets, similar to taxes imposed in World War II, is extremely difficult to design and administer, and has not been proposed.)[9]

One administrative change that helped a narrow group of people was the IRS's recent increase in the mileage rate for deducting costs of operating a car for business purposes from 40.5 cents to 48.5 cents for the last four months of 2005. This rate is also used by the government and many businesses to reimburse employees.

In early November, several New England Senators indicated that they would offer an amendment to the reconciliation bill to impose a temporary windfall profits tax on oil, modeled after the provision in the 1970s, and use the proceeds for the Low Income Energy Assistance Program (LIHEAP). This provision was not adopted.

Providing Relief to the Disaster Victims

The tax system is limited in the degree that it can provide direct assistance to all victims in disaster areas, because many low income people who may be the most needy do not pay taxes. Only provisions that allow refundable tax benefits would be of assistance to them. As with other short term uses of the tax system, enacting and distributing tax benefits is difficult, and tax benefits that are limited by region present special administrative problems. For these reasons, direct aid may be more successful, and most of the provisions Congress enacted initially involved direct aid.

---

[9] See CRS Report RL33578, *Energy Tax Policy: History and Current Issues*, by Salvatore Lazzari, for a history of the windfall profits tax.

Some provisions that already existed in the tax law can aid victims of the disaster, although the benefits are more likely to be concentrated among higher income individuals. There are also some administrative actions that IRS took, largely to extend tax filing requirements. There were also a number of proposals for tax provisions that are aimed at helping victims of Katrina, some of them directed not at the victims, but at those assisting the victims, which were adopted in H.R. 3768.

Pre-Existing Tax Provisions

Current tax law contains provisions allowing for the deduction of uninsured losses and has some special rules for losses in presidentially declared disaster areas. Casualty losses relevant to Hurricane Katrina would include destruction due to wind and floods, and also would include theft. These losses also include property loss due to government ordered demolition because the property is unsafe. Another provision of the law allows certain exclusions for disaster relief payments.[10]

Casualty losses fall into three categories that are treated differently: business losses, employee related losses, and personal losses. Business losses might include the loss of, or damage to, business property or other business assets (such as tools, automobiles, etc.) and loss of inventory. Employee-related losses might include an automobile used for business purposes. Personal losses include damage to homes, furnishings, and automobiles.

Casualty losses for businesses are allowed in full and are deducted like any other costs, including provisions that allow carrybacks and carryforwards of losses. Employee and personal losses are itemized deductions. Employee-related losses are reduced by 2% of adjusted gross income. Personal losses are reduced by $100 plus 10% of adjusted gross income. There are complex rules which deal in part with the fact that gain on appreciated property has never been taxed (so that the loss is limited to the cost basis of the property, generally the acquisition cost less depreciation plus improvements). There are provisions that allow the taxpayer to postpone gain when insurance payments are greater than the adjusted basis which are extended to four years for homes and two years for businesses in a disaster area.

Losses in areas that are presidentially declared disaster areas can be deducted in the tax year preceding the loss, so that taxpayers with a loss from Hurricane Katrina can file an amended 2004 tax year return to claim a refund.

If part of a federal disaster loan is canceled, it is a reimbursement and reduces the casualty loss deduction.

Disaster relief grants in general that reimburse property losses or medical expenses reduce casualty and medical expense deductions. Qualified disaster relief grants made for other purposes (such as living expenses, funeral expenses) are not

---

[10] See CRS Report RS22249, *Income Tax Relief in Times of Disaster*, by Pamela Jackson. A more detailed discussion can be found in IRS Publication 547, *Casualties, Disasters, and Thefts*, available at [http://www.irs.gov].

taxable under either income or payroll taxes. Wage replacement payments, such as unemployment insurance, are taxable.

Administrative Actions of the Internal Revenue Service

The IRS has the authority to postpone for up to a year tax deadlines for income and employment tax filing and payments (and abate interest), and for making contributions to an IRA. Eligible taxpayers include individuals whose main home is in the disaster area, businesses whose principal place of business is in the area, relief workers from government or philanthropic organizations, and businesses and estates or trusts with tax records in the disaster area.

The IRS announced a number of actions in response to the disaster. It created a toll free telephone number for taxpayers in the disaster area, 866-562-5227, and waived fees for taxpayers requesting copies of their tax returns. It extended filing deadlines in the disaster area to January 3, 2006 and expanded the areas eligible. It also postponed certain filing requirements for charities and tax exempt bond issuers and, with other agencies, extended the deadline for making mandatory contributions to pension plans.

Current law allows tax credits for low-income housing that taxpayers are eligible for if their properties are largely rented to qualified individuals. The Treasury Department and IRS announced (news release IR-2005-92) that they would allow owners of low-income housing anywhere in the United States to shelter victims who do not qualify as low income, temporarily suspending income limits and non-transient requirements.

More recently, the IRS announced a further extension of the filing date to February 28 and provided some relief for victims of Hurricane Rita.

New Provisions and Their Development

There were several legislative changes that have been considered in the past. One action that has been taken in the past relaxes the rules for mortgage revenue bonds.

Under current law, states can issue tax exempt bonds to provide mortgages for low income renters who purchase homes below a price ceiling and have not lived in their own home in the past three years. To qualify, 95% of the mortgages in a bond issue must meet income, price, and the three-year requirements. The three-year rule means that the benefit largely accrues to first-time home buyers, and this restriction is often referred to as a first-time home buyer restriction. The purchase price requirement limits the price to 90% of the average price of homes, and the income limit restricts income to 115% of median income, with some adjustments for small families and areas where housing costs are high relative to income. These rules are waived for a portion of loans in economically distressed areas.

In the Taxpayer Relief Act of 1997, a provision was adopted to waive the three-year rule for disaster areas, allowing existing homeowners to qualify. In addition, the rules for economically distressed areas were applied with respect to the price and income limits. The provision was, however, made temporary, and expired after 1998.

Senate Proposal. Senate Finance Committee Chairman Grassley and Ranking Democrat Baucus proposed a tax relief bill that passed the Senate (S. 1696) that included the mortgage revenue bond provision and a number of other provisions. The package included housing assistance (allowing a personal exemption of $500, capped at $2,000, for taxpayers who house dislocated individuals) and provisions dealing with cash flow, employment, charitable giving, casualty losses, and administrative issues. This bill was passed on September 15.

Two categories of provisions were aimed at providing increased cash flow to residents of the disaster area. One provision would exempt the forgiveness of debt due to the hurricane damage (forgiveness of debt is normally considered taxable income). The remaining provisions would reduce barriers to access funds in retirement plans and Individual Retirement Accounts (IRA). The penalty for early withdrawals from retirement plans such as IRAs and 401(k)s would be eliminated, and the income tax on these amounts paid over three years rather than one. These amounts could also be recontributed in the next three years and treated as rollovers. Loan limits would be increased and payments could be deferred.

Employment related proposals would qualify residents of the disaster area who became unemployed as a result of the hurricane for the work opportunity tax credit (WOTC) which provides a credit to employers, generally at 40% of wages, of up to $2,400 for hiring eligible workers. The proposal would also provide a credit for employers in the disaster area for 40% of wages paid until the end of the year.

The following tax benefits for charitable donations would be allowed through the end of the year. Non-corporate businesses producing food would be allowed the same rules as corporations; they could deduct in addition to cost of producing food one-half of the value in excess of cost, not to exceed twice the cost. The restriction that the deduction can be no more than twice the cost is retained. Donations of book inventory would be allowed a full market value deduction. Provisions allowing a rollover of IRAs into charities for individuals age 70½ and allowing rollovers of IRAs of those 59½ to a charitable remainder trust without including the proceeds in income. This provision would benefit taxpayers who do not itemize and reduce income for purposes of determining when Social Security payments are taxable. The limit on cash contributions as a share of income that can be deducted by individuals would be increased from 50% to 60%. A provision that would be allowed through the end of 2006 would increase the limit on charitable contributions of corporations from 10% to 15% of taxable income. The proposals would also allow IRS to disclose information to state officials about denying tax exemption status to organizations or other actions, and would increase the mileage rate deduction for charitable volunteers.

Other proposals included eliminating the 10% percent floor on deducting casualty losses and extending the replacement period for both business property and homes to five years for Hurricane Katrina losses. The proposal would also dedicate fees from certain letter rulings to IRS for disaster relief, extend the authority of IRS to post pone deadlines until February 28, 2006, and clarify that the extension includes employment and excise taxes as well as income and estate and gift taxes.

House Proposal. Also on September 15, the House passed H.R. 3768 (sponsored by Congressman McCrery). This bill had a number of provisions identical to or similar to the Senate plan. The bill lifts the three-year requirement for mortgage revenue bonds, allows families who provide housing for dislocated persons a $500 deduction for each dislocated person, exempts forgiveness of indebtedness from income, and allows the IRA and pension benefits but with a $100,000 ceiling. The WOTC coverage was expanded, but allowed only to employers in the disaster area for individuals who lived in the disaster area before the hurricane. The proposal eliminates both the $100 and 10% floors from the casualty loss deduction and extends the replacement period to five years.

The charitable provisions were more limited and targeted to hurricane relief. Cash donations related to Hurricane Katrina are exempt from the 50% income limit and the phase-out of itemized deductions if made in 2005; similarly, the corporate limit is waived for cash donations related to the hurricane. The bill would also increase the mileage reimbursement rate for charity volunteers.

H.R. 3768 also contains a provision that holds families harmless against the loss of tax benefits due to temporary relocations by allowing the option of calculating the earned income and child credit based on 2004 income. The Treasury Department is also given the authority to ensure taxpayers do not lose dependency exemptions or child credits because of relocations.

The Joint Committee on Taxation has estimated the House bill to cost $5.2 billion over 10 years, with the casualty loss deduction the single largest item at $2.4 billion. No estimates have been released for the Senate bill but it will be more costly.

Discussion of Tax Provisions for Relief

These tax proposals would have effects that are different from direct spending measures, because of both distributional effects and targeting. Some of the provisions relate to property relief. As a result, these provisions tend to benefit higher income individuals. Lower income individuals are less likely to have IRAs and 401(k) and other retirement plans, and are less likely to itemize and have homes (and thus benefit from expanded casualty loss deductions) or business property. In addition, lower income individuals have lower marginal tax rates and are less likely to have tax liability in general.

The proposals also differ in the degree to which they are targeted to the disaster area. While many of these provisions are targeted, the ones applying to charitable giving in general are not directed at the disaster area. It is likely that only a small fraction of this increased general giving will benefit the Katrina victims.

Businesses that donate food and books, and cash, are more likely, for both transport cost reasons and public relations, to donate to causes within their own area. The victims of Katrina tend to be concentrated in Mississippi, Louisiana, and nearby states.

While there has been increased giving to charities that are in the disaster area, a large fraction of individual giving normally goes to causes where little or none of the donations would help Katrina victims. Data also indicate that increased giving to charities that are aiding hurricane victims is already declining,[11] an expected outcome as people become less likely to respond after the height of the crisis. Thus, induced charitable giving is more likely to follow normal patterns. About a third of contributions are made to religious organizations (probably close to half after dealing with double counting of private foundations which are generally not final recipients),[12] and most of this spending tends to go for provision of sacramental services. Similar points could be made about the other important categories of spending.[13] Very high income people, who are more likely to reach the maximum share of giving, may be especially likely to direct their giving to universities and colleges; education is the next highest category of recipient after religion and accounts about 20% of the giving of the highest income classes.[14] Higher income individuals are also likely to give to private foundations and the limited payout requirements of private foundations mean that the money may not be spent for years; even if the limit for giving to private foundations is not lifted, the general limit increase could permit more giving for those who give to private foundations. Wealthy donors are also now using other mechanisms such as supporting organizations and donor advised funds that act, like private foundations, as ways to contribute money now and spread out spending far into the future.[15]

The provision allowing rollovers of IRAs into charitable remainder trusts would have virtually no effects on charitable giving in this case, since a charitable remainder trust leaves a residual amount to charity; that gift is completed only after the beneficiary dies. So, except for the extremely small portion of people who die immediately after setting up the trust, this provision is unlikely to help the victims of Katrina.

In addition to this targeting issue, there is some evidence that incentives for charitable giving induce less than a dollar of giving for each dollar of revenue loss,

---

[11] See Elizabeth Williamson, "Charitable Giving: A Generous Response Tends to Slow," *Washington Post*, Sept. 14, 2005, p. A25. This article cites a Red Cross spokesperson and data from an online giving site showing a decline in contributions.

[12] Based on data from Giving USA [http://www.aafrc.org/].

[13] See the articles on different types of charitable organizations in *Who Benefits from the Nonprofit Sector*, edited by Charles T. Clotfelter (Chicago: University of Chicago Press, 1992). For example, data in the article "Religious Organizations" by Jeff E. Biddle (pp. 92-133), indicate that about 70% of spending of religious organizations goes for services (the church building, the minister), and only about 6% goes to poor people.

[14] See Charles Clotfelter, "The Impact of Fundamental Tax Reform on Non-Profit Organizations." In *Economic Effects of Fundamental Tax Reform*, ed. Henry J. Aaron and William G. Gale (Washington, D.C.: The Brookings Institution, 1996).

[15] These issues are addressed in testimony by Jane G. Gravelle before the Senate Finance Committee on Charities and Charitable Giving, Apr. 5, 2005.

due to a relatively low price elasticity.[16] A temporary benefit may be more effective, but it is likely largely to speed up planned gifts that are not likely to benefit the disaster victims.

For these reasons, revenue lost from financing charitable contribution subsidies for general giving is likely to have a negligible effect on aiding victims compared to direct spending or to tax subsidies contingent on being a survivor of the disaster.

While more focused on hurricane relief, these targeted benefits in the House bill may be more difficult to administer.

Further Legislative Action

After passage of both bills, the Senate passed an amendment to H.R. 3768, which was more similar to the House bill. The main area in which revisions were made was in the charitable contributions provisions. The IRA rollover provisions were dropped, and a provision similar to the House bill lifted the limit on contributions by corporations and individuals for contributions directed at Hurricane Katrina. The information sharing provisions with state and local officials were also dropped. In other provisions, the effective dates were altered in some cases, and the $100 floor for casualty losses was eliminated.

On September 21, both houses passed a final version of H.R. 3768, which was signed by the President on September 23, with a cost of $6.1 billion (whether measured over five years or 10 years). For IRAs and retirement plans, the bill includes a penalty free withdrawal capped at $100,000, income averaging for the distributions, rollovers, and the loan provisions. This provision is small, costing only $70 million over the years 2006-2015. It also includes the work opportunity tax credit for individuals affected by the hurricane (through 2005 for employers outside the area and through August of 2007 for employers inside the disaster area), along with the employee retention credit, but limited to firms with no more than 200 employees. These employment provisions cost $131 million over 10 years.

Charitable giving provisions include suspending the income limits for charitable contributions related to Hurricane Katrina (this provision costs $871 million over 10 years), and the provisions for gifts of food, gifts of books to public schools and mileage deductions ($56 million altogether). The $500 personal exemption for sheltering victims costs $128 million.

The most costly provision was eliminating the floors on casualty losses ($2.42 billion) which accounted for close to half the cost. The provision extending the replacement period for non-recognition of gain was the next most costly at $1.8 billion. Other provisions including the exclusion of cancellation of indebtedness ($293 million), the rules for mortgage revenue bonds (waiving the first time homebuyer requirement and increasing the limit from $15,000 to $150,000 for home improvement loans, $154 million), allowing the use of prior year income to

---

[16] See CRS Report RL31108, *Economic Analysis of the Charitable Contribution Deduction for Non-Itemizers*, by Jane G. Gravelle for a discussion.

determine the earned income tax credit and child credit ($125 million), and administrative relief provisions ($30 million).

H.R. 4155, which relates to incentives for rebuilding and is discussed below, also included some provisions similar to those in H.R. 3768 for victims of Hurricane Rita (which could also be extended to victims of Hurricane Wilma). The Senate reconciliation bill included incentives for rebuilding and extension of relief provisions to victims of Hurricanes Rita and Wilma.

Incentives for Rebuilding

The final category of tax benefits involve incentives for rebuilding in the disaster area. Government assistance for rebuilding may involve two types of policies. One is grant assistance to rebuild the public infrastructure (roads, schools, etc.) which might include port facilities that were formerly privately owned and might include reconstruction of low income housing. Another policy is to provide tax subsidies for private firms. Mortgage revenue bonds fall into a slightly different category, to provide private subsidies directed at homeowners rather than businesses. In his address on September 15, the President's proposals included a proposal for a Gulf Opportunity Zone that would provide tax subsidies to businesses.[17]

Both the House and the Senate considered tax cuts under general reconciliation rules. The House bill, H.R. 4297, did not contain provisions relating to hurricane victims. The House had, however, already passed H.R. 4337, which allows for tax credit bonds, advance refundings (issuing new bonds for a project prior to the maturing of existing bonds), and providing a federal guarantee.

The Senate reconciliation bill, S. 2020, included a set of provisions affecting rebuilding in the Gulf, amounting to $7.6 billion over the ten-year period 2006-2015. Of that amount, provisions costing $1.7 billion would extend the relief provisions for Katrina in H.R. 3768 to victims of Rita and Wilma (including an elimination of the size requirement in all three disaster areas for the employee retention credit). The Gulf Zone provisions of the bill would have allowed bonus depreciation (deducting 50% of the cost of investment immediately) for both equipment (through 2007) and structures (through 2008). It would have also increased the current amount of equipment that can be deducted immediately by small business from $100,000 to the total of all property in the zone, up to $200,000. It would have expanded the amount of private activity bonds, low-income housing credits, and new-markets credits available in the region, and would have allowed an additional advance refunding (issuing new bonds before the previous ones mature). It would have extended the period that net operating losses can be carried back to offset prior-year income to five years and allowed extended carryback periods for public utilities and timber producers. It would also have allowed an increase in the amount of timber

[17] Some of the issues surrounding rebuilding are discussed in more detail in testimony by Jane G. Gravelle before the Senate Finance Committee on October 6, 2005 on *Tax Incentives in the Aftermath of Hurricane Katrina*. This testimony can be found at [http://finance.senate.gov/sitepages/hearing100605.htm]

reforestation costs that could be deducted immediately, a 50% deduction for certain demolition and clean-up costs, and an extended period for expensing of environmental remediation costs. Finally, the bill expanded the tuition tax credits for students in the zone.

H.R. 4440 passed the House on December 7 and would have cost $8.1 billion for the period 2006-15. It had many provisions similar to the Senate proposal, and included $1.5 billion for extending the relief provisions to victims of Rita and Wilma, but did not eliminate the size requirement for the employee retention credit. It included provisions for bonus depreciation, increased small business expensing of equipment, expansions of private activity bonds, low income housing credits, and advance refundings. It also included the benefits for public utilities, timber, reforestation expensing, environmental remediation costs, and expensing for demolition and clean up costs. It included increased benefits for tax exempt bonds, including special allocations of private activity bond financing, advance refundings, the expanded availability of tax exempt bonds for buildings (business structures and rental housing), public utility property, housing reconstruction in general, and municipal financing. The bill also introduced tax credits for certain bonds. In addition to bond provisions, the bill would increase the credit for rehabilitated buildings in the area from 10% to 13% and would increase the credit for certified historic structures from 20% to 26%. Tax benefits are limited for certain types of businesses, primarily affecting the casino business, an issue that has been subject to some controversy. (The Senate proposal included these businesses).

The final version of H.R. 4440 enacted into law included the provisions in the House bill which, in turn, included many Senate provisions. While new provisions such as the increase in the rehabilitation tax credit were retained, the final legislation also lifted the ceiling for the employee retention tax credit, a provision contained in the Senate bill.

Prior Geographically Targeted Subsidies

The main examples of past legislation to address disasters were the Liberty Zone provisions adopted in 2002 for the area in lower Manhattan that was affected by the terrorist attacks. These provisions included expansion of the WOTC for small employers, accelerated depreciation for equipment investments and leasehold improvements, increased private activity bonds (which are generally limited by a state cap) and favorable treatment of capital gains realized from the replacement of property. These provisions were originally made available for a few years (varying by incentive), but were extended in most cases through 2010.

Current tax law contains other geographically targeted provisions often referred to as enterprise zones. (Many states have enterprise zone programs as well.) They comprise 40 empowerment zones (30 urban and 10 rural), 95 enterprise communities (65 urban and 30 rural), and 40 renewal communities. Tax incentives for empowerment zones include a 20% employer wage credit for the first $15,000 of wages for zone residents who work in the zone, an additional $35,000 (above the $100,000 generally allowed) in expensing of equipment investments of qualified zone businesses, and expanded tax exempt financing for certain zone facilities. Renewal communities are allowed a 15% wage credit on the first $10,000 of wages, the additional $35,000 in capital expensing, and partial expensing of qualified buildings. Enterprise communities receive tax exempt financing benefits. Schools in enterprise communities and empowerment zones are also eligible for qualified zone academy bonds, where the federal government effectively pays the interest on the bonds. These areas are also eligible for special benefits for cleaning up environmentally contaminated areas (brownfields). There are also special provisions for Indian reservations and the District of Columbia. There is also a new markets tax credit for investors, equal to 5% of the original investment and for the next two anniversary dates, and a 6% credit for the following four anniversary dates, along with capital gains tax benefits for investors.

New Orleans already had a renewal community designated area, the New Orleans/Jefferson area, on the Mississippi river west of the French quarter, but it is only a part of the city. There was also a renewal community in Mobile, Alabama. The Treasury announced that it will give additional consideration to approving new markets coverage for organizations that target their investments to the disaster areas.

These measures indicate the types of geographically targeted tax incentives that have been and are now being allowed: wage credits, accelerated depreciation, tax exempt bond expansion and tax subsidized bonds. There are other options, however, that might include an expansion of the tax credit for rehabilitation of older buildings. This type of provision might be more appropriate for a city with a significant tourism business like New Orleans, whereas lower Manhattan was primarily a financial center, and it was ultimately enacted in H.R. 4440.

Justification for Subsidies

There is a considerable economic literature discussing both the justifications for geographically targeted subsidies to private business and assessing the effectiveness of these subsidies.

Private rebuilding will occur in the absence of tax subsidies, although government construction of essential public infrastructure, such as roads, is vital to any area's recovery. The issue is what speed or magnitude of rebuilding is desirable. Normally the need for subsidies would occur either to achieve distributional objectives or because of market failures — circumstances where an efficient allocation of investment does not occur because of unpriced costs.

The issue often addressed in the economics literature, reflecting the normal goal of enterprise zones and similar policies, is not about rebuilding a devastated area, but about encouraging development in areas that are chronically depressed. There are two efficiency reasons that are commonly given for this intervention. One is that there is a mismatch between available labor supply, and the businesses that need employees — an argument that in general would apply to urban areas, not rural ones. For example, businesses in some areas out-lying areas of the city may find it difficult to locate employees, while unemployment in the inner city may be high. This mismatch causes lower income in the city as a whole and a lower tax base. If transportation costs or lack of knowledge creates a barrier to mobility around the city, one approach is to try to develop the inner city to create jobs for residents. There are, of course, alternative policies, such as providing job matching services and subsidized mass transit for residents of low income areas, or providing low-income housing in areas of the city that are more prosperous. For a variety of reasons these alternatives may not be accepted by the city residents, and so the option of trying to stimulate development in the depressed area may be chosen.

A second efficiency argument is that depressed areas tend to breed more crime which imposes costs on society (both from being a victim of crime and from paying for the resources such as police and prisons needed to deal with crime). This argument might apply to both rural and urban areas.

In either of these cases, the objective is to provide jobs for residents of depressed areas. That rationale suggests that tax subsidies provided should be in the form of wage subsidies, which are more likely than subsidies for investment to produce jobs. (In fact, under certain circumstances capital subsidies could actually decrease employment by encouraging labor saving investments.) Yet many of the subsidies provided in these geographically targeted areas are subsidies for capital investment.

A second objective is redistributional — to help poor people. The difficulty with this argument is that there is no obvious reason to concentrate our help on poor people who live in the poorest neighborhoods and exclude equally poor people who do not.

There is also the issue of whether intervention should be provided by the federal government or the state government. If the motive is efficiency then the source of funds might depend on who is bearing the costs of that inefficiency, and in the case of revenue base and crime may include both taxpayers in the states and localities and taxpayers across the national in general. If the motive is distributional, then there is more of a case for a national effort, particularly in the case of Hurricane Katrina since the states and localities involved have lost much of their revenue base as well.

In the case of the rebuilding of areas devastated by Hurricane Katrina, the question is whether the standard arguments for enterprise zones can be applied to rebuilding areas that are not (at least in their entirety) chronically depressed, but have been destroyed by a natural disaster. It is not clear that they can be. Rather, the principal justification for intervention may be largely distributional — the desire to help people who have faced a significant loss to reclaim their lives.

A different efficiency objective may also be invoked: aid to devastated areas by the federal government may be viewed as an implicit form of insurance — the country as a whole acts to spread the risk of the cost of natural disasters. If there are imperfect markets for catastrophic insurance, then aid in rebuilding is needed to achieve an efficient allocation of resources. In particular, the cost to businesses in a catastrophe exceeds the loss of property (which can be covered by insurance) because the business also loses its customer base and work force, and it is difficult for private insurance markets to provide coverage for this type of loss.

Until the rationale for the intervention is clear, it is difficult to determine the optimal design or size of subsidies for rebuilding. But if aid is viewed as a nationwide catastrophic insurance program then it is appropriate for the federal government to intervene. Benefits need not be limited to lower income recipients and the measures should probably include a range of subsidies including capital subsidies. A case may be made for limiting the benefits to pre-existing businesses.

Evidence on the effectiveness of subsidies is unclear. There is a significant body of empirical studies focused mainly on state enterprise zones; in general, most of these studies have not found evidence of effects on growth or employment.[18] These results do not necessarily mean that there are no positive effects, but rather that the effects are small and difficult to detect statistically. Specific evidence of the empirical effect of federal programs is virtually non-existent and although some studies have found effects, there are some reservations about their methodology.[19] These results, however, may not be very meaningful for measuring the potential effect of aid to rebuild the disaster area, especially if the motive is not to address a market failure but, effectively, to be part of a catastrophic insurance package.

Conclusion

The use of tax policy to address problems in the aftermath of the hurricane is subject to many limitations. Fiscal stimulus may not be needed, is difficult to implement in a timely fashion, and will add to long-term fiscal pressures. Relief from energy prices is also difficult to address through tax measures. There are some narrowly targeted relief measures for victims that may be effective, but general subsidies for charitable giving are not very target efficient. Longer term benefits to help rebuild the area may be desirable, not so much because they induce giving, but because they constitute part of a national risk sharing activity to deal with catastrophes.

---

[18] For a brief review, see Leslie Papke, "Enterprise Zones," in *The Encyclopedia of Taxation and Tax Policy*, ed. Joseph J. Cordes, Robert W. Ebel, and Jane G. Gravelle (Washington, D.C.: The Urban Institute, 1999). A new edition is in press and will be available in 2005.

[19] See General Accounting Office, *Community Development: Federal Revitalization Programs Are Being Implemented, but Data on the Use of Tax Benefits Are Limited*. GAO-04-306, Mar. 2004.