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EXTENSION OF INDIVIDUAL AND CORPORATE TAX REDUCTIONS TO 1976

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

OF THE

UNITED STATES SENATE

BY THE STAFF OF THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

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INTRODUCTION

This pamphlet deals with those provisions of the Tax Reduction Act of 1975 that expire at the end of this year. These include increases in the standard deduction, the $30 credit for each taxpayer and dependent, the earned income credit, and the changes in corporate tax rates and the surtax exemption. Each of the possible options outlined in the latter part of the pamphlet is consistent with the second concurrent resolution on the budget for fiscal year 1976, which will set a revenue floor of $300.8 billion and assumes a tax reduction of $6.4 billion in fiscal year 1976.

The committee may want to extend the 1975 tax cuts only for part of 1976. A six-month extension could be achieved by enacting a tax reduction for calendar year 1976 that is one-half as large as the tax cut the committee otherwise would have selected for the whole year and providing that the full year's reduction be reflected in lower withheld taxes and lower estimated tax payments during the first six months of 1976. A nine-month extension could be achieved by a change in tax liability of three-fourths the size to which the committee would otherwise have agreed, with the reduction to be reflected fully in withheld and estimated tax payments over the first nine months of 1976.

THE TAX REDUCTION ACT OF 1975

Individual tax cuts

The Tax Reduction Act of 1975 included four individual income tax reductions that applied only to the year 1975. These were an increase in the standard deduction, a tax credit of $30 for each taxpayer or dependent, a 10-percent refundable tax credit based on earned income, and a tax credit for home purchases.

The Act increased the minimum standard deduction (or low-income allowance) from $1,300 to $1,600 for single people and to $1,900 for married couples. (For married people filing separate returns, the increase was from $650 to $950.) The percentage standard deduction was increased from 15 percent to 16 percent. Also, the Act increased the maximum standard deduction from $2,000 to $2,300 for single people and to $2,600 for married couples. (For married couples filing separate returns, the increase was from $1,000 to $1,300.)

The $30 credit applies to each taxpayer and to dependents for whom a taxpayer claims personal exemptions. There is no credit, however, for the additional personal exemptions available to the blind and the aged. This credit cannot exceed tax liability (that is, it is not refundable).

The earned income credit equals 10 percent of earned income up to a maximum of $4,000 (a maximum credit of $400). The amount of earned income eligible for the credit, however, is reduced dollar-for-dollar as adjusted gross income rises above $4,000, so that the credit is phased out entirely when adjusted gross income is greater than

$8,000. Unlike the $30 credit, the earned income credit may exceed tax liability, in which case it is refunded to individuals. The credit is available only to families with dependent children.

The tax reductions from the changes in the standard deduction and the $30 credit for the entire year are being reflected in lower withheld taxes over the last 8 months of 1975.

The Act also included a 5-percent nonrefundable tax credit for the purchase of a new principal residence, with a maximum credit of $2,000 (on a $40,000 home). This credit applies only to purchases in 1975 of what was the existing inventory of unsold homes or homes under construction as of March 26, 1975, and only to purchases of those homes during the year 1975. The credit is not applicable to any home whose price has been increased after February 28, 1975.

Another provision of the Act was a refund of 1974 tax liability totaling $8.1 billion.

Business tax cuts

The Tax Reduction Act of 1975 increased the rate of the investment tax credit to 10 percent through December 31, 1976. For this period, a corporate taxpayer may also elect an 11-percent credit if an amount equal to the additional one percent is contributed to an employee stock ownership plan. After 1976, the credit is to revert to 7 percent generally and to 4 percent for public utilities. The Act also increased the limitation on the amount of used property eligible for the investment credit from $50,000 to $100,000 for 1975 and 1976.

The investment credit is available for (1) tangible personal property, (2) other tangible property (other than a building and structural components) which is an integral part of manufacturing production or which constitutes a research or storage facility, and (3) elevators and escalators. To be eligible for the credit, property must have a useful life of at least 3 years. When its useful life is 3 or 4 years, property qualifies for one-third of the normal credit; property with a useful life of 5 or 6 years qualifies for two-thirds of the normal credit; and property with a useful life of 7 years or more qualifies for the full credit.

Generally, property qualifies for the credit during the year in which it is placed in service. However, the Tax Reduction Act of 1975 made the credit available as progress payments are made in the case of property with lead times in construction longer than two years. This change is being phased in over a five-year period.

The amount of the credit a taxpayer previously could take in any one year generally cannot exceed $25,000 plus 50 percent of tax liability in excess of $25,000. (Excess credits may be carried back 3 years and forward for 7 years.) For public utilities, however, the Tax Reduction Act of 1975 raised the 50-percent limit to 100 percent for 1975 and 1976, 90 percent in 1977, 80 percent in 1978, 70 percent in 1979 and 60 percent in 1980.

The Tax Reduction Act of 1975 provided two other tax cuts directed largely to small businesses. Prior to that Act, corporations paid a 22-percent normal tax and a 26-percent surtax, and the initial $25,000 of taxable income was exempt from the surtax. For the year 1975, the Act raised the surtax exemption from $25,000 to $50,000 and reduced the normal tax on the first $25,000 of corporate income from 22 percent

to 20 percent. Thus, for 1975 corporations pay a 20-percent rate on the first $25,000 of taxable income, a 22-percent rate on the next $25,000 of income and the 48-percent rate on income above $50,000. Without further legislation, the corporate tax will once again be 22 percent on the initial $25,000 of income and 48 percent on income above $25,000 after the end of 1975.

REVENUE EFFECT OF THE TAX REDUCTION ACT OF 1975

The Tax Reduction Act of 1975 provided $24.8 billion of tax reductions or increased expenditures in calendar year 1975, $2.0 billion of which was offset by tax increases. The refund on 1974 income taxes was $8.1 billion. The increase in the standard deduction will lead to a revenue loss of $2.8 billion and the $30 credit to one of $5.2 bililon. The earned income credit involves a loss of $1.4 billion and the home purchase credit a loss of $0.6 billion, so that the total reduction in individual income taxes is $18.1 billion. The Act also increased the investment tax credit by $3.3 billion, and it reduced other business taxes, largely for small business, by $1.5 billion. Finally, the Act provided increased expenditures of $1.9 billion through a $50 payment to social security recipients and increased unemployment compensation.

The increase in the standard deduction and the $30 credit, which involve a decline in tax liability of $8 billion, are being reflected in lower withheld taxes over the last eight months of 1975. The withholding change, then, is at an annual rate of $12 billion ($1 billion per month). Even if these provisions are extended through 1976, there will be an increase in withholding taxes on January 1, 1976, because in 1976 the $8 billion tax cut will be reflected in lower withheld taxes over a 12-month period instead of over 8 months. Because of the growth in income in 1976 over 1975, a tax cut of $13 billion for 1976 is needed to maintain existing withholding rates.

EXTENSION OF TAX REDUCTION IN THE HOUSE BILL

The House bill (H.R. 10612) makes permanent the increases in the standard deduction (including the low-income allowance) in the Tax Reduction Act of 1975. Also, the bill extends the $30 credit through 1976 and provides an alternative credit, which taxpayers can use if it exceeds the $30 credit. The alternative credit equals 2 percent of the first $12,000 of taxable income, or a maximum credit of $240. (There is no maximum on the $30 credit, so a nine-person family may claim a credit of $270.)

The House bill also extends the increase in the investment credit through 1980, including the used property limitation, but not the additional one-percent credit for employee stock ownership plans, and it extends the small business tax cuts through 1977.

In terms of tax liability for calendar year 1976, the continuation of the 1975 level for the standard deduction through 1976 involves a revenue loss of $2.9 billion. The tax credit causes a loss of $10.5 billion, of which $5.5 billion is attributable to the $30 credit and $5.0 billion to the 2-percent alternative credit. The detailed income distribution of these tax cuts is shown in table 3 in the Analysis of

Specific Tax Reductions section below. The estimates there are at 1975 income levels because the Treasury Tax Model, from which they are derived, has not yet been updated to 1976 income levels. The 1976 estimates are, however, approximately 5 percent higher than the 1975 estimates.

The changes in the investment credit lose no revenue in 1976 because the 10-percent credit and the increased used property limitations are already in effect for that year, but they will involve a revenue loss of $3.3 billion for 1977. The small business tax cuts lose $1.9 billion in 1976, of which $1.6 billion is attributable to the increase in the surtax exemption and $0.3 billion to the reduction in the tax rate on the first $25,000 of corporate income. The total tax cut for 1976, then, is $15.3 billion.

In terms of budget receipts for fiscal year 1976, the tax cuts in these House provisions lose $6.47 billion. Of this, $5.88 billion is attributable to the individual tax cuts and $0.59 billion to the small business tax cuts.[1]

ADMINISTRATION PROGRAM

On October 6, 1975, President Ford announced that he opposed simply extending the 1975 tax cuts for one year and instead proposed a larger permanent tax reduction tied to a spending ceiling for fiscal 1977. The President's proposed tax reductions would reduce tax liability for calendar year 1976 by $26.3 billion. The spending ceiling he proposed for fiscal 1977 was $395 billion, which is $28 billion below his estimate of budget outlays unless there is specific action to restrain spending.

The specific tax cuts proposed by the President included an increase in the personal exemption from $750 to $1,000 (revenue loss of $10.4 billion in 1976), an increase in the standard deduction to a flat $1,800 for single returns and $2,500 for joint returns ($4.4 billion), an individual rate reduction ($6.8 billion), extension of the small business tax cuts from the Tax Reduction Act of 1975 ($1.9 billion), a permanent 10-percent investment credit (no loss in 1976 but a loss of $3.3 billion in 1977), a 2-point corporate rate reduction ($2.2 billion), and a program of tax reductions for public utilities ($0.6 billion). The income distribution of the individual tax cuts is shown in table 4 below.

CONGRESSIONAL BUDGET RESOLUTIONS

Both Houses of Congress have passed budget resolutions that set a revenue floor for fiscal 1976. The Senate resolution also set a floor for the transition quarter between fiscal 1976 and fiscal 1977. These resolutions have been reconciled but the conference report has not been passed. Once this occurs, any revenue bill that violates the revenue floor in the resolution is subject to a point of order.

The tentative conference agreement on the second concurrent resolution assumes a revenue floor of $300.8 billion. This is low enough to permit a $6.4 billion tax reduction (approximately the size of the reduction in the House bill).

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[1] For the transition quarter between fiscal years 1976 and 1977, the tax cuts lose $3.64 billion.

The administration tax reduction program is not consistent with the budget resolution as agreed to by the conferees since it involves a revenue loss of $11.8 billion in fiscal 1976. The offsetting spending cuts proposed by the President would not take effect until fiscal 1977.

ECONOMIC IMPACT OF TAX REDUCTIONS

The staff has prepared forecasts of the behavior of the economy during the next two years under the assumptions both that tax cuts of $15.3 billion are enacted and that the reductions in the 1975 Act are allowed to expire. Comparing these two forecasts provides an estimate of the economic impact of extending the tax cuts.

The forecasts use the econometric model of Chase Econometric Associates, Inc. This model consists of over 100 equations, estimated statistically from historical data, describing the behavior of key variables in the economy. For example, one equation relates new passenger car sales to disposable income, the relative price of cars, the relative price of gasoline, the stock of cars on the road, the tightness in the credit market, and the age distribution of the population. Another relates business investment in plant and equipment to industrial production, capacity utilization and the after-tax cost of capital, a variable that includes both long-term interest rates and various tax incentives. To make forecasts with the model, it is necessary to make assumptions about fiscal and monetary policies, food prices, oil prices and several other variables whose behavior cannot be predicted accurately by the model itself. By changing one's assumptions about (say) tax policy, it is possible to use an econometric model to estimate the impact of changes in policy on the variables that can be predicted by the model, such as gross national product, unemployment and interest rates.

A summary of the forecast under the assumption of no tax cut is shown in table 1. Without the extension of the tax cut, the economy does continue to recover at a healthy rate through the first half of 1976, but the recovery begins to weaken in the second half of the year. The unemployment rate falls to 7.7 percent in the second half of 1976, but after that the economy does not grow quickly enough to employ the new entrants to the labor force, and unemployment rises slightly. The Chase forecast also shows the rate of inflation declining in the first half of 1976 but increasing thereafter.

There are two principal reasons why the recovery is not expected to continue at a vigorous pace after the first half of 1976 without extension of the tax cuts. First, much of the strength in the economy in late 1975 and early 1976 represents the recovery of inventory investment from the record negative levels of early 1975 (a rate of—$30 billion) to more normal positive levels (+$10 billion). (This is what accounted for most of the rapid growth in the third quarter of this year.) Once this normal level of inventory investment is attained, little further economic growth can be expected from this source. Second, the growth in consumption drops significantly in mid-1976 because of the $13 billion increase in withholding taxes that occurs on January 1, 1976, if the tax cuts expire. Because long-term interest rates are high, the recovery in housing is expected to be relatively weak in 1976. Business investment is expected to be strong in 1976, partly in response to the increase

in the investment credit in the Tax Reduction Act, which is what is expected to keep the recovery going even at a slower pace in late 1976, but this is not enough to cause the recovery to continue beyond the end of 1976.

Table 1 also shows the forecast of the behavior of the economy if the tax reductions are extended. In this case, unemployment continues to decline through the first quarter of 1977, reaching 7.3 percent. This is 500,000 fewer unemployed workers than if there is no tax cut extension. Gross national product is $25 billion higher by the middle of 1977 than if the 1975 tax cuts are allowed to expire. GNP in 1958 prices (that is, adjusted for inflation) is 1.3 percent higher at that time as a result of extending the tax cuts, and industrial production is higher by 2.0 percent. The tax cuts cause a slight increase in consumer prices in 1977 (but not in 1976). They also cause interest rates to be higer, mainly because of the greater strength of the economy if the tax cuts are extended.

TABLE 1.—ECONOMIC EFFECTS OF TAX REDUCTIONS

[Dollar amounts in billions]

Year and quarter	1975		1976				1977			
	3d	4th	1st	2d	3d	4th	1st	2d	3d	4th
Gross national product:										
Tax cut	1,503.6	1,545.0	1,589.8	1,638.6	1,686.2	1,743.3	1,796.3	1,848.4	1,899.5	1,947.1
No tax cut	1,503.6	1,545.0	1,587.2	1,631.4	1,674.0	1,726.1	1,775.1	1,824.4	1,874.2	1,921.2
Difference	0	0	+2.6	+7.2	+12.2	+17.2	+21.2	+24.0	+25.3	+25.9
Real GNP (1958 prices):										
Tax cut	808.3	818.3	830.8	843.9	855.5	868.2	879.7	889.2	896.5	899.7
No tax cut	808.3	818.3	829.0	839.6	848.7	859.0	868.8	877.5	884.7	888.3
Percent difference	0	0	(+.2)	(+.5)	(+.8)	(+1.1)	(+1.3)	(+1.3)	(+1.3)	(+1.3)
Unemployment rate:										
Tax cut	8.4	8.3	8.1	7.8	7.5	7.4	7.4	7.3	7.4	7.5
No tax cut	8.4	8.3	8.1	7.8	7.7	7.7	7.8	7.8	7.9	8.1
Difference	0	0	0	0	−.2	−.3	−.4	−.5	−.5	−.5
Consumer price index:										
Tax cut	162.9	166.2	168.8	171.4	174.3	177.9	181.1	184.5	188.0	192.2
No tax cut	162.9	166.2	168.8	171.4	174.3	177.9	181.0	184.3	187.8	191.8
Percent difference	0	0	0	0	0	0	(+.1)	(+.1)	(+.1)	(+.2)
Treasury bill rate:										
Tax cut	6.33	5.92	6.36	7.21	7.73	7.98	8.45	8.76	9.02	9.21
No tax cut	6.33	5.92	6.12	6.82	7.24	7.38	7.75	7.98	8.21	8.39
Difference	0	0	+.24	+.39	+.49	+.60	+.70	+.78	+.81	+.82
Index of industrial production:										
Tax cut	114.1	117.5	121.4	124.5	127.0	129.3	132.3	134.4	135.9	136.7
No tax cut	114.1	117.5	121.0	123.7	125.6	127.4	129.9	131.8	133.2	133.9
Percent difference	0	0	(+.3)	(+.6)	(+1.1)	(+1.5)	(+1.8)	(+2.0)	(+2.0)	(+2.1)

Note: These forecasts were prepared by Chase Econometrics Associates, Inc. Numbers for the 3d quarter of 1975 are actual figures.

In considering the duration of the tax cut it is desirable to estimate for how long the economy is likely to be below full capacity. By the first quarter of 1975, real gross national product had declined 8 percent below its peak in the fourth quarter of 1973. Industrial production had declined by 12 percent. The economic growth since then has only increased real GNP to a level 4.4 percent below its 1973 peak. Potential output in the economy has grown at an average rate of 4 percent in the postwar period, and if this has been the case since 1973, the economy is still 11 percent below capacity. Even if the abnormally low growth rate in capacity of 2 percent is assumed, the economy is over 8 percent below its potential. If the recovery proceeds at a 6-percent rate (approximately the growth rate for 1976 predicted in the Chase forecasts with extension of the tax cuts), then under the assumption of a 4-percent annual growth in capacity, the economy would not reach full employment until 1980.

ANALYSIS OF SPECIFIC TAX REDUCTIONS

The "base case"

For purposes of comparison with the following tables showing the distribution of various tax reductions, table 2 shows the number of taxable returns, their percentage distribution by income class and the distributions of tax liability and of adjusted gross income less tax liability (that is, after-tax income) under 1972–74 law at 1975 income levels. This would be the situation if there is no new legislation.

TABLE 2.—DISTRIBUTION OF INDIVIDUAL INCOME TAX LIABILITY AND ADJUSTED GROSS INCOME UNDER 1972–74 LAW, 1975 INCOME LEVELS

[Dollar amounts in millions]

AGI class (thousands)	Number of taxable returns (thousands)		Adjusted gross income		Tax liability		Adjusted gross income minus tax liability	
	Number	Percentage distribution	Amount	Percentage distribution	Amount	Percentage distribution	Amount	Percentage distribution
Under $5	11,135	16.0	$57,387	6.0	$2,044	1.6	$55,343	6.7
$5 to $10	19,916	28.6	152,490	16.0	14,069	10.9	138,421	16.9
$10 to $15	16,819	24.1	206,968	21.8	23,122	17.9	184,846	22.4
$15 to $20	10,680	15.3	184,945	19.5	23,706	18.3	161,239	19.6
$20 to $30	7,849	11.3	187,405	19.7	28,022	21.6	159,383	19.4
$30 to $50	2,425	3.5	89,362	9.4	16,950	13.1	72,412	8.8
$50 to $100	690	1.0	45,815	4.8	12,064	9.3	33,751	4.1
$100 and over	149	.2	26,036	2.7	9,445	7.3	16,591	2.0
Total	69,663	100.0	950,408	100.0	129,422	100.0	820,986	100.0

Individual income tax cuts in the House bill (H.R. 10612)

The House bill makes permanent the increase in the standard deduction provided by the Tax Reduction Act of 1975, extends the $30 credit through 1976 and, in addition, permits taxpayers to claim a credit equal to 2 percent of the initial $12,000 of taxable income (a maximum credit of $240) as an alternative to the $30 credit. The revenue loss from making permanent the standard deduction changes is $2.9 billion in 1976 ($1.28 billion in fiscal year 1976); the revenue loss from extending the $30 credit is $5.5 billion ($2.42 billion in fiscal year 1976) and the 2-percent alternative credit increases the revenue loss by $5.0 billion ($2.19 billion in fiscal year 1976) to a total of $13.4 billion ($5.88 billion in fiscal year 1976). The distribution by income class of the tax reduction from these provisions is shown in table 3.

Table 3 also shows how the tax cuts in the House Bill change after-tax income for each income class. This is one measure of the effect of the tax cuts on the income distribution. The House bill causes the largest percentage increase in after-tax income in the $5–$10,000 income class, and progressively smaller percentage increases in higher income classes. The "under $5,000" income class, however, experiences a smaller percentage increase than the income classes between $5,000 and $20,000.

President's individual tax cut proposal

The President has proposed a $21.6 billion tax cut for individuals composed of an increase in the personal exemption to $1,000, an increase in the standard deduction to a flat $1,800 for single returns and $2,500 for joint returns, and a tax rate reduction. The income distribution of these components and the total at 1975 income levels is shown in table 4. (At 1975 levels, the administration proposal loses $20.7 billion in revenue.)

In fiscal year 1976, these tax cuts reduce tax receipts by $10.3 billion.

TABLE 3.—DISTRIBUTION OF COMPONENTS OF THE INDIVIDUAL TAX REDUCTIONS IN THE HOUSE BILL (H.R. 10612), 1975 INCOME LEVELS

[Dollar amounts in millions and number of returns in thousands]

AGI class	Increased standard deduction [1]		$30 per capita credit [2]		Alternative credit of 2 percent of taxable income up to $12,000		Alternative credits of 2 percent of taxable income up to $12,000 and $30 per capita, combined (2) + (3)		Increased standard deduction, alternative credits of 2 percent of taxable income or $30 per capita, combined (1) + (4)		Percentage increase in after-tax income [3]
	Amount	Percent distribution	Amount	Percent distribution	Amount	Percent distribution	Amount	Percent distribution	Amount	Percent distribution	
	(1)		(2)		(3)		(4)		(5)		(6)
Under $5	$502	18.2	$299	5.7	$28	0.6	$327	3.3	$828	6.5	1.5
$5 to $10	1,062	38.5	1,190	22.7	697	14.7	1,887	18.9	2,949	23.2	2.1
$10 to $15	374	13.6	1,505	28.7	1,240	26.2	2,745	27.5	3,119	24.5	1.7
$15 to $20	527	19.1	1,079	20.6	1,283	27.1	2,362	23.7	2,889	22.7	1.8
$20 to $30	240	8.7	824	15.7	1,049	22.2	1,873	18.8	2,114	16.6	1.3
$30 to $50	46	1.7	257	4.9	324	6.8	582	5.8	627	4.9	.9
$50 to $100	8	.3	75	1.4	90	1.9	165	1.7	174	1.4	.5
$100 and over	1	.....	15	.3	20	.4	35	.4	36	.3	.2
Total (1975 income levels)	2,760	100.0	5,243	100.0	4,732	100.0	9,975	100.0	12,735	100.0	1.6
Total (1976 income levels)	2,898		5,505		4,969		10,474		13,372		

[1] The Tax Reduction Act of 1975 increased the minimum standard deduction from $1,300 to $1,600 for single returns and to $1,900 for joint returns; the percentage standard deduction from 15 to 16 percent; and the maximum standard deduction from $2,000 to $2,300 for single returns and to $2,600 for joint returns. The House bill makes these increases permanent.

[2] The estimates are made sequentially; that is, col. 2 assumes col. 1 has been implemented.

[3] The income measure used here is adjusted gross income.

Note: Details may not add to totals because of rounding.

TABLE 4.—DISTRIBUTION OF THE COMPONENTS OF THE PRESIDENT'S TAX REDUCTION PROPOSAL AS COMPARED TO 1972–74 LAW, 1975 LEVELS OF INCOME

[Amounts in millions of dollars]

AGI class (thousands)	Standard deduction change [1]		$1,000 personal exemption [2]		Rate reduction		Total		Percentage increase in after-tax income [3]
	Amount	Percent distribution	Amount	Percent distribution	Amount	Percent distribution	Amount	Percent distribution	
Under $5	726	17.1	397	4.0	102	1.6	1,225	15.9	2.2
$5 to $10	2,042	48.0	1,827	18.5	1,098	16.7	4,967	24.0	3.6
$10 to $15	934	22.0	2,539	25.7	2,040	31.0	5,513	26.6	3.0
$15 to $20	355	8.3	2,043	20.7	1,788	27.2	4,186	20.2	2.6
$20 to $30	160	3.8	1,861	18.8	1,287	19.6	3,308	16.0	2.1
$30 to $50	32	.8	801	8.1	204	3.1	1,037	5.0	1.4
$50 to $100	5	.1	330	3.3	48	.7	383	1.8	1.1
$100 and over	1	[4]	80	.8	10	.2	91	.4	.5
Total (1975 income levels)	4,255	100.0	9,878	100.0	6,577	100.0	20,711	100.0	2.5
Total (1976 income levels)	4,468		10,372		6,906		21,746		

[1] The President's proposal increases the standard deduction to a flat $1,800 for single returns and $2,500 for joint returns.

[2] This estimate assumes enactment of the increase in the standard deduction in the House bill.

[3] The income measure used here is adjusted gross income.

[4] Less than 0.1 percent.

Note.—Detail may not add to totals due to rounding.

In terms of its effect on the distribution of after-tax incomes, the administration proposal is similar to the House bill. The $5–$10,000 income class has the largest percentage increase in after-tax income, and the percentage increase declines steadily for higher income classes. The "under $5,000" income class, however, receives a smaller percentage increase in after-tax income than the income classes between $5,000 and $20,000.

Increases in the standard deduction

The Tax Reduction Act of 1975 increased the minimum standard deduction from $1,300 to $1,600 for single returns and to $1,900 for joint returns. It raised the percentage standard deduction from 15 percent to 16 percent and the maximum standard deduction from $2,000 to $2,300 for single returns and to $2,600 for joint returns. Each of these changes applied only to the calendar year 1975. The House bill makes them permanent, which involves a revenue loss of $2.9 billion in 1976. The distribution of this revenue loss by income class (at 1975 income levels) is shown in table 5. The difference between the $2.8 billion revenue loss shown in table 5 and the $2.9 billion figure for 1976 results entirely from the expected growth in income in 1976 over 1975. The revenue loss is $1.28 billion for fiscal year 1976.

TABLE 5.—REVENUE EFFECT OF INCREASES IN THE STANDARD DEDUCTION IN TAX REDUCTION ACT OF 1975 [2]

(1975 income levels)

AGI class (thousands)	Number of returns affected (thousands)			Decrease in tax liability [1]	
	With tax decrease	Made nontaxable	Shifting to standard deduction	Amount (millions)	Percentage distribution
Under $5	10,693	1,753	734	$502	18.2
$5 to $10	16,167	209	2,683	1,062	38.5
$10 to $15	9,670	2	1,269	374	13.6
$15 to $20	4,992	.....	1,706	527	19.1
$20 to $30	1,879	.....	753	240	8.7
$30 to $50	264	.....	107	46	1.7
$50 to $100	36	.....	14	8	.3
$100 and over	4	.....	1	1	.....
Total	43,705	1,963	7,268	2,760	100.0

[1] This measures the change in tax liability during the calendar year, assuming 1975 income levels.

[2] The Tax Reduction Act of 1975 increased the minimum standard deduction from $1,300 to $1,600 for single returns and to $1,900 for joint returns; the percentage standard deduction from 15 to 16 percent; and the maximum standard deduction from $2,000 to $2,300 for single returns and to $2,600 for joint returns.

In the past Congress has used the minimum standard deduction, together with the personal exemption, to eliminate individual income taxes for people with incomes below official government poverty levels. The recent inflation, particularly the sharp increase in food and energy prices, has led to a significant increase in poverty levels which, until the Tax Reduction Act of 1975, had not been matched by an increase in the income level at which an individual becomes taxable, the tax threshold.

Table 6 shows estimated poverty levels for 1975 and 1976 and the tax threshold under various assumptions about the tax law. If the 1975 tax cuts expire, the tax threshold will be $1,550 below the poverty level for a four-person family, so that a four-person family that is defined as being poor could pay as much as $222 in income tax. For a six-person family, there will be a $1,970 gap between the poverty level and the tax threshold, which could lead to an income tax burden of $285. If the increases in the standard deduction and the $30 credit are extended to 1976, the tax threshold will exceed the poverty level for two- and three-person families and will be only slightly below the poverty level for larger families.

Increasing the standard deduction also simplifies the tax system by encouraging people not to itemize their deductions. In 1975, approximately 7 million tax returns will switch to the standard deduction as a result of the increase in it in the Tax Reduction Act of 1975.

TABLE 6.—POVERTY LEVELS AND TAX THRESHOLDS

Family size	Poverty levels [1]		Tax thresholds	
	1975	1976	If 1975 tax cuts expire [2]	With extension of 1975 tax cuts [3]
1	$2,790	$2,970	$2,050	$2,564
2	3,610	3,840	2,800	3,829
3	4,300	4,570	3,550	4,793
4	5,500	5,850	4,300	5,757
5	6,490	6,900	5,050	6,717
6	7,300	7,770	5,800	7,667

[1] Estimated by U.S. Department of the Treasury assuming inflation of 9.1 percent in 1975 over 1974 and 6.4 percent in 1976 over 1975.

[2] If the tax cuts expire, the minimum standard deduction will be $1,300.

[3] This involves a minimum standard deduction of $1,600 for single people and $1,900 for married couples filing joint returns and a tax credit equal to $30 for each taxpayer and dependent.

Nonrefundable tax credits

There are two principal issues that arise in designing tax credits similar to the $30 credit and the 2-percent credit in the House bill. The first issue is what income classes benefit from the credit. Under the $30 credit, most of the tax reduction goes to lower-income taxpayers. Under the 2-percent alternative credit, the benefit is received by middle-income taxpayers, whose taxable income is sufficiently high that 2 percent of taxable income exceeds $30 per taxpayer and dependent. The second issue is the distribution of the tax reduction by family size. Under the $30 credit, the tax reduction is proportional to family size; under the 2-percent alternative credit, the reduction is independent of family size except insofar as taxable income varies with family size. Thus, the 2-percent credit benefits single persons and smaller families, particularly those in the middle and upper income range, compared to the $30 credit.

The distribution of the $30 credit by income class and that of the 2-percent alternative credit is shown in table 3. For the $30 credit, 57.1 percent of the tax reduction goes to taxpayers whose adjusted gross incomes are less than $15,000. Under the 2-percent alternative, 41.5 percent of the additional tax cut goes to this group.

TABLE 7.—DISTRIBUTION OF TAX REDUCTIONS BETWEEN JOINT AND OTHER RETURNS

	Percent of Total
Tax liability under 1974 law paid by joint returns	78.7
Tax reduction received by joint returns under:	
$30 and 2-percent alternative credits (House bill)	74.8
$55 per capita credit	82.4
$65 credit per taxpayer, $45 credit per dependent	81.4
$1,000 personal exemption	82.9

In the material below, several possible alternatives to the credit in the House bill that have approximately the same revenue impact are analyzed.

Instead of the 2-percent alternative credit, there could be a $55 credit for each taxpayer and dependent. This would involve a revenue loss of $10.0 billion ($4.36 billion in fiscal year 1976), compared to $10.5 billion in the House bill. The distribution of the tax reduction by income class, as shown in table 8, is skewed moretoward the lower income classes than the credit in the House bill. With the $55 credit, 56.4 percent of the reduction goes to taxpayers with incomes below $15,000 compared to 49.7 percent under the credits in the House bill. Also, the $55 credit would be more generous to larger families than the House bill.

A variation on the per capita credit which would provide somewhat greater benefit to single persons and small families would be a credit of $65 for each taxpayer and $45 per dependent. The income distribution of this provision is shown as the third provision in table 8. This has approximately the same distribution by income class as the $55 credit.

Table 7 shows the percentage of the tax reduction from these credits that is received by joint returns. Under the $55 credit, 82.4 percent of the reduction goes to joint returns, compared to 74.8 percent in the House bill credit. (Joint returns have 78.7 percent of the tax liability.)

Another alternative would be to combine an increase in the $30 credit to $45 with an additional increase in the standard deduction. A further increase in the minimum standard deduction to $1,800 for single returns (instead of to $1,600) and to $2,200 for joint returns (instead of $1,900), and a further increase in the maximum standard deduction to $2,500 for single returns (instead of $2,300) and to $2,900 for joint returns (instead of $2,600), plus a $45 credit (instead of $30) would involve a revenue loss of $9.8 billion ($4.33 billion in fiscal year 1976). This is $600 million less than the tax credits in the House bill. The income distribution is shown in table 8. Under this alternative, 59.6 percent of the reduction goes to taxpayers with income less than $15,000.

The revenue impact of various possible combinations of a credit for the taxpayer and a credit for dependents is shown in table 9.

TABLE 8.—DISTRIBUTION OF TAX REDUCTION FROM ALTERNATIVE INDIVIDUAL INCOME TAX REDUCTIONS, 1975 INCOME LEVELS [1]

(Amounts in millions of dollars)

AGI class	$45 per capita tax credit and larger increase in the standard deduction [2]		$55 per capita tax credit		Tax credit of $65 per taxpayer and $45 per dependent [3]		Increase of the personal exemption to $1,000		Tax credits in House bill [4]	
	Amount	Percent distribution	Amount	Percent distribution	Amount	Percent distribution	Amount	Percent distribution	Amount	Percent distribution
Under $5	629	6.7	497	5.3	561	5.7	397	4.0	327	3.3
$5 to $10	2,421	25.8	2,086	22.1	2,245	22.8	1,827	18.5	1,887	18.9
$10 to $15	2,537	27.1	2,739	29.0	2,819	28.7	2,539	25.7	2,745	27.5
$15 to $20	1,817	19.4	1,975	20.9	2,017	20.5	2,043	20.7	2,362	23.7
$20 to $30	1,410	15.0	1,511	16.0	1,538	15.7	1,861	18.8	1,873	18.8
$30 to $50	421	4.5	471	5.0	480	4.9	801	8.1	582	5.8
$50 to $100	118	1.3	137	1.5	139	1.4	330	3.3	165	1.7
$100 and over	23	.2	27	.3	28	.3	80	.8	35	.4
Total (1975 income levels)	9,376	100.0	9,444	100.0	9,827	100.0	9,878	100.0	9,975	100.0
Total (1976 income levels)	9,845		9,916		10,318		10,372		10,474	

[1] Estimates made assuming extension of the 1975 standard deduction changes.

[2] Further increase over and above those provided in the Tax Reduction Act of 1975. Increasing the minimum standard deduction from $1,600 to $1,800 for single returns, and from $1,900 to $2,200 for joint returns; increasing the maximum standard deduction from $2,300 to $2,500 for single returns and from $2,600 to $2,900 for joint returns. The reduction from the 1975 Act standard deduction changes are shown in table 3.

[3] A joint return has 2 taxpayers so each spouse would get a $65 credit.

[4] The greater of $30 per capita or 2 percent of the initial $12,000 of taxable income.

TABLE 9.—REVENUE IMPACT OF ALTERNATIVE TAX CREDITS, 1975 INCOME LEVELS [1]

(Millions of dollars)

Credit per dependent	Credit per taxpayer					
	$45	$50	$55	$60	$65	$70
$30	6,810	7,328	7,844	8,357	8,868	9,377
$35	7,136	7,653	8,167	8,679	9,189	9,697
$40	7,459	7,975	8,489	9,000	9,509	10,015
$45	7,781	8,296	8,808	9,319	9,826	10,332
$50	8,100	8,615	9,127	9,636	10,142	10,647
$55	8,419	8,932	9,443	9,951	10,456	10,959
$60	8,735	9,248	9,757	10,264	10,768	11,270
$65	9,050	9,561	10,069	10,574	11,077	11,578
$70	9,363	9,872	10,379	10,883	11,385	11,884

[1] These estimates assume enactment of the increases in the standard deduction in the House bill.

Personal exemption

Still another alternative to the tax credit in the House bill would be an increase in the personal exemption from $750 to $1,000. This would involve a revenue loss of $10.4 billion ($4.56 billion in fiscal year 1976), or $100 million less than the House bill. The distribution is shown in table 8. The increase in the exemption is less generous to lower income groups than either the $55 credit, the $45 credit combined with the larger increase in the standard deduction, or the credit in the House bill. With the exemption increase, 48.2 percent of the tax reduction goes to taxpayers with incomes below $15,000, compared to 49.7 percent under the House bill, 56.4 percent with the $55 credit and 59.6 percent with the $45 credit and the larger increase in the standard deduction. Like the $55 credit, the increase in the exemption is beneficial to larger families. A problem with increasing the exemption temporarily is that taxpayers might not understand that the increase is simply a temporary change to stimulate the economy, since the exemption is a permanent feature of the tax system.

Earned income credit

The earned income credit equals 10 percent of the initial $4,000 of earnings, but it is phased out as income rises from $4,000 to $8,000. It provides more benefit to low-income families than any other feature of the tax system because it is refundable; that is, not limited to tax liability. Extending the credit for 1976 involves a revenue loss of $1.4 billion. The entire reduction would be received by 6 million families with dependents and incomes of less than $8,000. The distribution by income class is shown in table 10.

TABLE 10.—REVENUE EFFECT OF EARNED INCOME CREDIT

(1975 income levels)

AGI class	Reduction in tax liability	
	Amount (millions)	Percent distribution
Under $5,000	$918 [1]	66
$5,000 to $8,000	473	34
Total	1,391	100

[1] This includes $200,000,000 of refunds to individuals who did not have to file tax returns under 1970 filing requirements and who are not represented in the Treasury tax model.

The earned income credit is not reflected in withholding in 1975 because most of those eligible for the credit had their withholding reduced to zero in the last 8 months of 1975. This reduction to zero was necessary to match withholding and liability as closely as possible given the amount of tax withheld in the first four months of the year and the size of the tax reductions.

Some of the earned income credit could be reflected in withholding for 1976. The staff estimates that $1.1 billion of the $1.4 billion cost

of the credit would be refundable and could not be reflected in withholding unless there are substantial changes in the withholding system.[2] Because the credit applies to a limited class of taxpayers and is subject to an income phaseout, to reflect fully the earned income credit in withholding would require a separate withholding schedule for those employees eligible for the credit. Such a separate schedule would be an administrative burden (particularly on employers) out of proportion to the number of employees benefiting. Because of the income phaseout, the full amount of the credit cannot be made available to all employees who have dependents without creating substantial amounts of underwithholding for two-earner families or those with unearned income. One solution to this dilemma would be to permit an eligible employee whose income is below, say, $6,000 or $6,500 to claim an additional withholding exemption. This would permit part of the earned income credit to be reflected in withholding without creating any significant underwithholding.[3]

Since most of the earned income credit cannot be reflected in withholding, it could be expected to reduce receipts in fiscal year 1976 by less than $50 million.

Corporate surtax exemption and tax rates

Corporate income is generally subject to a normal tax of 22 percent and a surtax of 26 percent, with the initial $25,000 of taxable income exempt from the surtax. In the Tax Reduction Act of 1975 the surtax exemption was increased to $50,000 and the normal tax was reduced to 20 percent on the initial $25,000 of taxable income. Both changes applied only to the year 1975. The House bill extends these changes through 1977. The revenue cost is $1.9 billion for 1976 ($0.59 billion in fiscal year 1976).

These tax reductions are designed to provide tax relief to small businesses. The increase in the surtax exemption from $25,000 to $50,000 provides a tax reduction of $6,500 (.26 × $25,000) to all corporations with taxable income above $50,000, a smaller reduction to corporations with taxable income between $25,000 and $50,000, and no tax reduction for corporations with taxable income below $25,000. Of this $1.6 billion reduction, 23 percent is received by corporations with taxable income below $50,000. In addition there is a 2-point reduction in the normal tax on the first $25,000 of taxable income. Sixty-eight percent of this tax reduction goes to corporations with incomes less than $50,000.

POSSIBLE COMBINATIONS

Given the objective of a tax reduction no greater than $6.4 billion in the fiscal year 1976, there are many different types of combinations of reductions which could achieve this result. The material presented below sets out four such possibilities for the consideration of the committee.

The President has requested that a tax reduction for calendar year 1976 be accompanied by a ceiling on expenditures for the fiscal year

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[2] The administration is currently defining the refundable part of the earned income credit as an outlay, implying that none of the refundable part should be reflected in lower withholding.

[3] This approach would require employees to file a new W–4 with their employers. Should the earned income credit not be extended after 1976 it would require the employees to file another W–4 in 1977 eliminating the extra exemption claimed for 1976.

1977. Concern has been expressed that this makes it necessary to determine a ceiling on expenditures for the fiscal year 1977 before there has been an opportunity for the Congress to apply its newly established congressional budget procedures. Under these procedures a ceiling in expenditures would ordinarily be provided by a budget resolution passed before next May 15. In addition, there has been concern that this would require the establishment of a budgetary ceiling before the Congress has received the President's budget and before it would know the areas of reductions proposed in order to achieve any given budget ceiling. This problem could be dealt with by providing an extension of any of the reductions described below for a 6-month (or 9-month) period with consideration prior to next June (or next September) of the desirability of extending the cuts for the remainder of the year. This result could be obtained by providing a reduction in tax liability of one-half (or three-quarters) of a full year's cut but at the same time making provision for a reduction in withholding reflecting the *full* amount of the reduction in liability in the first 6 months (or 9 months).[4] This would appear to meet the basic objective of the President in that no tax reduction would be provided which would have any effect in the fiscal year 1977 until after the Congress (through its regular budget procedure) had established an expenditure ceiling.

Another suggestion has been that the Congress merely extend present withholding rates for a period of 3 to 6 months, leaving the determination of tax liability to legislation to be acted upon next year. This, however, would appear to involve difficulties for taxpayers who report on a fiscal year basis with years ending in the first 6 months of the calendar year. Such taxpayers, because of the reduced withholding, would find the amount withheld in their cases totally inadequate to meet their tax liability. Moreover, if a tax reduction should be enacted subsequently, such a reduction, in order to provide relief in the case of these fiscal year taxpayers, would presumably need to be made retroactive and necessitate the refiling of returns by the fiscal year taxpayers. While the number of fiscal year individual taxpayers is relatively small (close to 50,000), the number of corporate fiscal year taxpayers represents an important segment of the business community accounting for approximately 57 percent of all corporate taxpayers.

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[4] Modifications of the declaration system would also be necessary to make it clear that the first two declaration payments could reflect the full tax reductions provided.

POSSIBLE TAX CUT PACKAGES

(In billions)

	Effect on fiscal year 1976 collections	Reduction in tax liability for calendar year 1976
HOUSE BILL		
1. Extend 1975 act standard deduction changes for individuals (minimum standard increased to $1,600 for single returns and to $1,900 for joint returns; percentage standard increased to 16 percent; and maximum standard increased to $2,300 for single returns and to $2,600 for joint returns)	$1.28	$2.9
2. Extend the $30 tax credit for each individual taxpayer and and each dependent	2.42	5.5
3. Provide a tax credit of 2 percent of taxable income on the first $12,000 of taxable income as an alternative to the $30 credit	2.19	5.0
4. Extend the 1975 act corporate rate changes (20 percent rate on the first $25,000 of income, 22 percent on the next $25,000 and 48 percent above that level)	.59	1.9
Total	6.47	15.3
OPTION 1		
1. Extend 1976 Act standard deduction changes for individuals (minimum standard increased to $1,600 for single returns and to $1,900 for joint returns; percentage standard increased to 16 percent; and maximum standard increased to $2,300 for single returns and to $2,600 for joint returns)	1.28	2.9
2. Extend the $30 tax credit for each individual taxpayer and each dependent	2.42	5.5
3. Increase the $30 credit to $55	1.94	4.4
4. Extend the earned income credit (10 percent on the first $4,000, phased out at $8,000)	.04	1.4
5. Extend the 1975 act corporate rate changes (20 percent rate on the first $25,000 of income, 22 percent on the next $25,000, and 48 percent above that level)	.59	1.9
Total	6.27	16.2

POSSIBLE TAX CUT PACKAGES

(In billions)

	Effect on fiscal year 1976 collections	Reduction in tax liability for calendar year 1976
OPTION 2		
1. Extend 1976 Act standard deduction changes for individuals (minimum standard increased to $1,600 for single returns and to $1,900 for joint returns; percentage standard increased to 16 percent; and maximum standard increased to $2,300 for single returns and to $2,600 for joint returns)	1.28	2.9
2. Extend the $30 tax credit for each individual taxpayer and each dependent	2.42	5.5
3. Increase $30 credit to $65 for taxpayers and to $45 for dependents	2.12	4.8
4. Extend the earned income credit (10 percent on the first $4,000, phased out at $8,000)	.04	1.4
5. Extend the 1975 act corporate rate changes (20 percent rate on the first $25,000 of income, 22 percent on the next $25,000, and 48 percent above that level)	.59	1.9
Total	6.41	16.6
OPTION 3		
1. Increase the standard deduction changes in the 1975 Act (minimum increased to $1,800 for single persons and to $2,200 for joint returns; percentage standard increased to 16 percent; and maximum standard increased to $2,500 for single persons and $2,900 for joint returns)	2.06	4.7
2. Extend the $30 tax credit for each individual taxpayer and each dependent	2.39	5.4
3. Increase the $30 credit to $45	1.16	2.6
4. Extend the earned income credit (10 percent on the first $4,000, phased out at $8,000)	.04	1.4
5. Extend the 1975 act corporate rate changes (20 percent rate on the first $25,000 of income, 22 percent on the next $25,000, and 48 percent above that level)	.59	1.9
Total	6.24	16.1

Table 11 shows the amount of tax reduction by adjusted gross income class and the percentage increase in after-tax income (using adjusted gross income as the measure of before-tax income) for the tax cuts in the Tax Reduction Act of 1975, the House version of the Tax Reform Act of 1975, and the options presented above.

Table 12 shows the tax threshold under the House bill and the three options. Under each of the options, the tax threshold exceeds the poverty level for all families but not for single persons.

TABLE 11.—DISTRIBUTION OF TAX REDUCTION PACKAGES, 1975 INCOME LEVELS

[Dollar amounts in millions]

AGI class (thousands)	Tax Reduction Act of 1975 [1]		House bill [2]		Option 1 [3]		Option 2 [4]		Option 3 [5]	
	Amount	Percent increase in after-tax income	Amount	Percent increase in after-tax income	Amount	Percent increase in after-tax income	Amount	Percent increase in after-tax income	Amount	Percent increase in after-tax income
Under $5	$1,719	3.1	$828	1.5	$1,917	3.6	$1,981	3.6	$2,049	3.7
$5 to $10	2,725	2.0	2,949	2.1	3,621	2.6	3,780	2.7	3,956	2.9
$10 to $15	1,879	1.0	3,119	1.7	3,113	1.7	3,193	1.7	2,911	16
$15 to $20	1,606	1.0	2,889	1.8	2,502	1.6	2,544	1.6	2,344	1.5
$20 to $30	1,064	.7	2,114	1.3	1,751	1.1	1,778	1.1	1,650	1.0
$30 to $50	303	.4	627	.9	517	.7	526	.7	467	.6
$50 to $100	83	.2	174	.5	145	.4	147	.4	126	.4
$100 and over	16	.1	36	.2	28	.1	29	.1	24	.1
Total (all income levels)	9,394	1.1	12,735	1.6	13,595	1.6	13,978	1.7	13,527	1.6
Total (1976 income levels)	9,794	.....	13,372	.....	14,205	.....	14,607	.....	14,134	.....

[1] Increase in minimum standard to $1,600 for single returns and $1,900 for joint returns; increase in percentage standard to 16 percent; increase in maximum standard to $2,300 for single returns and $2,600 for joint returns; $30 credit; earned income credit.

[2] Increase in standard deduction from Tax Reduction Act; alternative tax credits of $30 per capita or 2 percent of first $12,000 of taxable income.

[3] Same as Tax Reduction Act except $55 credit.

[4] Same as Tax Reduction Act except credit of $65 per taxpayer and $45 per dependent.

[5] Increase in minimum standard to $1,800 for single returns and $2,200 for joint returns; increase in percentage standard to 16 percent; increase in maximum standard to $2,500 for single returns and $2,900 for joint returns; $45 credit; earned income credit.

TABLE 12.—TAX THRESHOLDS FOR TAX CUT PACKAGE [1]

Family Size	1976 Poverty Level	Option 1–House Bill	Option 2 [2]	Option 3 [3]	Option 4 [4]
1	$2,970	$2,564	$2,743	$2,814	$2,871
2	3,840	3,829	4,186	4,329	4,343
3	4,570	4,793	5,317	5,383	5,414
4	5,850	5,757	6,433	6,433	6,467
5	6,900	6,717	7,550	7,483	7,517
6	7,770	7,667	8,650	8,525	8,567

[1] These do not tax account of the earned income credit.

[2] $55 credit.

[3] $65 credit per taxpayer, $45 per dependent.

[4] $45 credit and larger increase in the standard deduction.

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