[COMMITTEE PRINT]

INDIVIDUAL INCOME TAX REDUCTIONS

PREPARED FOR THE USE OF THE

COMMITTEE ON WAYS AND MEANS

BY THE STAFF OF THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

OCTOBER 6, 1975

U.S. GOVERNMENT PRINTING OFFICE
59-530 WASHINGTON : 1975 JCS-44-75

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PRESENT LAW

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 Reduction Act provided that the tax reductions from these three provisions for the entire year be reflected in lower withholding 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. Although the committee could provide a similar refund for 1975 taxes, that decision need not be made until next year, so the issue is not discussed in this pamphlet.

The Tax Reduction Act cut business taxes by increasing the investment tax credit and the corporate surtax exemption and by reducing the corporate tax rate on the first $25,000 of taxable income. These tax cuts are also only temporary, and their extension is analyzed in the pamphlet on capital formation.

The budget target suggested by the First Concurrent Resolution on the Budget for fiscal year 1976 (which involves a deficit of $68.8 billion) assumes that the changes in the standard deduction, the $30 credit, the earned income credit and the changes in corporate rates and the surtax exemption are all extended through calendar year 1976.

REVENUE EFFECT OF THE TAX REDUCTION ACT

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 $2.5 billion and the $30 credit to one of $5.3 billion. The earned income credit involves a loss of $1.5 billion and the home purchase credit a loss of $0.6 billion, so that the total reduction in individual income taxes is $18.0 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 about $8 billion, are being reflected in lower withholding over the last eight months of 1975. The withholding change, then, is at an annual rate of $12 billion. Even if these provisions are extended through 1976, there will be an increase in withholding taxes of $4 billion on January 1, 1976, to reflect the fact that, in 1976, the $8 billion tax cut will be reflected in lower withholding over a 12-month period instead of over 8 months. The earned income credit is not being reflected in lower withholding in 1975, because most people who will use the credit will have no withholding taxes in the last 8 months of 1975 because of the $12 billion cut in withholding. If the earned income credit is extended to 1976, however, the part of the credit that goes to taxpayers with some withholding tax could be reflected in lower withholding in 1976.

CAUSES OF THE RECENT RECESSION

The recent recession began at the end of 1973 and appears to have ended in the second quarter of 1975. The economy had been expanding rapidly through 1972 and the early months of 1973, mainly as a result of expansionary monetary and fiscal policies, the devaluation of the dollar, and the temporary decline in the rate of inflation that resulted from the wage and price controls that the President imposed in August 1971. By the middle of 1973, however, the boom had slowed considerably and the rate of real economic growth had fallen to only 2 percent in the second and third quarters of that year. The main reasons for this "growth recession" in mid-1973 appear to have been the sharp increase in the rate of inflation in 1973 and the cyclical forces that affect housing, auto sales, inventory accumulation and business investment.

Inflation tends to reduce the rate of economic growth for several reasons. It reduces the confidence that both consumers and businesses have in the economy, which causes them to curtail discretionary spending. Also, inflation raises interest rates, which reduces housing and business investment spending. Finally, in a progressive tax system inflation causes tax receipts to rise, not only in current dollars but also in constant dollars, so that consumer spending is reduced. (A 10-percent inflation raises individual income taxes by over 16 percent, so that the increase in the real income tax burden is over 6 percent.) In the absence of significant new government spending programs, however, this increase in tax revenues tends to be larger than the increase in government spending. For these reasons, it appears that the high rate of inflation during 1973 and 1974 (9 percent in 1973 and 12 percent in 1974) was a major cause of the weakness of the economy in those years.

The oil embargo and the sharp increase in oil prices in the fall of 1973, coming at a time when the economy was already in a "growth recession," also appears to have had a serious impact on the economy. The embargo reduced the supply of goods and services in the economy, while the increased price of oil reduced demand, mainly because people had to spend more for energy and, therefore, had less income to spend on other things. At the time, it was not clear whether the effect on demand or the effect on supply would be stronger, but in retrospect it appears that the effect of the high oil prices in dampening aggregate demand was greater than the effect of the embargo in reducing aggregate supply. Thus, the net effect of energy developments in late 1973 and early 1974 was to increase the gap between actual and potential output in the economy. Probably, the relative mildness of the impact of the embargo on the aggregate supply of goods and services in the U.S. economy was a result of the administration's policy of shifting as much of the oil shortage as possible to gasoline, although the relatively mild winter and voluntary conservation efforts appear to also deserve some credit.

Another important cause of the recession, appears to be the behavior of business inventory investment, historically the most volatile major category of spending in the economy. In 1973, shortages appeared in several key U.S. industries, including paper, chemicals, steel and other basic materials industries. These are all commodities that are traded in world markets, and a simultaneous boom in all the major industrial countries had significantly increased demand for these goods. In some cases shortages in the U.S. market may have occurred because price controls kept down the price that U.S. buyers could pay, while not affecting the price to foreigners. Also, investment in some of these industries had been sluggish in the late 1960's and early 1970's because the overvaluation of the dollar made it difficult for these industries to meet foreign competition. In any case, throughout 1973 many businesses, influenced by fear of shortages, attempted to accumulate substantial inventories, even though final sales to consumers were growing quite slowly and, by the end of 1973, actually declining. The oil embargo further increased businessmen's fear of shortages, and in the fourth quarter of 1973, inventory investment had increased to a record annual rate of $29 billion. This inventory boom laid the groundwork for a serious economic decline, which occurred as soon as businessmen realized the weakness of consumer demand and began to liquidate their excess inventories by sharply cutting their new orders.

Recognizing the problems that were being caused by excessive inventory investment, particularly its effect on the rate of inflation, the Federal Reserve System decided to take action to stop it in early 1974. For businesses to accumulate inventories, they need bank loans, which grew at an annual rate of 18 percent in the early months of 1974 mainly as a result of large inventory investment. However, because of its concern with inflation, the Federal Reserve, through its open market operations, did not permit any appreciable growth in nonborrowed bank reserves between February and August 1974. As a result, interest rates rose sharply, with the Federal funds rate reaching 13 percent in July.

Without tight money, the inventory liquidation that inevitably follows a period of excessive inventory accumulation, together with the general weakness in the economy resulting from inflation and the transfer of purchasing power from consumers to oil producers, probably would have caused the recession to continue throughout 1974. The tight money, however, appears to have aggravated the downturn. Both housing and business investment, which are sensitive to interest rates, registered sharp declines beginning in late 1974, and real gross national product fell at an annual rate of 9 percent in the last quarter of 1974 and at a rate of 12 percent in the first quarter of 1975. Unemployment rose to a peak of 9 percent, the highest rate since the depression.

The Fed permitted bank reserves to grow at a very rapid rate during the last four months of 1974. Along with the Tax Reduction Act of 1975, which was signed into law at the end of March, this easier monetary policy brought the economic decline to a halt, and real gross national product actually rose at a 2-percent rate in the second quarter of 1975. The economy appears to have grown at about a 7-percent rate during the third quarter of this year, suggesting that a recovery from the recession is underway.

BASE CASE ECONOMIC FORECASTS

The staff has prepared forecasts of the behavior of the economy during the next two years under the assumption that the 1975 tax reductions are not extended. This "base case" forecast is used in predicting the effects of extending them.

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 major uncertainty facing the economy is whether the price of domestic oil will be freed from price controls. The staff, therefore, has made one "base case" forecast under the assumption that price controls on old oil are phased out over a three-year period, and a second forecast under the assumption that old oil is decontrolled on January 1, 1976, and that a deregulation profits tax somewhat like the one on which the Senate Finance Committee agreed in July 1975 is enacted. In both cases, we assume repeal of the $2 license fee on crude oil and the $0.60 license fee on petroleum products.[1]

A summary of the base case forecast under the assumption of phased decontrol 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 7.5 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). Once this normal level of inventory investment is attained, little further economic growth can be expected from this source. Second, in the base case the growth in consumption drops significantly in mid-1976 because of the $12 billion increase in withholding taxes that occurs on January 1, 1976, if the tax cuts expire. Because 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.—BASE CASE FORECAST—PHASE DECONDTROL

[Dollar amounts in billions]

Quarter	1975 3d	1975 4th	1976 1st	1976 2d	1976 3d	1976 4th	1977 1st	1977 2d
Gross national product:								
Current dollars	1,491.9	1,537.3	1,585.6	1,636.3	1,684.9	1,738.9	1,794.4	1,845.1
Percent change from previous quarter	14.2	12.2	12.6	12.8	11.9	12.8	12.8	11.3
Real GNP:								
1958 prices	797.2	806.4	819.1	832.6	842.8	852.1	859.3	866.1
Percent change from previous quarter	7.0	4.6	6.3	6.6	4.9	4.4	3.4	3.2
Unemployment rate (percent)	8.4	8.2	8.1	7.7	7.5	7.5	7.6	7.7
Consumer price index:								
1967=100	163.0	166.6	169.0	171.8	175.1	178.9	182.9	186.7
Percent change from previous quarter	8.7	8.8	5.9	6.6	7.7	8.7	9.0	8.3
AA corporate bond rate (percent)	9.6	9.8	10.0	10.4	10.6	10.7	10.8	11.1

Note: This forecast assumes no extension of the 1975 tax cuts and decontrol of old oil prices over a 3-year period.

[1] Under the Senate Finance Committee's deregulation profits tax, a 90-percent tax rate was applied to the deregulation profits on old oil, defined as the price in excess of the controlled price as of April-June 1975, plus an inflation factor of ½ percent per month. The tax permitted a plowback credit for investments in excess of a threshold, with the credit limited to 25 percent of tax liability. The amount of old oil, subject to the tax was phased down to zero over a 5½-year period. The revenue from the deregulation profits tax and the estimated increased corporate income tax receipts arising from decontrol were returned to individuals through income tax cuts.

Table 2 shows the Chase forecast under the assumptions that the tax cuts are not extended, old oil is decontrolled on January 1, 1976, and Congress enacts a deregulation profits tax with individual tax cuts. The outlook for income and employment is more pessimistic in 1976 with decontrol, although the outlook for 1977 is not very different under phased decontrol with no deregulation profits tax than under decontrol with a deregulation profits tax. The higher gasoline prices that result from decontrol discourage car sales in 1976, and the higher price level causes interest rates to rise. A third potential effect of decontrol, the transfer of purchasing power from consumers to oil producers is largely dealt with through the deregulation profits tax and the accompanying individual tax cuts.

The Chase forecast suggests that decontrol does not prevent the recovery from occurring, even without the tax cuts, but it does reduce its strength. The growth in real GNP is only 5 percent through 1976 and 4 percent in the first half of 1977, which causes a drop in the unemployment rate to only 7.6 percent. Inflation stays at about an 8-percent rate through the next 18 months.

The forecast indicates that the economic outlook in the short-run would be somewhat better if price controls were phased out over a longer period, as long as the oil import license fees were still removed, but not if the license fees remained in place.

TABLE 2.—BASE CASE FORECAST—DECONTROL

[Dollar amounts in billions]

Quarter	1975 3d	1975 4th	1976 1st	1976 2d	1976 3d	1976 4th	1977 1st	1977 2d
Gross national product:								
Current dollars	1,491.9	1,537.3	1,592.5	1,643.3	1,692.3	1,746.3	1,800.3	1,854.7
Percent change from previous quarter	14.2	12.2	14.4	12.8	11.9	12.8	12.4	12.1
Real GNP:								
1958 prices	797.2	806.4	815.8	828.7	838.7	847.6	857.1	865.7
Percent change from previous quarter	7.0	4.6	4.7	6.3	4.9	4.2	4.5	4.0
Unemployment rate (percent)	8.4	8.2	8.1	7.7	7.6	7.6	7.7	7.7
Consumer price index:								
1967=100	163.0	166.6	170.1	173.1	176.5	180.4	184.0	187.8
Percent change from previous quarter	8.7	8.8	8.6	6.9	7.9	8.9	8.0	8.3
AA corporate bond rate (percent)	9.6	9.8	10.1	10.5	10.8	10.9	11.0	11.3

Note: This forecast assumes no extension of the 1975 tax cuts, decontrol of old oil prices in January 1976, and enactment of a deregulation profits tax with rebates to individuals.

EFFECTS OF EXTENDING 1975 TAX CUTS

To quantify the effects of extending the 1975 tax cuts, the staff worked through the Chase model under the assumption that the increase in the standard deduction, the $30 credit, the earned income credit, the increase in the investment credit, and the changes in the corporate surtax exemption and corporate tax rates were extended through 1976 and 1977. This would mean a tax reduction of about $11 billion in 1976 and about $14 billion in 1977.

Table 3 shows the Chase forecast under the assumption that the tax cuts are extended and there is phased decontrol. The effect is a stronger recovery in the first half of 1976, with a growth rate of real gross national product over 7 percent. The recovery still weakens somewhat in late 1976, however, for essentially the same reasons as in the base case. According to the model, the tax cut raises GNP by a gradually increasing amount, with the peak effect being almost $17 billion in the second quarter of 1977. It causes the unemployment rate to decline by 0.5 percent, or by over 400,000 workers, in that quarter. The extension of the tax cuts has a modest effect on consumer prices, causing the price level to be higher by 0.4 percent than in the base case, mainly because the lower unemployment rate causes wages to rise. (This means an annual increase in the rate of inflation of slightly less than 0.3 percent in the next year and one-half.) Long-term interest rates also are predicted to increase slightly (by 0.2 percentage points) as a result of the tax cut, because of the slightly greater inflation.

TABLE 3.—EFFECT OF EXTENDING TAX CUTS—PHASED DECONTROL

[Dollar amounts in billions]

	1975		1976				1977	
Quarter	3d	4th	1st	2d	3d	4th	1st	2d
Gross national product:								
Current dollars	1,491.9	1,537.3	1,588.8	1,643.2	1,695.5	1,752.1	1,809.8	1,861.9
Change from base case	0	0	3.2	6.9	10.6	13.2	15.3	16.8
Percent change from base case	0	0	.2	.4	.6	.8	.9	.9
Real gross national product:								
1958 prices	797.2	806.4	821.1	836.3	848.2	858.4	866.2	873.1
Percent change from previous quarter	7.0	4.6	7.3	7.4	5.7	4.9	3.6	3.2
Percent change from base case	0	0	.2	.5	.6	.7	.8	.8
Unemployment rate:								
Percent	8.4	8.2	8.0	7.5	7.3	7.2	7.2	7.2
Change from base case	0	0	−.1	−.2	−.3	−.4	−.4	−.5
Consumer Price Index:								
1967=100	163.0	166.6	169.0	171.8	175.2	179.1	183.2	187.1
Percent change from previous quarter	8.7	8.8	5.9	6.7	7.8	8.9	9.3	8.5
Percent change from base case	0	0	0	0	.1	.2	.3	.4
AA corporate bond rate:								
Percent	9.6	9.8	10.0	10.5	10.7	10.8	11.0	11.3
Change from base case	0	0	0	.1	.1	.1	.2	.2

Note: This forecast assumes extension of the 1975 tax cuts and decontrol of old oil prices over a 3-year period.

Table 4 shows the impact of extending the 1975 tax cuts under the assumption that old oil is decontrolled and a deregulation profits tax is enacted with individual tax rebates. The effect of the tax cut is approximately the same as in the case of phased decontrol—an increase in gross national product of $17 billion in mid-1977 and a decline in unemployment of 0.5 percentage points. With both decontrol and extension of the tax cuts, the recovery proceeds at a relatively slow, but steady, pace through both 1976 and the first half of 1977.

An individual income tax cut at a time when there is unused productive capacity can be expected to increase the levels of output and employment in the economy because individuals will spend some fraction of the increase in their after-tax income resulting from the tax cut. The equations in the Chase econometric model, for example, suggest that in the first quarter following an increase in after-tax income, about one-third of the additional income will be spent on consumer goods and two-thirds will be saved. After the first year, consumers will be spending about three-mourths of their increased income and saving the remaining one-fourth.

TABLE 4.—EFFECTS OF EXTENDING TAX CUTS—DECONTROL

[Dollar amounts in billions]

Quarter	1975 3rd	1975 4th	1976 1st	1976 2nd	1976 3rd	1976 4th	1977 1st	1977 2nd
Gross national product:								
Current dollars	1,491.9	1,537.3	1,594.7	1,649.6	1,702.5	1,759.4	1,815.9	1,871.9
Change from base case	0	0	2.3	6.3	10.3	13.1	15.5	17.1
Percent change from base case	0	0	.1	.4	.6	.8	.9	.9
Real GNP:								
1958 prices	797.2	806.4	817.2	832.2	844.0	853.9	864.2	873.0
Percent change from previous quarter	7.0	4.6	5.4	7.3	5.7	4.7	4.8	4.1
Percent change from base case	0	0	.2	.4	.6	.7	.8	.8
Unemployment rate:								
Percent	8.4	8.2	8.1	7.6	7.4	7.3	7.3	7.2
Change from base case	0	0	0	−.1	−.2	−.3	−.4	−.5
Consumer price index:								
1967=100	163.0	166.6	170.1	173.1	176.6	180.6	184.3	188.2
Percent change from previous quarter	8.7	8.8	8.5	7.0	8.1	9.1	8.2	8.6
Percent change from base case	0	0	0	0	.1	.2	.3	.4
AA corporate bond rate:								
Percent	9.6	9.8	10.1	10.5	10.8	11.0	11.1	11.5
Change from base case	0	0	0	0	.1	.1	.2	.2

Note: This forecast assumes extension of the 1975 tax cuts, decontrol of old oil prices and enactment of a deregulation tax with tax rebates for individuals.

To the extent that the increased disposable income resulting from the tax cut is spent, still more additional income is created for the workers who are hired to produce the goods and services for which there is increased demand and for the owners of the firms that produce these products. Some of this additional income will be needed to pay income taxes, but some of the increased after-tax income will be spent, leading to further increases in income, and so forth. These secondary increases in income and spending are termed the "multiplier effect." Depending on individuals' propensity to spend and on tax rates, the additional spending and income resulting from a tax reduction may be larger than the size of the tax cut itself. Furthermore, the increase in the Federal deficit resulting from the tax cut is only about two-thirds as large as the tax cut itself, because taxes are paid on the additional income that results from individuals' spending part of their tax cuts.

The additional saving that occurs both out of the tax cut itself and out of the additional income that results from individuals' spending part of their tax cuts is important because it is this saving that provides a flow of funds to finance the increased deficit caused by the tax cut.

There is, however, some tendency for the tax cut to raise interest rates. The individuals who increase their saving as a result of their higher after-tax income will not want to hold all of their additional assets in the form of government securities. In particular they will want to increase their holding of cash and bank deposits. Unless the Federal Reserve System expands bank reserves to accommodate this increased demand for money, interest rates can be expected to rise. Indeed, this appears to be the reason for the rise in Treasury bill rates of 125 basis points (1.25 percentage points) in the last several months.

The beneficial effects of a tax reduction cannot be expected to occur if the economy is at or near full capacity. In this case, the additional demand resulting from the tax cut serves only to push up prices, and since there is no increase in real income from which increased saving can occur, the increased Federal deficit in this case does "crowd out" private borrowing.

In considering the duration of the tax cut, therefore, it is desirable to estimate for how long the economy is likely to be below full capacity. In the second quarter of 1975, real gross national product declined 7½ percent below its peak in the fourth quarter of 1973. Industrial production declined by 13 percent. 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 was 14 percent below capacity in the second quarter of 1975. Even if the low growth rate in capacity of 2 percent is assumed, the economy was over 10 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 1982. Under the more conservative assumption of 2 percent annual growth in capacity, a recovery at 6 percent per year will not lead the economy to full employment until 1978. Unless the recovery is unexpectedly strong and capacity is growing very slowly, then, the economic outlook appears to be for a prolonged period of excess capacity in the economy, suggesting that some economic stimulus will be needed for several years.

EFFECTS OF ENLARGING THE TAX CUTS

To prevent an increase in withholding taxes on January 1, 1976, it would be necessary to increase the individual tax reductions by $4 billion. To examine the effects of enlarging the tax cuts, the staff worked through the Chase model under the assumption of an additional tax cut of $4.4 billion, which would raise the overall tax reduction (including the tax reductions for small corporations) to $15 billion for 1976.

The effects of enlarging the tax cuts under the assumption of phased decontrol are shown in table 5. The model predicts a vigorous recovery through all of 1976, with the unemployment rate falling to 7.0 percent. The recovery still tends to lose momentum in early 1977, but the results appear satisfactory for 1976. The enlargement of the tax cut, according to the model, adds $8 billion to GNP by mid-1977 and reduces the unemployment rate by 0.2 percent at that time, relative to a simple extension of the tax cuts. There is a slight increase in consumer prices (0.2 percent over one and one-half years) and a slight rise in interest rates.

Table 6 shows the effect of enlarging the tax cut if there is decontrol and a deregulation profits tax. The effects of the enlarged tax cut are approximately the same as in the case of phased decontrol. The unemployment rate falls to 7.0 percent by mid-1977, and gross national product is higher by $8 billion.

TABLE 5.—EFFECTS OF ENLARGING TAX CUTS—PHASED DECONTROL

[Dollar amounts in billions]

Quarter	1975 3d	1975 4th	1976 1st	1976 2d	1976 3d	1976 4th	1977 1st	1977 2d
Gross national product:								
Current dollars	1,491.6	1,537.4	1,589.0	1,645.6	1,700.1	1,758.3	1,817.2	1,869.8
Change from extending tax cuts	0	0	0	2.2	4.3	6.1	7.4	8.1
Percent change from extending tax cuts	0	0	0	.1	.3	.4	.4	.4
Real GNP:								
1958 prices	797.2	806.4	821.1	837.5	850.3	861.2	869.4	876.3
Percent change from previous quarter	6.8	4.7	7.3	8.0	6.1	5.1	3.8	3.2
Percent change from extending tax cuts	0	0	0	.2	.3	.3	.4	.4
Unemployment rate:								
Percent change	8.4	8.2	8.0	7.5	7.2	7.0	7.0	7.0
Change from extending tax cuts	0	0	0	0	−.1	−.2	−.2	−.2
Consumer price index:								
1967=100	163.0	166.6	169.0	171.8	175.2	179.2	183.3	187.3
Percent change from previous quarter	8.7	8.8	5.9	6.7	7.9	8.9	9.3	8.7
Percent change from extending tax cuts	0	0	0	0	0	.0	.1	.1
AA corporate bond rate:								
Percent	9.6	9.8	10.0	10.5	10.7	10.9	11.0	11.4
Change from extending tax cuts	0	0	0	0	0	.1	.1	.1

Note: This forecast assumes an increase in the tax cuts of $4.4 billion, and decontrol of old oil prices over 3 years

TABLE 6.—EFFECTS OF ENLARGING TAX CUTS—DECONTROL

[Dollar amounts in billions]

Quarter	1975 3d	1975 4th	1976 1st	1976 2d	1976 3d	1976 4th	1977 1st	1977 2d
Gross national product:								
Current dollars	$1,491.9	$1,537.3	$1,595.7	$1,652.4	$1,707.3	$1,765.7	$1,823.4	$1,880.0
Change from extending tax cuts	0	0	1.0	2.8	4.7	6.3	7.5	8.1
Percent change from extending tax cuts	0	0	.1	.2	.3	.4	.4	.4
Real GNP:								
1958 prices	797.2	806.4	817.8	833.7	846.3	856.9	867.5	876.3
Percent change from previous quarter	7.0	4.6	5.7	7.8	6.1	5.0	5.0	4.1
Percent change from extending tax cuts	0	0	.1	.2	.3	.4	.4	.4
Unemployment rate:								
Percent	8.4	8.2	8.1	7.6	7.3	7.1	7.1	7.0
Change from extending tax cuts	0	0	0	−.1	−.1	−.2	−.2	−.2
Consumer price index:								
1967=100	163.0	166.6	170.1	173.1	176.6	180.7	184.4	188.4
Percent change from previous quarter	8.7	8.8	8.5	7.0	8.1	9.2	8.3	8.7
Percent change from extending tax cuts	0	0	0	0	0	.1	.1	.1
AA corporate bond rate:								
Percent	9.6	9.8	10.1	10.6	10.9	11.1	11.2	11.6
Change from extending tax cuts	0	0	0	0	.1	.1	.1	.1

Note: This forecast assumes an increase in the tax cut of $4.4 billion, decontrol of old oil prices on Jan. 1, 1976, and enactment of a deregulation profits tax with individual tax rebates.

ANALYSIS OF SPECIFIC TAX REDUCTION PROPOSALS

Increases in the standard deduction

Historically, 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 7 shows both estimated poverty levels for 1975 and 1976 and the tax threshold under various assumptions about the tax law. By itself, the increase in the minimum standard deduction in 1975 was sufficient to raise the tax threshold approximately up to the poverty level for 2- and 3-person families, but not in other cases. Along with the $30 credit, however, the increased minimum standard deduction has raised the 1975 tax threshold above the poverty level for all individuals except single persons. In 1976, the poverty level will increase because of inflation, and while the tax threshold will still exceed the poverty level for 2- and 3-person families, there will be a $300 shortfall for single persons and approximately a $200 gap for 4- and 5-person families, assuming a 7-percent rate of inflation. If the 1975 tax cuts are not extended, the tax threshold will fall significantly below the poverty level for all family sizes.

TABLE 7.—POVERTY LEVELS AND TAX THRESHOLDS

Family size	Poverty levels [1] (estimated)		Tax thresholds		
	1975	1976	In 1975 tax cuts expire	With increase in standard deduction [2]	With increase in standard deduction and $30 credit [3]
1	$2,694	$2,883	$2,050	$2,350	$2,564
2	3,470	3,713	2,800	3,400	3,829
3	4,253	4,551	3,550	4,150	4,793
4	5,442	5,823	4,300	4,750	5,607
5	6,423	6,873	5,050	5,650	6,717
6	7,226	7,732	5,800	6,400	7,667

[1] Staff estimates assuming 8-percent inflation in 1975 and 7 percent in 1976.
[2] An increase in the minimum standard deduction from $1,300 to $1,600 for single returns and $1,900 for joint returns.
[3] An increase in the minimum standard deduction to $1,600 for single returns and $1,900 for joint returns and a $30 tax credit for each taxpayer and dependents.

Increasing the standard deduction also simplifies the tax system by encouraging people not to itemize their deductions. In 1975, approximately 5 million tax returns can be expected to switch to the standard deduction as a result of the increase in it in the Tax Reduction Act.

The Tax Reduction Act, for the first time, made the minimum and maximum standard deduction greater for joint returns than for single returns. In both cases, the increase was $300 greater for joint returns. Such a differentiation helps achieve a more equitable distribution of the tax burden between married couples and single persons in the income ranges where the minimum and maximum standard deductions apply, and it brings the tax threshold into closer correspondence with the poverty level.

$30 Credit

The $30 credit for each taxpayer and for dependents was adopted in conference. The House version of the Tax Reduction Act provided no such credit but instead included a much larger increase in the standard deduction. The Senate deleted the increase in the standard deduction and substituted a $200 tax credit that taxpayers could claim in place of their personal exemptions. The conference, as a compromise, agreed to a smaller increase in the standard deduction and to the $30 credit, which is available in addition to the personal exemption.

There are several essential differences between increases in the standard deduction and a tax credit for personal exemptions, either an optional one as in the Senate bill or an additional one as in the conference report, as alternative ways to reduce taxes. Increasing the standard deduction provides no benefit to those who continue to itemize their deductions, while a credit provides the same benefit to all taxpayers regardless of whether they itemize. Some tilt toward those using the standard deduction is probably appropriate, since inflation has eroded the value of the minimum and maximum standard deductions while itemized deductions have been free to rise; but in other respects both types of taxpayers have been adversely affected by inflation, since the real value of both the personal exemption and the rate brackets has also been reduced by inflation. The compromise reached in conference, then, which provides some increase for both those on the standard deduction and for itemizers but a smaller increase for itemizers, is consistent with the way inflation has increased the tax burden of each group.

The increases in the standard deduction and the credit also have different effects on the tax burdens of families with different numbers of dependents. The benefit from the increase in the percentage standard deduction from 15 to 16 percent is the same regardless of family size, while the benefit from the increases in the minimum and maximum standard deductions in the Tax Reduction Act are the same for every joint return regardless of the number of dependents. In contrast, the tax benefit from the $30 credit increases proportionately as family size increases. An optional credit, like the one passed by the Senate, or an additional credit much larger than $30 would lead to what some observers think are excessive tax differentials between families depending on their size.

A third major difference is that increasing the standard deduction simplifies the tax law by inducing taxpayers to switch to the standard deduction, while a credit, especially the optional credit passed by the Senate, complicates it. Virtually any distribution of the tax burden between families with different incomes, with different sizes and with different amounts of itemized deductions can be achieved, at least approximately, by making the appropriate changes in the personal exemption, the standard deduction and the rate brackets, features of the tax system that are already reasonably well understood by the public. A credit, then, achieves little that cannot be done with existing tools.

Precisely because the credit is a new feature of the law, however, it is probably more easily understood by the public as a temporary measure to stimulate the economy rather than a permanent feature of the tax system.

Earned income credit

The earned income credit provides more benefit to low-income families than any other feature of the Tax Reduction Act because it is refundable: that is, not limited to tax liability. The entire benefit from the credit goes to families whose incomes are less than $8,000.

Some commentators have termed the earned income credit a "negative income tax" and judge it on the basis. Under a negative income tax, families would be guaranteed a certain level of income from the government, and their payment would decline by some amount (such as 50 cents) for each dollar of income they receive. There is no income guarantee under the earned income credit, and for families with earnings below $4,000 the credit increases as earnings rise (since the credit is 10 percent of earnings up to $4,000). In the income range over which the credit phases out (between $4,000 and $8,000), however, it does behave like a negative income tax and decline as income rises.

Because the credit increases as earnings increase for families with earnings below $4,000, the credit encourages work by those families.[1] However, the phaseout of the credit for those with incomes between $4,000 and $8,000 discourages work effort by that group, so it is not clear that the earned income credit increases the overall supply of labor.

Credit for home purchases

The Senate version of the Tax Reduction Act included a 5-percent credit on the purchase of a new principal residence, with a maximum credit of $2,000. In conference, this was amended to apply only to the existing inventory of homes and not to homes whose construction began after March 1975. The rationale for this limitation was that the banking committees were working on an emergency housing bill that would apply to homes constructed after March 1975. The bill containing this program, however, was vetoed by President Ford, and Congress sustained the veto.

One of the problems with the housing credit is that since it applies to owner-occupied homes but not to rental housing, it aggravates the existing tax preferences given homeowners *vis-a-vis* renters. This problem is especially important this year, since the recent decline in housing starts has centered disproportionately on units built for rental. Also, since new homes are purchased mainly by high-income families, they tend to receive a disproportionately large share of the benefit from the credit. However, sales of used homes by those buying new homes in response to the credit do tend to drive down the price of used homes, so that some of the benefit of the credit goes to lower-income people. but it is not clear how strong this effect really is.

Ways of enlarging the tax cut

To prevent an increase in withholding taxes on January 1, 1976, it is necessary to increase the size of the tax cut by $4 billion. This could be done by increasing the $30 credit to $50, by further increasing the standard deduction or by a combination of both proposals.

[1] The effect of the credit in encouraging work effort by those with low earnings is diluted by the interaction of the credit with payments provided by Aid to Families With Dependent Children (AFDC). Under existing law, AFDC payments can be reduced by 66⅔ cents for each dollar of earnings and by 100 percent of unearned income, and the earned income credit is counted as income for this purpose. Thus, for many families a decline in AFDC payments will offset part or all of their earned income credit. Also, some States are counting the credit as a resource for determining eligibility for AFDC and other programs, which could mean that recipients of the credit will be disqualified from these programs during the month in which they receive their refund from the credit.

Alternatively, there could be a tax credit equal to some fraction of taxable income. A credit of 1 percent of taxable income would involve a revenue loss of $5.9 billion, and a $4 billion reduction would mean a credit of ⅔ of one percent of taxable income. This would be a more explicit temporary tax reduction than an increase in the standard deduction. There could also be a tax credit equal to some fraction of tax liability. This would provide a larger reduction for upper-income taxpayers than a credit based on taxable income.

ALTERNATIVE PROPOSALS

1975 Tax Reduction Act

The Act raised the minimum standard deduction from $1,300 to $1,600 for single persons and to $1,900 for joint returns. It also increased the percentage standard deduction from a rate of 15 percent to 16 percent and the maximum standard deduction from $2,000 to $2,300 for single persons and to $2,600 for joint returns. In addition, the Act provided a tax credit, in addition to the personal exemption, of $30 for each taxpayer, spouse, and dependent. There was also provided a refundable earned income tax credit of 10 percent of earned income up to a maximum of $400, with the amount phased down to zero as adjusted gross income increases from $4,000 to $8,000. All of these individual tax reductions apply only to 1975.

Mr. Ullman

As one possible alternative he would make permanent the individual tax reductions made by the standard deduction revisions and continue for 1976 the $30 credit.

If the committee concludes that there should not be an increase in withholding rates in 1976, he would provide a tax credit equal to a percentage of taxable income but with a ceiling. This could be in addition to the $30 credit, or the two credits could be combined.

Mr. Corman

He suggests that the committee consider substituting a tax credit for the deduction for the personal exemption.

Messrs. Corman, Karth and Rangel

In the case of the earned income credit provided in the Tax Reduction Act of 1975, the proposal would provide a disregard of the credit (similar to the disregard language applied to the 1974 tax refund) for purposes of determining eligibility for other programs.

Mr. Stark and Mrs. Keys

The proposal would make the individual tax reductions permanent with the following modification: the $30 tax credit for each personal exemption should be deleted and substituted in lieu would be a tax credit for the personal exemption. For each year between 1976 and 1981, the credit would be increased by $50 and the exemption decreased by $150 so that, by 1981, only a credit of $250 per exemption would be available for all taxpayers.

Mr. Crane

The proposal would provide adjustments for the personal income tax brackets, the low income allowance and the standard deduction at the rate of inflation (H.R. 1817).