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TAX REDUCTION PROGRAM

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BUSINESS TAX REDUCTIONS

PREPARED FOR THE

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I. PRESENT LAW

A. WIN Tax Credit

The only tax provision in present law specifically designed to stimulate increased employment is the work incentive credit (WIN) and the associated welfare recipient tax credit. Under the WIN credit rules, employers can receive a tax credit equal to 20 percent of the wages paid during the first 12 months of employment to AFDC recipients or to those certified under the WIN program. The amount of the credit available to any employer is limited to $50,000 of tax liability plus one-half of tax liability in excess of $50,000. The WIN credit is generally not available if the employment is terminated without cause within a certain period (generally six months) after the employment starts.

Three changes, designed to encourage employers to participate in the WIN program, were made by the Tax Reform Act of 1976. First, the limitation based on tax liability was increased from the previous $25,000 of tax plus one-half the excess. Second, the period an employee must be retained for the credit to be available was reduced from 2 years to 180 days. Third, an exception to this retention rule was provided if dismissal results from a substantial reduction in business.

B. Investment Tax Credit

The investment tax credit now is 10 percent of the cost of qualified equipment. The Tax Reduction Act of 1975 and the Tax Reform Act of 1976 increased the rate of the investment credit from 7 percent to 10 percent (from 4 percent for public utilities) through 1980. The credit is allowed when the taxpayer places in service qualified equipment with a useful life of at least 3 years. Equipment with a useful life of 3 or 4 years receives one-third the credit and equipment with a useful life of 5 or 6 years receives two-thirds the credit. Used property qualifies for the credit, but the amount of qualifying property is limited to $100,000 (increased from $50,000 in the 1975 tax reductions). Generally, equipment becomes eligible for the credit when it is placed in service. For equipment with a normal construction period of 2 years or more, however, the credit is available as progress payments are made; this provision is being phased in between 1975 and 1979 and was part of the Tax Reduction Act of 1975.

In any taxable year, the credit is generally limited to $25,000 plus one-half of tax liability above that amount. Utilities, however, in the 1975 tax reduction, were allowed a 100-percent limitation for 1975 and 1976 with a phasedown by 10 percentage points a year to 50 percent by 1981; railroads and airlines, in the 1976 Act, were allowed the 100-percent limitation for 1977 and 1978 followed by a phasedown of 10 percentage points a year to 50 percent in 1983. For all businesses, unused credits may be carried back 3 years and carried forward 7 years, subject to the limitations applicable in those years. Unused credits from prior years are to be used before credits earned in later years.

An additional one percentage point of credit is allowed if that amount is placed in an employee stock ownership plan (ESOP), a provision enacted in the Tax Reduction Act and extended through 1980 in the Tax Reform Act of 1976. (In the 1976 Act, an additional one-half percentage point of investment credit was provided if both the employer and employee put that amount into an ESOP.)

C. Corporate Tax Rates

Before 1975, the initial $25,000 of corporate taxable income was taxed at a 22-percent rate, while income in excess of that amount (the surtax exemption) was taxed at a 48-percent rate. Tax legislation enacted in 1975 and 1976 increased the surtax exemption to $50,000 for 1975 through 1977 and the tax rate on the initial $25,000 of corporate income was reduced from 22 percent to 20 percent. Thus, the new corporate rate structure is 20 percent on the first $25,000 of corporate taxable income, 22 percent on the next $25,000, and 48 percent on taxable income above $50,000. The revenue loss was $1.5 billion in fiscal year 1975, and it will increase to $1.8 billion in fiscal year 1978.

D. Payroll Taxes

The payroll tax for social security and hospital insurance purposes in 1977 is 11.7 percent of the first $16,500 of each employee's wage or salary income. The employer and the employee contribute equal shares of 5.85 percent. Self-employed persons generally pay a tax of 7.9 percent of the first $16,500 of their self-employment income. The taxable wage base is increased annually in order to finance increases in social security benefits required by law to offset annual increases in the cost of living. Also, the tax rates are scheduled under present law to increase in 1978, 1981, and 1986.

Almost every kind of employment providing wages, salaries, or earnings from self-employment is covered by the social security payroll tax (FICA or SETA) or a similar tax for railroads. In some occupations, such as household work or farm employment, workers are covered only if certain conditions, usually minimum earnings requirements, are met.

II. HOUSE BILL—NEW JOBS TAX CREDIT

A. General

The House bill would provide employers with an income tax credit of 40 percent of the first $4,200 of wages paid to each additional employee in 1977 and 1978. Generally, the maximum credit allowed for adding one new employee would be $1,680 (40 percent of $4,200). The maximum total credit for any employer or taxpayer would be limited to $40,000.

For 1977, the bill provides that the credit would be equal to 40 percent of the increase in the employer's 1977 unemployment insurance wages over 103 percent of 1976 unemployment insurance wages. For most employers, "unemployment insurance wages" for 1976 and 1977 are the wages reported by the employer for Federal unemployment insurance (FUTA) purposes. For 1978, the credit would be 40 percent of the increase in 1978 unemployment insurance wages (up to $4,200 per employee) over 103 percent of 1977 unemployment insurance wages.[1]

In both 1977 and 1978 a "cap" would be placed on the credit. The cap would be equal to 40 percent of the increase in total wages (unemployment insurance wages without any dollar limit) for the year over 103 percent of total wages for the preceding year.

Generally, the bill limits the credit available to any taxpayer to $40,000 for any calendar year. In addition, the credit for any employer that is not a taxpayer (such as a partnership) is limited to $40,000 for any calendar year. An employer could qualify for both the new jobs tax credit and the WIN credit.

B. Additional Credit for Handicapped Employees

Under the bill, an employer would receive a supplemental credit for additional wages paid to handicapped employees in 1977 and 1978. This supplemental credit for 1977 would be 10 percent of the increase in unemployment insurance wages (up to $4,200 for any one employee) paid to handicapped employees in 1977 over 103 percent of the unemployment insurance wages paid to the handicapped employees in 1976. A total wage limitation would apply to the 10-percent credit as it would to the 40-percent credit; that is, the credit could not exceed 10 percent of the increase in 1977 total wages paid to handicapped employees over 103 percent of the 1976 total wages paid to handicapped employees. The 1978 10-percent credit computation would be the same as that for the 1977 10-percent credit, except that it would be based on 1978 increases over 1977 levels. The credit for handicapped employees would be allowed only to the extent the employer otherwise qualifies for the 40-percent credit in the year. The 10-per-

[1] For 1976 and 1977, FUTA wages are limited to the first $4,200 of wages paid to an employee; for 1978, the limit increases to $6,000.

cent credit would be allowed without regard to the $40,000 overall credit limitation.

The credit would be given for hiring handicapped persons who have been referred to the employer during or upon completion of an individualized written rehabilitation plan under a State plan for vocational services approved under the Vocational Rehabilitation Act. The bill defines a handicapped person as an individual who has a physical or mental disability which results in a substantial handicap to that person's employment.

C. Eligible Employees and Employers

The bill does not allow a credit for an employee's wages unless more than half of the employee's wages are for services in the employer's trade or business. The bill excludes, for example, household employees, such as maids, chauffeurs, and gardeners. Also, the credit would apply only if more than half of the employee's wages are for employment within the United States (that is, the 50 States and the District of Columbia).

Generally, agricultural employers will not be covered by the FUTA system until 1978. In order to make the credit available to them, the bill provides that farmers would determine unemployment insurance wages for 1976, 1977, and 1978, on the basis of their social security tax (FICA) records, counting wages up to $4,200 (rather than the higher FICA limits) for each employee.

Under the bill, railroad employers would use seven-eighths of their Railroad Unemployment Insurance Act (RUIA) wage base in lieu of the FUTA wage base. The RUIA system is based on wages up to $400 per month ($4,800 annually). The seven-eighths ($4,200/$4,800) computation is designed to equate RUIA wages with FUTA.

The bill would exclude employees who are not covered under the FUTA system and who are not farm or railroad employees. Accordingly, the credit would not be provided with respect to self-employed persons, employees of employers who are excluded under the FUTA minimums, and certain persons in the fishing industry.[2] The bill also provides that employees of governments and tax-exempt organizations do not qualify for the credit regardless of any other provision.

If any employee is fired and replaced with another employee in order to earn a new jobs tax credit, the bill provides that the employer would lose twice the amount of credit the employer attempted to gain. For example, if an employer dismisses an employee in June 1977, after the employee had been paid $4,200 for the year, and replaces that employee with another employee who is paid $4,200 for 1977 (to obtain a $1,680 credit), the employer's new jobs tax credit would be reduced by up to $3,360 (but not below zero).[3]

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[2] An employer is not liable for FUTA taxes for a calendar year unless (1) wages of at least $1,500 are paid during any calendar quarter in that calendar year or the preceding calendar year or (2) the employer employed at least one person on each of 20 days (each in a different week) during that calendar year or the preceding calendar year (sec. 3306(a) of the Code).

Wages for persons employed in fishing are excluded from FUTA unless they are working on a vessel of more than 10 tons or unless the service is in connection with commercial salmon or halibut fishing (sec. 3306(c)(17) of the Code).

[3] The exact amount of the reduction would depend upon the total new jobs tax credit the employer otherwise would have been allowed.

D. Business Changes, Controlled Groups, and Other Special Rules

The bill includes special provisions under which a change in the form of a business or a change in ownership of a business would not artificially create a new jobs tax credit.

Generally, all employees of all corporations that are members of a "controlled group of corporations" would be treated as if they were employees of the same corporation. The controlled group provisions would prevent arbitrary results under the credit rules where a business is operated by two or more related companies instead of one company Generally, under the controlled group rules, the credit allowed the group would be the same as if the group were merged into a single company

A comparable rule would be provided in the case of partnerships, proprietorships, and other trades or businesses (whether or not incorporated) which are under common control (as determined under regulations), so that all employees of such organizations generally would be treated as if they were employed by a single person.

The bill also provides that any credit earned by a controlled group would be apportioned to members of the group on the basis of their proportionate contributions to the increase in unemployment insurance wages. The rules for apportioning the credit to partners, shareholders of an electing small business corporation (a subchapter S corporation), or the beneficiaries of a trust or estate are the same as under the investment tax credit. However, the bill limits the credit allowed to a partner, etc., to the proportionate part of the tax for the year attributable to the taxpayer's interest in the particular partnership, etc., from which the credit is derived.

E. Nonrefundability

The bill provides that the new jobs tax credit would be nonrefundable; that is, it could not exceed the taxpayer's income tax liability. Also, the bill provides that the new jobs tax credit would be allowed after all other nonrefundable credits have been allowed.

If, after applying all other nonrefundable credits, a person's remaining tax liability for a year is less than the new jobs tax credit, the excess credit could be carried back 3 years (including carrybacks to years before the enactment of the credit) and carried forward 7 years.

F Revenue Effect

It is estimated that enactment of this provision would reduce budget receipts by $0.7 billion in fiscal year 1977, $2.4 billion in fiscal year 1978, and $1.7 billion in fiscal year 1979.

III. ADMINISTRATION PROPOSAL

The Administration proposes a program of alternative business tax reductions. Each firm or self-employed person would be able to choose between an additional 2 percentage points of investment tax credit (an increase in the present 10 percent credit to 12 percent, plus the additional investment credit for ESOPs) or a refundable income tax credit based on a fraction of social security payroll taxes. (A refundable credit allows refunds of credits in excess of tax liability.) For each employer, the payroll credit would be equal to 4 percent of the employer's share of payroll taxes, which is currently 5.85 percent of taxable payroll. For the self-employed, the payroll credit would be equal to 2 percent of the self-employment payroll tax (currently 7.9 percent). A similar credit would be available to employers covered by the railroad retirement system. The credit for payroll taxes generally would not be available to nonprofit institutions and State and local governments.[4]

The effective date for both the additional investment tax credit and the payroll tax credit would be January 1, 1977; and both credits would be available through 1980. The alternative selected for 1977 by each taxpayer would be binding for all years through 1980. The reduction in budget receipts is estimated to be $0.9 billion in fiscal year 1977 and $2.4 billion in fiscal year 1978.

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[4] As first presented, the Administration proposal would have made the payroll credit available to nonprofit institutions and State and local governments.

IV. STAFF ANALYSIS

A. Administration Proposal

Investment tax credit

The investment tax credit has been previously used, in 1962, 1966, 1967, 1969, 1971, and 1975, to affect the level of economic activity. Firms which do a large portion of the nation's investing have received substantial benefit from this provision, and it has wide support among businesses. Many in the business community support various changes in business taxes to stimulate capital formation, such as integration of individual and corporate income taxes, general corporate rate reduction, and changes in depreciation rates. Consideration of such wide-ranging changes in the present bill, however, may not be appropriate because its purpose is to provide a quick economic stimulus.

The additional 2-percent investment credit is intended to make business more willing to make investments in equipment since, in effect, the credit lowers the cost of capital to business. Because the credit is received by the time the equipment is placed in service, many consider it more effective as an investment incentive, since businesses earn the amount of the tax incentive at the same time as or shortly after the outlay is incurred.

The investment credit was increased from 7 percent to 10 percent in 1975 in order to stimulate investment and speed the recovery from the recession which reached its depths in the first quarter of 1975. Investment in producers durable equipment (the type of investment most directly affected by the investment tax credit) fell from a high of $88.9 billion in the first quarter of 1974 (in seasonally adjusted annual rates, in terms of constant 1972 prices) to $73.5 billion in the third quarter of 1975. Investment did rise, however, to $79.2 and $78.8 billion, respectively, in the third and fourth quarters of 1976. Rates of capacity utilization in manufacturing as measured independently by the Federal Reserve Board, the Department of Commerce, and the Wharton Econometric Forecasting Associates show a similar pattern.

In view of the sluggish response by investors to the 43-percent increase (150-percent increase in the case of utilities) in the investment credit two years ago, some observers question whether a two-percentage-point increase in the credit would provide the stimulus needed by the business community. Others maintain that this present sluggishness in the economy is precisely the reason why the increase is necessary.

To the extent that increasing the investment credit at this time would stimulate investment, it is not clear that the increase would occur in those periods when the economy would benefit most. Because of the long lead time often required to plan major new projects, much of the investment stimulated by the proposed increase in the investment credit may not occur for 3 or 4 years. In addition, the fact that under the Administration proposal the additional investment credit would be available over a 4-year period means that no immediate incentive would be provided for a speedup of investment projects which businesses have already planned for the late 1970s.

Concern has also been expressed that many firms are not in a position to benefit fully from the present investment credit as qualified property is placed in service. The limitation on the investment credit which can be used in any taxable year is 50 percent of tax liability above $25,000. The continued recession has reduced profits and tax liability leaving less tax liability available to be offset in terms of dollars, even though the percentage limit has not changed. Still other firms—including leasing companies—continue to be highly profitable, but they have earned sufficient investment credit that they are not in a tax position to use all the credits they earn each year.

On the other hand, to the extent that increases in the investment credit do provide an effective incentive, the long-run growth of the economy is clearly aided. Increased investment can result in greater worker productivity and a higher level of output of goods and services than would otherwise be the case at times when the economy reaches full employment.

Payroll tax credit

This is a new proposal that has no precedent in tax law. Business firms which tend to use relatively more labor than capital, a category which includes many small businesses, would receive little benefit from the additional 2 percentage points of the investment credit and instead could be expected to elect the FICA payroll tax credit. This credit therefore would increase the cash flow of these firms, returning to them resources with which they may increase investment in equipment or goods, or employment, or they may lower prices.

It should be noted that this credit would be a very small fraction (0.23 percent) of taxable wages, and an even smaller proportion of total wages or total costs. Thus, the credit would not appear to be a significant incentive for expanding employment. Rather, it should be viewed as providing employers some temporary income tax relief from the costs of social security taxes.

It should be further noted, however, that since this credit is refundable (that is, businesses could receive a credit in excess of tax liability), it would benefit businesses even where they were in a nonprofitable situation or where businesses are at their maximum level of benefit from the investment credit and therefore could take no further advantage of any increase in the investment tax credit. It should also be pointed out that those who are concerned about businesses who are not profitable or who are at the maximum levels of certain tax incentives are advocating refundable credits generally. However, they would prefer a refundable credit in the case of other tax incentives rather than the refundable payroll tax credit. The discussion of a proposed refundable investment credit is set forth in part VI below.

Elective aspect of proposal

Employers would have to make a binding choice of either the additional investment tax or the payroll tax credit on the basis of their forecasts of their own investment needs, employment levels, and wage rates over the next four years. Trade and service firms (which are particularly labor intensive) and new establishments (which have little or no tax liability) may be the ones most likely to elect the payroll tax credit. It has been recommended that an annual election be substituted for the four-year binding election. However, this would encourage "bunching" of investments in certain years; firms could concentrate investments in one year and shift to the payroll tax credit in the following year.

Although the elective nature of this proposal has the advantage that it channels more tax relief to labor-intensive firms than would be true if only the investment credit would be available, the idea of an election has two disadvantages. First, an election of this type requires a business to forecast its future needs during the current period, making an election that is binding, and to stay with its choice even though its forecast proves to be erroneous. This makes decision-making more difficult and hazardous for the taxpayer. Second, by not providing an equal investment stimulus to all firms, the proposal may adversely affect the allocation of resources between capital-intensive and labor-intensive sectors. These disadvantages would become less important if the proposal were to apply for fewer than four years.

B. House Bill

The House concluded that the Administration's business tax proposal would provide little direct impetus for job creation and that neither of its alternatives would provide any real economic stimulus in the business sector. Consequently, the House included a temporary tax credit aimed at increases in employment generally.

By limiting the credit to increases in employment the House believes that the bill provides a substantial incentive to hire new workers for a relatively modest revenue cost. The inflation of the prior year's FUTA base by 3 percent prevents many firms from receiving the credit for a portion of the normal growth in their wages and employment. A credit of $1,680 per year (40 percent of the first $4,200 in wages paid to additional employees) is approximately 13 percent of the total annual compensation of average full-time employees in the private sector and an even larger proportion of the cost after ordinary tax deductions are taken. The incentive to hire disadvantaged workers, whose compensation tends to be lower than average, will be even more substantial.

The clearly temporary nature of this provision is designed to make the employer's response an immediate one. Firms can take the opportunity to hire additional workers who can be employed to build up inventories to meet the increased sales which would be induced by other parts of this bill. Farms with order backlogs, firms which may have deferred general maintenance activities because of the recession, and firms which may wish to increase the quality of their goods or services will have an incentive to add workers to their payrolls immediately.

The House provided a $40,000 overall limit on the credit. The limitation furthers the policy of focusing the stimulative impact of the credit on small businesses. In fact, fewer than 1 percent of employers (including unicorporated employers) will probably be affected by the $40,000 limitation. On the other hand, because large employers are eligible for a credit for only 24 additional employees, the limitation effectively eliminates the stimulus for employers of over 30 percent of the workforce.

If the committee is interested in adopting some form of a credit for new jobs, using the FUTA-based approach of the House bill has several advantages. The credit can be easily administered by employers and the government. For the vast majority of businesses, this provision will require no additional recordkeeping, tracing of employees, or extensive searching through old records; they will use records already maintained in order to file required FUTA returns. Thus, employers can easily understand their status with respect to this credit. In the interest of simplicity, no records of employee hours, no distinctions between part-time and full-time employees, and no tabulations of new employees (other than handicapped employees, for whom a special credit is provided) are necessary. The 103 percent increase over the previous year's wages attempts to prevent employers from benefitting from conversion of existing full year, full-time jobs into new part-year, part-time jobs. If the committee desires to go further to prevent this conversion, a somewhat higher cap (for example, 105 percent) could be adopted.

A new jobs tax credit based on FUTA wages is intended to be an incentive for new hiring. But it also provides a benefit for increasing wages of existing employees who earn less than the FUTA wage base. Employees who earn less than $4,200 from any one employer include part-time and seasonal employees and those changing jobs during the year.

An argument against any general new jobs tax credit, including that adopted by the House, is that increases in employment by individual employers for which credits would be given do not necessarily result in corresponding increases in total U.S. employment. For example, shifts in employment among firms which do not produce an increase in total U.S. employment may occur if individual employers are given an incentive to produce for themselves goods or services that formerly were supplied by outside firms.

Firms which have steady or declining employment would receive no credit under the House bill. These firms may be concentrated in particular industries or particular regions. However, during a period of expanding employment, such as 1977–78, it is likely that few States will have absolute declines in private employment (and even these States may contain substantial numbers of growing firms). Nonetheless, it should be kept in mind that an analysis fo this question cannot be performed simply by making projections of a State's total employment. Employment of establishments and subsidiaries of large national firms (which would receive little benefit from the credit under the House bill) would have to be excluded from such projections in order to determine whether this provision has a disproportionate regional impact.

A disadvantage of the FUTA-based credit may be that it could create incentives for new employment to take the form of part-time or part-year jobs, since wages above $4,200 for an employee are not eligible for the credit. Many of those who currently hold part-time jobs are not the primary wage earners in their families. It should be noted, however, that filling employment needs with other than full-time workers necessitates additional costs for recruiting, screening, training, and supervision.

Also, the potential for abnormal expansion of part-time and seasonal work depends on the number of workers who normally would be expected to earn substantially more than $4,200 per year from any one employer. Because there are normally a substantial number of employees who work part-time or only part of the year for any one employer, the average employer may pay as many as one-third of his or her employees less than $4,200 during the year, and as many as half may pay less than $6,500. Thus, the potential for distortion toward new part-time employment is limited to jobs which are relatively high paying or have little turnover, and these are generally the same jobs for which the costs of hiring, screening, training, and supervision make part-time or part-year employment most disadvantageous.

The total wage cap used in the House bill is designed to reduce the incentive to split full-time into part-time positions. At the same time, however, it does not allow an employer to receive credit for new employees who replace the overtime work performed by existing employees, since this could reduce the total wage bill. Employers already have a substantial incentive to reduce overtime, however, since most workers are paid at least 50 percent more for overtime hours than for straight-time hours.

The House bill also has been criticized because it offers the potential for some taxpayers to receive more than 100 percent of an employee's wages in deductions and credits. This problem can be eliminated by a modification of the bill providing for a reduction of the deduction for wages. (See discussion on "*Reduction of Wage Deduction*" in the section on possible House bill modifications, below.)

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V. ALTERNATIVES AND POSSIBLE MODIFICATIONS TO THE JOBS TAX CREDIT

A. Alternative Jobs Credit Proposals

Several other types of new jobs tax credit programs have been proposed; some focus on targeting the credit to certain groups of employees, some use methods other than FUTA to determine increases in employment, and some relate the availability of the credit to nationwide unemployment patterns at any given time. Specific provisions of these alternatives also include various kinds of limits on the credit, directing it to small businesses in some cases.

Targeted proposals

The targeted proposals would give the credit only for the hiring of certain persons, or would give an increased credit for hiring these persons. These various proposals are directed to such groups as those who have been unemployed for substantial periods of time (for example, 15 weeks or 26 weeks), of those who are under age 22, over age 54, or members of minority groups.

The major advantage of a targeted new jobs credit is that it would direct the credit toward people who are the most difficult to employ. By encouraging the employment of persons who might not otherwise be hired, the credit would also be less likely to be given for normal growth in employment. The primary disadvantage of a targeted proposal is difficulty of administration both for the taxpayer and for the Internal Revenue Service. Also, such targeting is apt to give rise to complaints of discrimination if it is effective in terms of persuading employers to prefer some applicants over others for reasons that are not related to job qualifications.

Most versions of targeting the credit to long-term unemployment also require a certification procedure, which may be especially complex for unemployed people (such as new labor force entrants) who are not currently drawing unemployment benefits. The experience of the Federal government with the WIN program suggests that certification may be an impediment to use of this program. In the case of targeting toward employees above or below a certain age, for example, the employer would have to identify those persons and certify their eligibility. In addition, if the target group is large, the credit could lead to the displacement of existing employees. Consequently, while this type of program may be desirable as a means of combatting longer-term structural unemployment, it is less well adapted to encouraging broad-based increases in employment over the next two years.

Methods of determining credit base

The House bill uses an annual aggregate FUTA wage base and an aggregate total wage base to determine the employer's credit. The alternative proposals use other methods to compute the credit. Some would require the employer to count hours of employment of new employees or of all employees (or both). Others would require identification of the new employees as such or require tracing of new employees to determine a minimum period of employment. The concept of full-time employees is used in some of the proposals which count the number of these employees. Still other proposals would simply use the average number of individuals employed in a certain period, such as in a calendar quarter. The alternatives that determine the credit as a percentage of employee wages use the full amount of employee wages (rather than the $4,200 FUTA amount).

A credit based on hours could give the employer, for example, a $1-per-hour credit for the first 26 weeks of employment of a new employee in a year. A similar credit of 50 cents per hour could be given for the new employee's second 26 weeks of employment. Some of these proposals provide targeting by requiring that only a person unemployed for at least 26 weeks before being hired by the employer could be considered a new employee.

A credit based on hours of new employees has the advantage of giving the credit only for actual hours worked by new employees. It does not require average increases in employment and is not, therefore, subject to the potential inequities created by using averages. Firms with decreasing employment could use the credit. However, a focus on new employees also results in giving a credit to employers who merely replace existing employees with these new employees, unless another provision is added to prevent this type of job "churning". Such a provision would probably involve the concept of incremental averages.

There are also disadvantages to hour-counting in general. It is difficult to determine, for example, how to count overtime hours, hours of sick leave, annual leave, and administrative leave. In addition, many employees are not now paid in terms of hours (such as salespersons and salaried employees), and the jobs credit would require employers to keep hours records for these employees for the first time. Employers would have to reconstruct records for base periods occurring before passage of the Act. The recordkeeping tasks would be a substantial deterent to immediate use of the program as an incentive to hiring because employers would not be certain of their base period or their current hours totals at any given time. In addition, the recordkeeping would require new monitoring by the Internal Revenue Service and it would require new regulations, which might take a long time to write before the program would be used. These kinds of administrative problems, which many employers are now experiencing under the new pension law, make it unlikely that the method is practical for a two-year program.

As an alternative to a credit based on actual hours of new employees only, a credit has been proposed for the net increase in hours of employees hired in 1977 and 1978 over hours of those hired in 1976 and 1977, respectively, or for the increase in hours of all employees in 1977 and 1978 over the appropriate base year. In addition to the advantages and disadvantages of programs based on hours, discussed above, this type of proposal offers a credit to a business that increases work hours without increasing the number of employees, thereby offering a business tax cut to more employers but giving the credit where no new employees are hired.

Some of the jobs proposals would base the computation of a credit on increases in the number of full-time employees. This method would eliminate the problem of replacing full-time with part-time employees. But, as with the proposals based on hours, the determination of what constitutes full-time employment is administratively difficult. Experience with the new pension law again is indicative of the problems associated with converting part-time work into full-time equivalencies or of counting full-time employees. These concepts are not necessarily used by many employers, and they would require new regulations and the construction and monitoring of new records.

Other proposals would determine the average numbers of persons employed. This method would count all employees, whether full- or part-time or full- or part-year. Unless this concept were further refined to full-time equivalence, it could lead to the splitting of many full-time into part-time positions, to a greater extent than the FUTA based proposal. It would be likely to give some credit where no new employment—and even decreases in employment—existed.

Another possible method to limit the use of part-time or part-year employees to generate credits is a requirement that a new employee be employed a minimum period, such as 60 or 180 days, before the employer is entitled to receive the credit with respect to that employee. This type of limitation may be necessary where the credit is based not on wages (FUTA or total) or on hours, but on numbers of employees. This method has the same administrative disadvantages as does any counting of employees. That is, the employer must identify employees separately and keep new records (particularly if the 60 or 180 days are to be full-time equivalent days of work). Identification of employees is particularly difficult where the credit is allowed only for increases in employment; new employees replacing existing employees would have to be separated from those filling new positions.

As discussed above, some of the new jobs tax credit proposals use wages to compute the credit. Most of these alternatives use the full amount of an employee's wages rather than the $4,200 FUTA amount. These proposals are based on a somewhat different policy than the House bill, because they encourage the hiring of skilled and highly-paid employees as much as, or even more than, the hiring of lower-paid employees. The use of total wages also has the advantage of eliminating job churning problems. On the other hand, these alternatives have a major disadvantage in that unless the only wages used are those of new employees, this kind of proposal could give a credit solely for wage increases.

Coverage for all employees

Included among the alternative proposals is a proposal that would give a credit per hour (for example, $1 per hour) for 20 percent of all hours of all employees, even if the employer has no new or increased employment. This type of credit would therefore be available in some form to all employers. The proposal is based on a different policy assumption than are the others, which give the credit only for increases in hiring. It is thus similar in concept to the Administration's four percent of FICA tax proposal, but is subject to the administra tive problems associated with counting hours, discussed above.

Credit limits

Several of the alternative proposals limit the amount of credit an employer may receive; for example, providing an $80,000 limitation, compared to the House bill's $40,000 limitation. An increase in the total credit limitation makes the program more useful to larger employers. An alternative type of limit, for proposals where numbers of new employees are counted, is on the number of such employees who may be counted (for example, 10 each calendar quarter) or on the maximum dollar amount for each eligible employee (such as $2,000). As discussed above, any counting of employees involves administrative problems.

Keying the credit to unemployment rates

Another aspect of an alternative proposal includes keying the credit to the nationwide unemployment rate. For example, the credit could be applicable in a year in which unemployment is greater than 5 percent for any 3 months, or the base period number of employees could be scaled down (thus increasing the potential credit) if unemployment rises above 6 percent in any year or quarter.

The major advantage to this type of proposal is that greater relief would be automatically provided when unemployment is high and the credit would not be used extensively when unemployment is low. On the other hand, the program would not be predictable for employers (since they would not know their credit base until after the end of the year) which would substantially reduce the incentive impact. This, plus the fact that for employers significantly exceeding their base period number of workers any reduction would be a windfall, means that this aspect of the proposal is more like an automatic business tax cut than an incentive for employment.

B. Possible Modifications to the House Bill

The House Committee on Ways and Means evaluated alternative proposals, such as those discussed above. On balance, that committee decided that the simpler, more predictable FUTA-base proposal would be superior for that committee's goals of quick economic stimulus and a jobs incentive to small business. Several modifications to the House bill that would incorporate other policies have been suggested.

Reduction of wage deduction

The House bill has the potential of giving an employer tax benefits exceeding 100 percent of an employee's wages when one considers the deduction for wages as a business expense in addition to the 40-percent credit. Consequently, it has been suggested that the deduction for an employee's wages be reduced by the amount of the credit received (applying the 100-percent-of-tax limitation on the credit without regard to this reduction, if the credit is not refundable). Such a provision would eliminate any situation where the credit would give an employer an incentive to pay an employee not to work. The reduction in revenue loss attributable to such a reduction of the deduction, if that provision were added to the House bill, is estimated to be approximately $900 million.

Increase in credit percentage

Because a reduction of the wage deduction, discussed above, reduces the effective rate of the credit, the credit percentage could be increased at the same time. An increase to 50 percent would permit a credit with more incentive value, would allow use of the 10-percent additional credit for handicapped employees, and at the same time would not permit an employer to receive more than 100 percent of an employee's wages in tax deductions and credits. A 50-percent credit, with a $50,000 maximum per employer, is estimated to produce a revenue loss of almost $3 billion on a full-year basis as compared to $2.4 billion for the 40 percent credit with its $40,000 maximum. The combined revenue loss of a jobs credit that includes the reduction of the wage deduction and the increase in the percentage of the credit from 40 percent to 50 percent is estimated to be $1.9 billion, if the limitation is increased to $50,000.

Increase in total wage base

Concern has been expressed with the possibility under the House bill of an employer replacing full-time employees with part-time employees. The employer could thereby increase its FUTA base and generate a credit without increasing employment. The total wage cap under the House bill limits such job churning since an employer cannot receive the credit unless the employer's total wages also increase. The total wage cap under the House bill is based on total wages for 1977 in excess of 103 percent of total wages for 1976 (a similar provision applies for 1978 in excess of 1977). The three-percent increment is an attempt to account in part both for normal growth in employment and normal salary increases. A modification that has been suggested to the House bill is an increase in the total wage cap increment from 3 percent to 5 percent. An employer, under such a provision, which did not increase total wages in 1977 by 105 percent over 1976 wages would not be eligible for any 1977 credit.

Decrease in base of FUTA increment

Another modification to the House bill that has been suggested is lowering the 3-percent increment used for the FUTA base. The 3-percent increment is to account for normal employment growth. In fact, few employers precisely average 3 percent, and the increment would make many employers ineligible for the credit. Lowering the increment would thus have the advantage of increasing the number of employers eligible for the credit. However, the rate of the credit would have to be lowered substantially if the revenue cost is to remain constant. For example, if the $40,000 credit limitation were removed and wage deductions were reduced by the amount of the credit, lowering the 103-percent base to 100 percent would require a decreased credit rate from 35 percent to approximately 18 percent; lowering the base to 95 percent would permit a credit rate of only 10 percent.

New businesses

The House bill permits a full credit for new businesses. For example, a business beginning in 1977, which had no FUTA base in 1976, would receive full credit for all of its employees. Some persons have expressed concern that this large credit would provide new businesses with too great a competitive advantage vis-a-vis existing businesses. One modification that could be made to the House bill is a percentage limit on the FUTA-base increase. For example, the increase in 1977 FUTA wages over 1976 FUTA wages could be limited to 50 percent or 33 percent of 1977 FUTA wages. A business beginning in 1977, in that case, would receive only half or one-third the credit for all its employees.

Credit limits

Other modifications could be made in the maximum credit allowable to any one employer to make the credit more of an incentive to larger employers. For example, the total credit limitation could be increased to $50,000 (from the House bill's $40,000). Another suggestion is that some portion of the credit could be permitted beyond a basic $40,000 or $50,000 limit. For example, the bill could provide a total credit ceiling of 40 percent of the first $100,000 of the increased FUTA wages over the base ($40,000 total credit) and of 20 percent on increases beyond $100,000. The 20-percent credit could be allowed with or without a limit. An unlimited extension of half the credit beyond the $40,000 ceiling is estimated to reduce revenue by an additional $800 million. If the ceiling were eliminated completely, the revenue cost of the House bill would increase from $2.4 billion to $4.0 billion annually. If the ceiling were eliminated from the House bill and the deduction for wages paid were reduced (as discussed above), the revenue cost would be $2.6 billion.

Handicapped employees

The House bill provides an additional 10-percent credit for the hiring of additional handicapped employees. The revenue decrease attributable to this extra credit is estimated to be $40 million. Some have argued that, while this type of credit may well be meritorious, it should be considered as part of broader tax reform legislation rather than included in a temporary stimulus package.

An alternative suggestion if some increase in aid to the handicapped is desired is to delete the additional 10-percent credit from the new jobs tax credit and instead to give a credit for accommodative devices for handicapped workers and the removal of barriers. This suggestion would change to a credit the existing accelerated depreciation deduction for removal of architectural and transportation barriers (section 190 of the Code). However, the deduction provision was enacted as part of the Tax Reform Act of 1976, and its effectiveness is as yet not known.

Extension to domestic employees

It has also been suggested that domestic workers (such as maids, housekeepers, and other household employees) should be eligible employees under any new jobs tax credit. The House bill eliminates this significant portion of the workforce from its employment incentive program. If the program were extended to domestic workers, the FICA system could be used to measure increases in employment (because domestic workers are not generally covered by the FUTA system).

The staff understands that many employers of domestic workers may not file the FICA returns required by present law and could thereby obtain the credit improperly. For example, if the credit is extended to domestic workers, an employer who failed to file a FICA return for an employee for 1976 could file a FICA return for the employee for 1977. The employer consequently could improperly claim the credit for the apparent increase in FICA wages and total wages. On the other hand, because the Internal Revenue Service could examine an employer's records for FICA purposes for years before and after the jobs credit year, employers might be reluctant to improperly claim the credit.

Alternatively, an incentive for hiring domestic workers could be provided through another credit program, perhaps by modifying the child care credit or work incentive credit (WIN) to include wages paid to domestic workers.

Refundability

The House bill would provide a 3-year carryback and 7-year carryover for the credit. It does not make the credit refundable; that is, the credit is limited to an employer's tax liability. Some persons have suggested that the credit should be refundable to private employers. A refundable credit would make the incentive more certain. However, no other business tax credits are refundable. Furthermore, there may be budget restrictions in the House on any refundable tax credits for fiscal 1978, because such refundable credits may be considered outlays. Making the House bill credit refundable to private employers is estimated to decrease revenues by about an additional $200 million on a full-year basis.

A refundable credit also could be provided for private tax-exempt institutions. Because these institutions provide a large portion of employment in this country, a refundable credit could give them an incentive to hire more persons. However, these employers do not have Federal FUTA records, and in many cases they do not have FICA records. Consequently, it would be difficult for these employers to reconstruct records to use the $4,200 FUTA-type base, and it would be difficult for the government to check such records. In addition, for many private, tax-exempt institutions, and especially religious institutions, the determination of who is the employer is difficult. This determination is necessary so that shifts of employees between groups (e.g. the rotation of teachers or ministers) do not result in increased credits. This refundable credit also could be subject to a budget restriction in the House.

A question arises in such cases as to whether such an extension of the credit would unfairly discriminate between private tax-exempt colleges and State colleges. Similar problems could arise as to hospitals, museums, libraries, etc. Also constitutional questions may be raised as to such payments to churches, especially with respect to the clergy.

The revenue loss attributable to extending the new jobs tax credit to private, tax-exempt institutions (not merely unrelated trades or businesses) is estimated to be $200 million.

C. Alternative elections of tax credit proposals

The Administration originally proposed an elective, alternative credit, which would give each employee an option of a 2-percent increase in the investment credit (from 10 to 12 percent) or a refundable credit equal to 4 percent of the employer's social security taxes (2 percent of self-employment taxes, in the case of self-employed employers). Some persons have suggested the 2-percent increase in the investment tax credit should be provided as an option for employers. In effect, under this proposal, the new jobs tax credit would be substituted for the social security (and self-employment) tax election in the original Administration proposal.

To maintain the same revenue impact, for example, an alternative 2-percent investment tax credit could be provided with up to a 24 percent new jobs tax credit (instead of the 40 percent credit) with the other features of the House bill. If the reduction of wage deductions (see above, *Reduction of wage deduction*) and a $40,000 ceiling were included in the modification, a maximum 38-percent new jobs tax credit could be provided at the same revenue impact as the House bill. Without any ceiling on the credit for any employer, but with the reduction of wage deductions, the alternative 2-percent investment tax credit could be provided with a 26-percent new jobs tax credit, with the same revenue impact as the House bill.

The business reductions could also be designed to offer an employer three choices: the 2-percent investment tax credit, a new jobs tax credit, or the 4-percent social security (FICA) tax credit described above in the Administration proposal. If the $2.4 billion revenue figure were to be maintained, providing the Administration's two options and new jobs credit option would require that the new jobs credit percentage be decreased substantially, perhaps to 10 or 15 percent; alternatively, a higher percentage could be used for the new jobs tax credit with the investment credit alternative limited to a 1 percent increase. In any case, the complexities of determining which option taxpayers would choose under a three-option election make it difficult to estimate with any precision what the revenue impact of any proposal would be.

Any proposal giving alternatives has the disadvantages associated with any business elections (see above, *IV. A. Staff Analysis of Administration Proposal*, part C). On the other hand, allowing the three alternatives would assure that virtually every business would receive some tax reduction, while at the same time maintaining the job incentive features of the House bill for some employers.

VI. OTHER BUSINESS TAX REDUCTION PROPOSALS

A. Refundable investment tax credit

It has been suggested that investment tax credits earned in excess of 50 percent of tax liability be refunded directly to the taxpayer rather than carried back 3 years and then carried forward 7 years. If first applicable to credits earned in 1977, it is estimated that such a proposal would reduce revenues by $900 million in fiscal year 1977, and $3.5 billion in 1978. Alternatively, it has been suggested that firms be able to sell unutilized credits to other firms not currently affected by the 50-percent limitation.

Those who favor a refundable investment credit argue that the current carryback and carryforward provisions substantially dampen the effectiveness of the credit as an incentive for capital formation. It is argued by others that such a refundable feature would encourage the most inefficient firms, those which are not profitable. to make investment decisions which might otherwise not take place. In this view, a refundable incentive would undercut market discipline and lead to an inefficient allocation of resources.

B. Decreases in corporate tax rates

A general reduction in the normal rate of the corporation income tax has also been proposed as an alternative to the administration's proposal and to the House bill. For example, it would cost $2.6 billion to reduce the normal tax rate by 2 percentage points (that is, to reduce the 20-percent rate on the first $20,000 income to 18 percent; reduce the 22-percent rate on the next $25,000 of income to 20 percent, and reduce the 48-percent rate on income in excess of $50,000 to 46 percent). This type of reduction would increase corporate cash flow, which could be used for increased investment, employment, or dividend payments to shareholders. The tax reduction would not, of course, aid noncorporate businesses. In addition, the tax reduction would not provide an incentive for any specific corporate actions.

VII. EXTENSION OF CERTAIN CORPORATE INCOME TAX REDUCTIONS

A. Present law

Prior to the 1975 Tax Reduction Act, corporate income was subject to a 22-percent normal tax and a 26-percent surtax (for a total tax rate of 48 percent). However, the first $25,000 of corporate income was exempt from the surtax. As a result, the first $25,000 of corporate income was taxed at a 22-percent rate and the income in excess of $25,000 was taxed at a 48-percent rate.

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. This resulted in a 20-percent rate on the first $25,000 of taxable income, a 22-percent rate on the next $25,000 of income, and a 48-percent rate on taxable income in excess of $50,000. These changes were extended by the Revenue Adjustment Act of 1975 through June 30, 1976.

The Tax Reform Act of 1976 extended the reduction in the normal tax rates and the increase in the surtax exemption through December 31, 1977, and applied these changes to mutual insurance companies.

B. House bill

The House bill would extend the reduction in the normal tax rates and the increase in the surtax exemption through December 31, 1978. Thus, the corporate rate structure would continue to be 20 percent on the first $25,000 of corporate taxable income, 22 percent on the next $25,000, and 48 percent on taxable income above $50,000.

This provision of the House bill would reduce budget receipts by $1.0 billion in fiscal year 1978 and $1.3 billion in fiscal year 1979.

C. Administration position

The Administration supports a one-year extension of the 1977 corporate tax reduction provisions.

D. Staff analysis

The temporary changes in the corporate surtax exemption provided by the 1975 Tax Reduction Act were adopted for two reasons; first, to grant tax relief to small businesses which are not likely to derive substantial benefits from the liberalizations in the investment credit in that Act because they are not capital intensive; and second, to provide temporary tax relief to small businesses as part of a program of tax reduction designed to help sustain the economy and promote economic recovery. These reasons for increasing the surtax exemption and lowering the normal corporate tax rate continue to apply in the current economic climate.

APPENDIX: SUMMARY OF SENATE BILLS RELATING TO EMPLOYMENT TAX CREDIT PROPOSALS

S. 149 (Senator Bentsen)—"Unemployment Tax Credit Economic Stabilization Act of 1977"

Where the national unemployment rate exceeds 5 percent for three consecutive months, there would be provided a tax credit equal to 5 percent of the annual average gross earnings for production and non-supervisory workers, as determined by the Bureau of Labor Statistics for each qualifying worker. Employees qualifying for the credit would be those placed on the payroll above the employer's employment base. At 5 percent unemployment, the employment base is the average number of full-time employees for the 12 months preceding the triggering of the credit. As unemployment increases, the employment base is reduced by 5 percent for each 1 percent increase in unemployment. To insure that the credit is available to all employers, credits in excess of tax liability would be refunded to employers.

S. 616 (Senator Dole)—"Employment Credit Act"

Provides a tax credit equal to $1 per hour worked by additional full-time employees. An additional 50 cents per hour credit would be provided for hiring persons who had been unemployed for more than 26 weeks. Additional hours worked and people employed would be those in excess of 1976 levels. A special base for high unemployment regions would be set at 90 percent of 1976 levels. The total tax credit would not exceed 20 percent of the total hours of employment for the calendar year and cannot exceed tax liability for the taxable year. This tax credit would be phased out before January 1, 1980.

S. 680 (Senator Schweiker)—"New Jobs Tax Credit Act"

Provides employers with a tax credit equal to 20 percent of wages paid to youths 21 years of age or under or to persons unemployed for 15 weeks or more who represent additional employees in excess of the average number of individuals employed by the taxpayer during 1976. The maximum credit allowable per employee would be $2,000. If the allowable tax credit exceeds the taxpayer's liability, he would receive a refund equal to the excess of the credit.

S. 731 (Senators Baker, Dole, Curtis, Danforth, Javits, Domenici, Percy, Bellmon, Chaffee, Griffin, Hayakawa, Heinz, Hatch, Lugar, McClure, Schmitt, Schweiker, and Young)—"Jobs Tax Credit"

Provides tax credit equal to $1 per hour worked by additional employees for the first 26 weeks of employment and 50 cents per hour worked for the second 26 weeks of employment. This credit would apply to new employees who were unemployed for more than 26 consecutive weeks immediately preceding their employment by the taxpayer. New employees are those individuals who were not employed by the taxpayer prior to January 1, 1977. No credit would be allowed where the employment of a new employee replaces any other individual from employment with the taxpayer. The amount of the credit may not exceed the taxpayer's liability for the taxable year. A three-year carryback and seven-year carryforward of excess credits is provided. No credits could be carried back, however, to taxable years ending before December 31, 1976.

S. 841 (Senator Matsunaga)—"The Small Business Employment Tax Credit Act of 1977"

Provides for an employment tax credit equal to 50 percent of the wages paid to additional employees. The credit would be limited to 10 new employees or less and to a maximum of $80,000 per year. Special provision is made for the hiring of unemployed persons who are under 21 years of age, Vietnam War veterans, individuals who have been unemployed for 15 weeks or longer, individuals 55 years of age or older, women or members of minority groups, and handicapped individuals. If the tax credit for new employees exceeds tax liability, the employer will be entitled to a tax refund. This credit would not be available after 1981.

S. 504 (Senator McClure)—"Jobs Creation Act of 1977"

Provides a permanent reduction in individual income-tax rates; allows an exclusion from gross income for qualified additional savings and investments of up to $1,000 per year ($2,000 for a married couple filing a joint return); allows a deduction for dividends paid by domestic corporations; increases the corporate surtax exemption to $100,000 and sets the corporate normal tax rate on the first $100,000 of taxable income at 20 percent; and revises the allowance for depreciation by permitting capital recovery allowances to be computed with reference to price adjustment increases for each taxable year.

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