

TAX REDUCTION PROGRAM

4

BUSINESS TAX REDUCTIONS

PREPARED FOR THE
COMMITTEE ON WAYS AND MEANS
BY THE STAFF OF THE
JOINT COMMITTEE ON TAXATION



FEBRUARY 14, 1977

U.S. GOVERNMENT PRINTING OFFICE

CONTENTS

	Page
I. Present Law-----	1
A. Investment Tax Credit-----	1
B. Corporate Tax Rates-----	1
C. Payroll Taxes-----	2
D. WIN Credit-----	2
II. Administration Proposal-----	2
III. Staff Analysis of Administration Proposal-----	3
A. Investment Tax Credit-----	3
B. Payroll Tax Credit-----	3
C. Elective Aspect of Proposal-----	4
IV. Tax Credits for New Employment-----	4
A. Proposals-----	4
B. Staff Analysis-----	5
V. Extension of Increases in Corporate Surtax Exemption--	7

I. PRESENT LAW

A. 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 depreciable property with a useful life of at least 3 years. Property with a useful life of 3 or 4 years receives one-third the credit, and property 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, property becomes eligible for the credit when it is placed in service. For property with an annual 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. (In the Tax Reform Act, an additional one-half percentage point of investment credit was provided if both the employer and employee put that amount into an ESOP.)

B. 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.

C. Payroll taxes

The payroll tax for Social Security and Medicare 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 pay 7.9 percent of their self-employment income on the first \$16,500 of their earnings. 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.

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

D. WIN credit

The only tax provision in current law designed to stimulate increased employment is the WIN (work incentive) credit. Under this provision, 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 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. Very few employers have made use of these provisions for several reasons: lack of knowledge, low availability of qualified workers among the target population, and strict "recapture" rules in the WIN credit. Changes made in these provisions in the 1976 Tax Reform Act may increase their use.

II. 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 to be 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 would not be available to nonprofit institutions and State and local governments.¹

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 \$2.3 billion in fiscal year 1978.

¹ As first presented, the Administration proposal would have made the payroll credit available to nonprofit institutions and State and local governments.

III. STAFF ANALYSIS OF ADMINISTRATION PROPOSAL

A. 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 at least when 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.

There have been many empirical studies of the impact of the credit on the decision to invest in equipment. While there is a fairly wide range of results from these studies, the general conclusion is that in a given economic environment the investment credit increases the willingness of businesses to invest by about as much as, or perhaps slightly more than, the revenue loss.

Since many firms have large amounts of excess capacity now (manufacturers' capacity utilization as measured by the Federal Reserve Board in December 1976 was 80.5 percent), some argue that an increase in the investment credit now would be less effective in changing investment demand than in other economic circumstances. It is also possible that the additional 2 percent proposed by the Administration would be too small a change to induce businesses to rethink their investment decisions.

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 will be available over a 4-year period means that no immediate incentive is provided for a speedup of investment projects which businesses have already planned. Furthermore, in the past, changes in the investment credit have been accompanied by transition rules which allow taxpayers to claim the credit for equipment not yet constructed but for which there are binding contracts. Thus, the total impact of this proposal may spill over into periods in which economic stimulus could be unnecessary, and even undesirable.

B. 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 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 is a very small fraction (0.23 percent) of taxable wages, and an even smaller proportion of total wages or total costs. Thus, the credit is not intended to be a significant incentive for expanding employment. Rather, it could more appropriately be viewed as providing employers some temporary income tax relief from the costs of social security taxes.

C. 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. In testimony before the committee, witnesses urged 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. This would not appear to be good business or economic policy.

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 needs during the period when the election is binding, and requires that it stay with its choice even though circumstances may have changed significantly. This makes decision-making more difficult 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.

IV. TAX CREDITS FOR NEW EMPLOYMENT

A. Proposals

Several proposals have been suggested to give employers tax credits to the extent they increase employment above 1976 levels.

General new jobs credit.—Employers would receive a credit equal to 25 percent of the first \$4,200 of wages paid to each additional employee. The credit would be equal to 25 percent of the difference between 1977 wages up to \$4,200 per employee minus 103 percent of 1976 wages up to \$4,200 per employee. (The three-percent increase on the base reflects anticipated normal growth in employment.) In order to ensure that employment of any firm actually increases, the credit would be limited to 25 percent of the difference between total 1977 wages minus 103 percent of total 1976 wages. A similar credit would be available for the increase in employment in 1978 over 1977 levels. Employ-

ers, other than farm and railroad employers, would use their 1976 and 1977 returns under the Federal Unemployment Tax Act (FUTA) as the basis for the first year's credit. Farm employers, who are not covered by FUTA until 1978, would use their FICA records throughout the credit period, making an adjustment to the \$4,200 limit for each employee. Railroad Unemployment Insurance Act (RUIA) returns would provide the basis for Railroad employees.² The credit would not be available for employees of State and local governments or tax-exempt organizations or for self-employed individuals. The credit would be allowed up to 100 percent of income tax liability, with a 3-year carryback and a 7-year carryforward. Special rules would be applied to prevent abuse in cases of separate businesses under common ownership, sales and purchases of businesses, and changes in business form.

The revenue loss is estimated to \$1.0 billion in fiscal 1977, \$2.6 billion in fiscal 1978, and \$1.5 billion in fiscal 1979. This estimate is based on the staff's best estimate of future employment growth. The revenue effect is, of course, sensitive to changes in employment. For example, employment growth of an additional 500,000 employees (0.5 percent of total employment) earning at least \$4,200 could add \$500 million to the revenue cost.

Targeted new jobs tax credit.—Several proposals have been made which would target any new jobs tax credit to the hiring of people who have been unemployed for substantial periods of time. This type of proposal could give the employer, for example, a \$1 credit for each hour worked by new employees in 1977 who had been unemployed for more than 26 weeks before being hired. (An employer could not displace an existing employee merely to receive the credit.)

Under these proposals, the credit could be limited, for example, to the increase in the number of hours worked by all employees of the employer during a particular calendar quarter over those of the corresponding quarter in the preceding year. That is, the employer could receive the credit for the new, long-term unemployed employees only if the employer's total hours of employment increased during the quarter.

A similar, but lower (50¢ per hour, for example), credit could be provided for increased employment in 1978 over 1977.

Revenue loss under this type of proposal is estimated to be \$0.7 billion in fiscal 1977, \$2.2 billion in fiscal 1978, and \$1.7 billion in fiscal 1979.

B. Staff analysis

One important problem with our present economic situation is the high level of unemployment. There is considerable agreement that any tax reduction bill should deal directly with this problem.

One of the major concerns expressed with respect to the Administration's business tax proposal is that it may provide little direct impetus for job creation. A second concern with the Administration's proposal is that neither alternative would provide any real economic stimulus in the business sector. The two percentage point increases in the invest-

²A simple mathematical computation would equate the \$4,800 RUIA base with the FUTA base. Other railroad records would be used to compute the total pay limit.

ment tax credit could be too small to provide any increased incentive for a business to make purchases that would not have been made with the present 10 percent investment tax credit. Those who support the FICA credit maintain that it would tend to make funds available for increased employment or price reduction, either of which would have an economic stimulus; others contend that the amount that would be made available under this proposal is so small in most cases that it would not have any real significant effect.

In view of these concerns those who favor a business tax reduction dealing directly with the unemployment problem have made jobs tax credit proposals which are intended to relate any business tax reduction to increased jobs.

A new jobs tax credit could provide a substantial incentive to employers to hire additional workers. The credit based on FUTA wages could provide a credit of \$1,050 for each new worker who receives at least \$4,200 in wages during the year. This represents approximately 8 percent of the total compensation of the average full-time employee in the private sector, and is apt to be a greater percentage of the compensation of the marginal, or newly hired, worker. The temporary nature of this credit could give employers an incentive to use the additional employees either to build up their inventories or to work down their order backlogs in 1977 and 1978.

A new jobs credit based on FUTA wages is primarily 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. The effect on these types of employees is not necessarily a disadvantage of the proposal. In most cases, these employees represent lower income individuals and, to the extent that their salaries are increased or more of them are hired, the proposal would appear to have a significant economic effect.

An argument that has been made against any general new jobs credit 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. Firms in growing industries would receive the credit for increases in employment that occur solely because of their normal growth. Firms with declining employment, on the other hand, would receive no credit. Also, there may be cases of shifts in employment among firms which do not produce an increase in total U.S. employment which may occur if individual employers are given an incentive to produce for themselves goods or services that formerly were supplied by outside firms.

Another argument made against any new jobs credit which is based on a limited dollar amount of employee wages is that it would provide an incentive to increase the number of job positions without a concomitant increase in hours of employment (for example, by converting full-time, full-year positions to part-time, part-year positions). The FUTA-based proposal contains a total wages limitation that prevents this job churning in most cases.

The major advantage of a targeted new jobs credit is that it would direct the credit toward particular kinds of employment. By encouraging the employment of persons who might not otherwise be hired,

it would be less likely to be given for normal growth in employment.

The primary disadvantage to the targeted proposal is difficulty of administration. It appears likely that the administration of any jobs credit based on hours of employment, such as a \$1 per hour credit, would be a substantial deterrent to its use, based on the experience of agencies and employers with definition of (and record-keeping for) hours of employment under the new pension law. Targeting the credit to the long-term unemployed also would require a certification procedure, which may be especially complex for unemployed workers (such as new labor force entrants) who are not presently 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.

V. EXTENSION OF REDUCTIONS IN CORPORATE TAX RATES

It is understood that the Administration supports, as part of its economic recovery program, an extension of the increase in the surtax exemption and the reduction in the normal tax from the present expiration date of December 31, 1977, through December 31, 1978.

Specifically, the surtax exemption was increased from \$25,000 to \$50,000, the normal tax on the first \$25,000 was reduced from 22 percent to 20 percent, and the 22-percent rate was applied to the second \$25,000 in the surtax exemption.

The changes were made initially in the Tax Reduction Act of 1975 for that year and they were extended to 1976 in the Revenue Adjustment Act of 1975. In the Tax Reform Act of 1976, these reductions in tax liability were extended through December 31, 1977.



