COMPARISON OF THE IMPACTS OF A CUT IN THE HOSPITAL INSURANCE AND DISABILITY INSURANCE PAYROLL TAXES WITH THOSE OF THE ADMINISTRATION'S 1978 TAX CUT PROPOSAL

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PREFACE AND INTRODUCTION

This paper has been prepared in response to the request of Chairman Giaimo and Congressman Mineta of the House Committee on the Budget for a comparison of the impacts of a cut in Social Security payroll taxes with those of the Administration's 1978 tax cut proposal. Chapter I provides brief descriptions of the Hospital Insurance and Disability Insurance programs, the Administration's tax cut proposal, and a proposal that would eliminate HI and DI payroll taxes. The second chapter compares the distributional impacts of a payroll tax cut with those of the personal income tax cuts proposed by the Administration. The final chapter examines the impact of a payroll tax cut and a personal income tax cut on the economy -- the levels of real GNP, unemployment and prices.

The issues raised in this paper involve complex and controversial economic relationships. Because this paper was written over a short time period, it should be regarded as a preliminary analysis of these problems.

CHAPTER I. PROPOSALS AND PROGRAMS

The possibility of a slowdown in the expansion of the economy in fiscal year 1979, which in part would be attributable to the scheduled 1978 and 1979 payroll tax increases for Old age, Survivors Disability, and Health Insurance,and for unemployment insurance has prompted the Administration to propose $25 billion in personal and corporate tax cuts. Alternatively, various members of Congress have proposed to reduce the payroll tax increases by eliminating the Hospital Insurance (HI) and Disability Insurance (DI) payroll taxes.

Background: The Disability Insurance and Hospital Insurance Programs

The Committee on Economic Security whose report served as the basis for the Social Security Act of 1935, recommended that health and disability insurance be a part of the Social Security program. These recommendations were not incorporated in the original act.

Disability Insurance. Action was deferred on disability insurance out of a concern that its costs could be large and would be difficult to predict. This concern was based on the experience of private insurance carriers whose costs had been affected by liberal court

interpretations of disability. In 1956, however, disability benefits were authorized for the permanently and totally disabled over the age of 50. Subsequently, benefits for dependents were provided, the minimum age was dropped, the disability definition was broadened to include those whose disability could be expected to last more than 12 months or to be fatal, and the required number of quarters of covered employment was reduced for disabled workers under 31.

The DI program has grown far more rapidly than was expected. This unanticipated growth has been attributed to such factors as the sharp rise in real benefits, the introduction of medicare benefits for the DI population, and high unemployment, all of which made the program more attractive. In addition, administrative changes may have led to a greater rate of acceptance into the program and a lower rate of termination. It is not known, however, to what extent the program growth reflects simply increased participation among those who are truly eligible as opposed to an increase in participants for whom the program was not intended.

The number of beneficiaries has grown from less than 1.7 million in 1965 to over 4.7 million in 1977, an average increase of 8.8 percent per year. Benefits from the disability insurance trust fund have increased

even more rapidly -- from $1.5 billion to $11.1 billion during the same period, an average annual increase of 18.2 percent. These benefits are made in the form of a monthly cash payment which is based on the wages earned by a worker while employed under social security coverage.

Hospital Insurance. The medicare program was established by the Social Security Amendments of 1965. The program for the aged and certain disabled persons consists of hospital insurance (HI), which provides protection against hospital and related institutional costs and supplementary medical insurance (SMI), which covers physicians' services and many other medical services.

The vast majority of persons reaching age 65 are automatically entitled to protection without cost under the Part A (HI) program. Persons aged 65 and older not entitled to coverage may obtain Part A protection, if they pay the estimated actuarial cost of such coverage. In 1975, eligibility was extended to disabled workers under age 65, disabled widows between the

ages of 50 and 65, persons aged 18 or older who receive benefits because of disability incurred prior to reaching age 22, and disabled railroad retirement system annuitants. To receive medicare benefits, the disabled must have been eligible for social security disability benefits for two years. People who need a kidney transplant or renal dialysis because of chronic kidney disease are, under certain circumstances, entitled to benefits under Part A. To qualify for this protection, the individual must either be currently insured under social security or be a dependent of an insured person.

As with disability insurance, the hospital insurance program has grown more rapidly than expected. The rising cost of hospital care is primarily responsible for outlay increases in this program. Hospital insurance outlays have grown from $2.6 billion in 1967 to $15.2 billion in 1977.

Financing. Disability insurance and the hospital insurance portion of medicare are financed primarily

TABLE 1. ESTIMATED BENEFICIARIES OF DIABILITY INSURANCE AND HOSPITAL INSURANCE (IN MILLIONS)

Beneficiaries	1968	1970	1977	1978	1979
Disability Insurance	2.1	2.5	4.7	4.9	5.2
Disabled workers	--	1.4	2.7	2.9	3.1
Dependents of disabled workers	--	1.1	2.0	2.0	2.1
Hospital Insurance	19.6	20.0	25.4	26.0	26.6
Aged	--	20.0	22.8	23.2	23.6
Disabled	a/	a/	2.6	2.8	3.0

Source: Budget of the United States, Appendix, Fiscal Years 1979, 1972 and 1970.

a/ Not applicable.

through social security payroll taxes paid by employees, employers, and self-employed people covered under social security. Currently, employers and employees pay a tax of 0.775 percent for disability insurance and 1.0 percent for hospital insurance on the employees wages up to a limit of $17,700. These rates are scheduled to rise gradually to 1.1 percent and 1.45 percent respectively by 1990. The wage base will also rise each year. The SMI portion of medicare is financed from premiums paid by enrollees and from general federal revenues paid into the trust fund.

DI and HI payroll tax receipts are expected to total $35.1 billion in fiscal year 1979. (see Table 2) The HI and DI trust funds are also supported by state deposits, some small general revenue payments for certain groups of people, and by interest earnings.

TABLE 2. DISABILITY INSURANCE AND HOSPITAL INSURANCE TRUST FUND RECEIPTS AND EXPENDITURES, FISCAL YEAR 1979 (MILLIONS OF DOLLARS)

Budget Authority	DI	HI	Total
Payroll Taxes Receipts	$14,900	$20,000	$35,100
Other Receipts	142	927	1,069
Interest	293	853	1,146
Total	$15,335	$21,980	$37,315
Expenditures	$14,786	$20,215	$35,001

Source: CBO estimates.

Issues. Until the 1977 amendments, much concern had been expressed about the financial soundness of the social security system--particularly the DI program--because commitments for future benefit payments were projected to outpace the accumulation of reserves in the trust funds. Increases in payroll tax rates were

enacted in late 1977 (P.L.95-216) to assure the actuarial balance of the system over the next forty years. Table 3 summarizes actual and projected trust fund tranactions.

General revenue financing of all or part of social security benefits has been debated for many years. Proponents of general revenue financing argue that it would provide payroll tax relief for low-income workers while substituting the more progressive income tax, which is levied on unearned income as well as earnings. Partial general revenue funding could postpone or make unnecessary further increases in the payroll tax.

Opponents argue that such indirect financing would tend to obscure the true cost of benefit liberalizations because increased benefits would not necessarily be tied to tax increases. Furthermore, they argue it would have a detrimental effect on the insurance nature of the program in which the worker earns the right to benefits through his work in covered employment. Some also feel that by cutting the tie between contributions and benefits, general revenue financing could lead to the introduction of a needs test for benefits.

TABLE 3. PAST AND PROJECTED PAYROLL TAX BASED REVENUES AND PRINCIPAL EXPENDITURES FOR HOSPITAL AND DISABILITY INSURANCE PROGRAMS (Dollars in Billions)

Fiscal Year	Disability Insurance		Hospital Insurance	
	Contributions a/	Total Outlays b/	Contributions a/	Total Outlays c/
1965	1.2	1.5	--	--
1967	2.2	2.0	3.1	2.6
1970	4.1	3.0	4.9	5.3
1971	4.6	3.6	4.9	5.9
1972	4.9	4.3	5.7	6.5
1973	5.5	5.5	9.9	7.3
1974	6.2	6.4	10.8	9.4
1975	7.4	8.0	11.5	11.6
1976	7.8	9.6	12.7	13.7
1977 c/	8.9	11.1	13.5	15.2
PROJECTED				
1978	12.6	12.6	16.9	18.2
1979	14.9	14.2	20.2	21.0
1980	16.7	17.2	23.5	24.3
1981	20.0	19.5	30.5	28.3
1982	22.9	22.3	36.1	32.9
1983	25.4	25.4	39.8	38.2

SOURCES: Actual data from 1977 Trustees Report and the 1979 Budget. Projections based on preliminary CBO estimates.

a/ Includes net payroll tax receipts, federal employee contributions and deposits by states; general revenue and interest income are excluded.

b/ Total expenditures including administrative expenses and transfers to railroad retirement program.

d/ Transition quarter not shown. New fiscal year basis from 1977 on (October 1 to September 30).

These arguments are more directly applicable to general revenue financing of OASI and DI than HI benefits since payments in the first two programs are now based upon a worker's wage history and contributions. Were either program shifted to income tax financing, current eligibility requirements would be called into question. Why should all taxpayers contribute to a system that does not provide all of them with protection? General fund financing of the DI program would also blur the present distinction between disability insurance and the supplemental security income program which is a needs-tested program for the permanently and totally disabled.

General revenue financing of medicare does not generate the same concerns. SMI is already principally funded from general revenues. HI benefits are unrelated to the amount of wages earned or taxes paid under social security. Moreover subjecting medicare to annual authorizations and appropriations could provide Congress with the opportunity to assess the benefits more frequently and might strengthen and reinforce efforts to contain rising health care costs. However,

it is a matter of debate whether the annual appropriation process or the discipline of tying expenditure increases to visible tax increases would impose the greater control.

The President's Tax Cut Proposal

President Carter has proposed a tax package that combines tax reductions and tax reforms for both businesses and individuals. Table 4 shows the revenue impact of the President's proposals over the 1979 to 1983 period.

Individuals

Tax Reductions. The individual tax reductions would come from a new $240 per-person tax credit and an across-the-board reduction in tax rates. The $240 credit would take the place of the present $750 personal exemption and the general tax credit, which is equal to $35 per dependent or 2 percent of the first $9,000 of taxable income, whichever is greater. The new rate schedule would range from 12 percent to 68 percent instead of the current 14 percent to 70 percent.

Tax Reforms. The major revenue-raising individual tax reforms proposed by the President are the repeal of the state gasoline and sales tax deduction ($2.3 billion revenue gain in fiscal year 1979), and the limitation on deductions for medical and casualty expenses ($1.3 billion revenue gain).

TABLE 4.

Summary of Revenue Effects of Income Tax Reductions, Tax Reforms and Telephone Excise and Unemployment Insurance Tax Reductions

($billions)

	Fiscal Years				
	1979	1980	1981	1982	1983
Individual Income Tax:					
Tax reductions	-22.5	-25.7	-29.2	-33.4	-38.5
Tax reforms	4.2	7.4	8.9	10.6	12.3
Net change	-18.3	-18.2	-20.3	-22.8	-26.2
Corporation Income Tax:					
Tax reductions	-6.3	-9.4	-11.1	-11.8	-12.8
Tax reforms	1.1	3.0	4.3	5.0	5.2
Net change	-5.1	-6.5	-6.8	-6.8	-7.6
Telephone excise and unemployment insurance tax reductions	-1.6	-2.0	-1.6	-1.2	-1.1
Total	**-25.0**	**-26.6**	**-28.6**	**-30.8**	**-34.9**

SOURCE: The President's 1978 Tax Program, Department of the Treasury, Washington, D.C.

Businesses

Tax Reduction. The major business tax reductions come from a cut in the corporate tax rate ($4 billion revenue loss in fiscal year 1979) and from a liberalization of the 10 percent investment tax credit ($2.4 billion revenue loss).

Tax Reforms. The major revenue-raising business tax reforms include the limit on entertainment deductions (revenue gain of $700 million in fiscal year 1979 and $1.5 billion in 1980) and the three-year phaseout of the Domestic International Sales Corporation (DISC) and foreign tax deferral provisions (revenue gain of $300 million in fiscal year 1979, increasing to $2.6 billion by fiscal year 1982).

Other

The President would also repeal the telephone excise tax and reduce the federal unemployment insurance tax rate, which would result in a total revenue loss of $1.6 billion in fiscal year 1979.

The Social Security Refinancing Act

The main proposal to eliminate the Disability Insurance and Hospital Insurance payroll taxes is

the "Social Security Refinancing Act" (H.R. 10754) which would finance the DI and HI portions of the social security program from general revenues. This general revenue financing would require annual authorization, as well as appropriation action by the Congress. The taxes now levied on payrolls and on self-employed individuals to finance the HI and DI programs would be eliminated. H.R. 10754 would also adjust the payroll tax rates used to finance the Old Age and Survivors Insurance Program (OASI). Table 5 compares the payroll tax under current law and under H.R. 10754 for those who are not self-employed. The tax on the self-employed would also be lowered --by 1.6 percent in 1979 and 1980 and by 2.7 percent in 1981.

TABLE 5. SOCIAL SECURITY PAYROLL TAX UNDER CURRENT LAW AND UNDER H.R. 10754 a/ (PERCENTS)

	Current Law				H.R. 10754
Calendar Year	Total	OASI	DI	HI	OASI
1979 and 1980	6.13	4.330	750	1.05	4.33
1981	6.65	4.525	.825	1.30	4.40
1982-1984	6.70	4.575	.825	1.30	
1985	7.05	4.750	.950	1.45	
1986-1989	7.15	4.750	.950	1.45	
1990-2001	7.65	5.100	1.100	1.45	
2002-2010					4.60
2011-2020					5.40
2021 and later					6.80

a/ Rate levied on employers and and employees each.

The specific revenue effects of elimination of the HI and DI taxes would involve a net tax reduction of about $28.4 billion in fiscal year 1979. Payroll taxes would decrease by $34.3 billion, but corporate income tax payments would rise because business would no longer have HI and DI payroll taxes to deduct as a business cost from their taxable income. The $28.4 billion net tax reduction implied by H.R. 10754 would be divided roughly $17.9 billion to individuals, $8.7 billion to business and $1.8 billion in fiscal relief for state and local governments.

Substitution of these payroll tax cuts proposed in H.R. 10754 for the Administration's proposed tax cuts would eliminate the need to raise general tax rates to finance HI and DI benefits in the short run. The level of the deficit would be roughly the same under either proposal. In the long run, however, DI and HI would have to compete directly with other programs for appropriations. If DI and HI costs increase rapidly in the future, general tax rates may have to be increased, or existing programs restricted or new initiatives curtailed. Such an outcome probably would not be viewed favorably by current DI and HI beneficiaries. Their benefit levels are protected by a trust fund which is financed by the payroll taxes of insured workers who

are not currently beneficiaries. Most medicare and DI beneficiaries do not pay payroll taxes. Many, however, do pay income taxes. General revenue financing of HI and DI could potentially increase their overall tax burden if it led to increased income taxes.

CHAPTER II THE ADMINISTRATION'S TAX CUT AND THE ELIMINATION OF HOSPITAL INSURANCE AND DISABILITY INSURANCE PAYROLL TAXES: COMPARISONS OF EFFECTS ON INDIVIDUALS

The revenue reduction over the period from 1979 to 1983 that would result from eliminating the employee share of the payroll tax for HI and DI would be approximately the same as that from the tax cut for individuals proposed by President. The overall distribution of the tax reduction by income class would also be approximately the same for the two proposals. However, some taxpayers would benefit significantly more from an HI and DI payroll tax cut than they would from the Administration's tax cut proposal. These include single people with incomes from $10,000 to $25,000, families with incomes over $30,000 (especially those with two earners), and families with incomes below $5,000. Most families with incomes in the $10,000 to $15,000 range would do better under the Administration proposal, however.

The revenue reduction from eliminating the employer share of the HI and DI payroll taxes would be much larger than that resulting from the business tax cuts proposed by the President. These employer and business

tax cuts are impossible to trace back to effects on individuals, however, so this chapter is concerned only with the comparison of the proposed reduction in employee payroll taxes and the Administration's proposed individual income tax cuts.

REVENUE REDUCTION

As shown in Table 1, eliminating the employee and self-employed share of HI and DI payroll taxes would result in a revenue reduction of $128.4 billion over the 1979 to 1983 period, while the Carter proposal for individual income tax cuts would result in a reduction of $105.8 billion with the reforms and $149.3 billion without them.

DISTRIBUTION OF THE TAX REDUCTION BY INCOME CLASS

Table 2 shows the overall distribution of the tax reduction from the proposed Administration individual income tax cuts (without the Administration's proposed tax reforms), compared to the distribution of the tax cut that would result from eliminating HI and DI taxes. It also shows the distribution that would result from an equal across-the-board percentage reduction in all individual income tax liabilities. (This last column is also the distribution of current law tax liabilities.)

TABLE 1. TOTAL REVENUE REDUCTION RESULTING FROM CARTER INDIVIDUAL INCOME TAX CUT PROPOSALS AND FROM ELIMINATION OF HOSPITAL INSURANCE (HI) AND DISABILITY INSURANCE (DI) PAYROLL TAXES, FISCAL YEARS 1979-1983, IN BILLIONS OF DOLLARS

	Fiscal Years				
	1979	1980	1981	1982	1983
Carter Individual Income Tax Proposal:					
Tax Reductions a/	-22.5	-25.7	-29.2	-33.4	-38.5
Tax Reforms	4.2	7.4	8.9	10.6	12.3
TOTAL	-18.3	-18.2	-20.3	-22.8	-26.2
Elimination of HI and HI Payroll Taxes					
HI					
Employee Share	- 9.6	-11.0	-14.4	-17.0	-18.8
Self-Employed Share	- 0.8	- 0.9	- 1.2	- 1.4	- 1.7
Subtotal	-10.4	-11.9	-15.6	-18.4	-20.5
DI					
Employee Share	- 7.1	- 8.0	- 9.5	-10.9	-12.1
Self-Employed Share	- 0.6	- 0.7	- 0.8	- 0.9	- 1.0
Subtotal	- 7.7	- 8.7	-10.3	-11.8	-13.1
TOTAL	-18.1	-20.6	-25.9	-30.2	-33.6

Source: Treasury Department and CBO estimates.

a/ $240 personal credit and rate changes.

TABLE 2. DISTRIBUTION OF TAX REDUCTIONS BY INCOME CLASS RESULTING FROM CARTER TAX CUT PROPOSAL, ELIMINATION OF HI AND DI PAYROLL TAXES, AND AN ACROSS-THE-BOARD PERCENTAGE REDUCTION IN TAX LIABILITIES a/

Expanded Income Class b/	Distribution of 1977 Tax Returns c/	Distribution of Total Tax Reduction From: Carter Tax Cut Proposal d/	Elimination of HI and DI Payroll Taxes	Across-the-Board Percentage Cut in Tax Liabilities
$ 0 - 5,000	28.9%	2.4%	5.5%	0.1%
5 - 10,000	22.9	11.6	13.3	6.1
10 - 15,000	18.3	18.2	18.5	13.4
15 - 20,000	13.4	20.7	25.7	17.0
20 - 30,000	11.3	27.1	23.2	24.2
30 - 50,000	3.8	12.8	10.5	16.3
Over 50,000	1.4	7.2	3.3	23.0
TOTAL	100.0%	100.0%	100.0%	100.0%

Source: Treasury Department and CBO estimates.

a/ The Treasury Tax Model, upon which the income tax portions of this table are based, has not yet been updated to reflect 1978 income levels. Instead, it superimposes the proposed 1979 tax law on 1976 income levels. If 1978 income levels were used, many taxpayers would be shifted into higher income classes. In order to make the HI and DI changes roughly comparable to the President's tax cut proposals, this table superimposes 1979 Social Security taxes on 1977 income levels.

b/ Expanded income is a broader concept than the "adjusted gross income" concept that appears on income tax returns and that the Treasury has used for tax analysis tables in previous years. Expanded income includes the untaxed half of capital gains, percentage depletion in excess of cost, depreciation in excess of straight line, and other "tax preference" items included in the minimum tax; however, it excludes investment interest up to the amount of investment income. It therefore comes closer to "real" total economic income than does the usual adjusted gross income figure.

c/ All of the distributions in this table are based on income tax return filing units. As a result, dependents and second earners from high-income families will appear in lower income categories if they file separate tax returns showing low earnings.

d/ Includes only $240 personal credit and rate changes. The effects of the President's proposed tax reforms are omitted.

While the table shows some differences in the distribution of the Administration and the HI and DI tax cuts, these differences should not be given much weight. Because of problems with the underlying data, the margin for error in this comparison may be almost as large as the relatively small differences shown. The most reliable conclusion that can be drawn, therefore, is that the overall distributional impact of the two tax cut approaches does not appear to be significantly different.

IMPACT ON INDIVIDUAL TAXPAYERS BY FAMILY SIZE AND INCOME LEVEL

While the overall distribution of the tax cut from eliminating HI and DI payroll taxes is not much different from the Carter tax cut, the differences would be fairly substantial for some people. Table 3 illustrates some of the kinds of taxpayers for whom the difference is likely to be most significant.

Single people with incomes between $10,000 and $25,000 would be substantially better off with the elimination of HI and DI, since their tax saving under the Carter proposal is fairly small.

Families with incomes above $30,000 -- especially those with two earners -- would have a much larger

tax saving if HI and DI were eliminated than they would under the Carter tax cut proposal. A two-earner family with no dependents in which each spouse earned $20,000 would save $403 more in taxes from an elimination of HI and DI, while a four-person family with one spouse earning $35,000 and the other earning $15,000 would save $602 more. The main reason for this is that the wage base ceiling for HI and DI (the highest amount of income to which the tax rate applies) is scheduled to increase from $17,700 to $22,900 in 1979, thereby imposing a substantial tax increase on all those earning more than $17,700. This puts a double burden on two-earner families, since both earners must pay the full HI and DI tax up to the full wage base amount.

The other main category of people who would be helped more by an HI and DI tax cut than by the Carter proposal are those with incomes below $5,000. Most of them pay no income tax now and thus would receive no additional tax relief under the Carter proposal (other than from the extension of the earned income credit, which is scheduled to expire at the end of this year). With the elimination of HI and DI taxes, however, those families at the $5,000 income level who had

earnings subject to the payroll tax would receive a payroll tax cut of $90, with those under $5,000 receiving somewhat smaller cuts.

A four-person family with income of $10,000 would do better under the Carter proposal, however. As shown in Table 3, that family would save $132 more under the Carter proposal than they would from elimination of HI and DI payroll taxes. While it is not shown in the table, preliminary calculations suggest that most families with incomes between $10,000 and $15,000 would do better under the Carter proposal. Families in this income range account for about 20 percent of all joint tax returns and 10 percent of total returns.

Table 3. TAX SAVING RESULTING FROM ELIMINATION OF HOSPITAL INSURANCE (HI) AND DISABILITY INSURANCE (DI) PAYROLL TAXES, COMPARED TO SAVING FROM CARTER ADMINISTRATION INDIVIDUAL INCOME TAX CUT PROPOSAL FOR FAMILIES OF DIFFERENT SIZES AT DIFFERENT INCOME LEVELS

ADJUSTED GROSS INCOME	Present Law Tax Liability a/	Tax Change From Carter Tax Cut Proposal b/	Tax Change From Elimination of HI and DI	Additional Tax Saving (-) Or Increase (+) from Elimination of HI and DI compared to Carter Proposal
		SINGLE PERSON		
5,000	278	- 99	- 90	+ 9
10,000	1,199	- 34	-180	-146
15,000	2,126	- 21	-270	-249
20,000	3,232	-126	-360	-234
25,000	4,510	-245	-412	-167
30,000	5,950	-365	-412	- 47
40,000	9,232	-488	-412	+ 75
50,000	12,985	-400	-412	- 12
		TWO PERSON FAMILY, NO DEPENDENTS, ONE EARNER		
5,000	0	0	- 90	- 90
10,000	761	-147	-180	- 33
15,000	1,651	- 99	-270	-171
20,000	2,555	-165	-360	-195
25,000	3,570	-260	-412	-152
30,000	4,712	-322	-412	- 90
40,000	7,427	-317	-412	- 95
50,000	10,610	-260	-412	-152

Source: Treasury Department and CBO estimates

a/ Assumes deductible expenses equal to 23 percent of income.

b/ Assumes deductible expenses equal to 20 percent of income. Includes only $240 personal credit and rate changes. The effects of the President's proposed tax reforms are omitted.

Table 3a. TAX SAVING RESULTING FROM ELIMINATION OF HOSPITAL INSURANCE (HI) AND DISABILITY INSURANCE (DI) PAYROLL TAXES, COMPARED TO SAVING FROM CARTER ADMINISTRATION INDIVIDUAL INCOME TAX CUT PROPOSAL FOR FAMILIES OF DIFFERENT SIZES AT DIFFERENT INCOME LEVELS

ADJUSTED GROSS INCOME	Present Law Tax Liability a/	Tax Change From Carter Tax Cut Proposal b/	Tax Change From Elimination of HI and DI	Additional Tax Saving (-) Or Increase (+) from Elimination of HI and DI compared to Carter Proposal
TWO-PERSON FAMILY, NO DEPENDENTS, TWO EARNERS (INCOME DIVIDED 50-50)				
5,000	0	0	- 90	- 90
10,000	761	-147	-180	- 33
15,000	1,651	- 99	-270	-171
20,000	2,555	-165	-360	-195
25,000	3,570	-260	-450	-190
30,000	4,712	-322	-540	-218
40,000	7,427	-317	-720	-403
50,000	10,610	-260	-824	-564
TWO PERSON FAMILIES, NO DEPENDENTS, TWO EARNERS (INCOME DIVIDED 70-30)				
5,000	0	0	- 90	- 90
10,000	761	-147	-180	- 33
15,000	1,651	- 99	-270	-171
20,000	2,555	-165	-360	-195
25,000	3,570	-260	-450	-190
30,000	4,712	-322	-540	-218
40,000	7,427	-317	-628	-311
50,000	10,610	-260	-682	-422

Source: Treasury Department and CBO estimates

a/ Assumes deductible expenses equal to 23 percent of income.

b/ Assumes deductible expenses equal to 20 percent of income. Includes only $240 personal credit and rate changes. The effects of the President's proposed tax reforms are omitted.

Table 3b. TAX SAVING RESULTING FROM ELIMINATION OF HOSPITAL INSURANCE (HI) AND DISABILITY INSURANCE (DI) PAYROLL TAXES, COMPARED TO SAVING FROM CARTER ADMINISTRATION INDIVIDUAL INCOME TAX CUT PROPOSAL FOR FAMILIES OF DIFFERENT SIZES AT DIFFERENT INCOME LEVELS

ADJUSTED GROSS INCOME	Present Law Tax Liability a/	Tax Change From Carter Tax Cut Proposal b/	Tax Change From Elimination of HI and DI	Additional Tax Saving (-) Or Increase (+) from Elimination o HI and DI compared to Carter Proposal
		FOUR PERSON FAMILIES, TWO DEPENDENTS, ONE EARNER		
5,000	-300	0	- 90	- 90
10,000	446	-312	-180	+132
15,000	1,330	-258	-270	- 12
20,000	2,180	-270	-360	- 90
25,000	3,150	-320	-412	- 92
30,000	4,232	-322	-412	- 90
40,000	6,848	-218	-412	-194
50,000	9,950	- 80	-412	-332
	FOUR PERSON FAMILIES, TWO DEPENDENTS, TWO EARNERS (INCOME DIVIDED 50-50)			
5,000	-300	0	- 90	- 90
10,000	446	-312	-180	+132
15,000	1,330	-258	-270	- 12
20,000	2,180	-270	-360	- 90
25,000	3,150	-320	-450	-130
30,000	4,232	-322	-540	-218
40,000	6,848	-218	-720	-502
50,000	9,950	- 80	-824	-744

Source: Treasury Department and Cbo Estimates

a/ Assumes deductible expenses equal to 23 percent of income.

b/ Assumes deductible expenses equal to 20 percent of income. Includes only $240 personal credit and rate changes. The effects of the President's proposed tax reforms are omitted.

Table 3c. TAX SAVING RESULTING FROM ELIMINATION OF HOSPITAL INSURANCE (HI) AND DISABILITY INSURANCE (DI) PAYROLL TAXES, COMPARED TO SAVING FROM CARTER ADMINISTRATION INDIVIDUAL INCOME TAX CUT PROPOSAL FOR FAMILIES OF DIFFERENT SIZES AT DIFFERENT INCOME LEVELS

ADJUSTED GROSS INCOME	Present Law Tax Liability a/	Tax Change From Carter Tax Cut Proposal b/	Tax Change From Elimination of HI and DI	Additional Tax Saving (-) Or Increase (+) from Elimination of HI and DI compared to Carter Proposal
	FOUR PERSON FAMILIES, TWO DEPENDENTS, TWO EARNERS (INCOME DIVIDED 70-30)			
5,000	-300	0	- 90	- 90
10,000	446	-312	-180	+132
15,000	1,330	-258	-270	- 12
20,000	2,180	-270	-360	- 90
25,000	3,150	-320	-450	-130
30,000	4,232	-322	-540	-218
40,000	6,848	-218	-628	-410
50,000	9,950	- 80	-682	-602

Source: Treasury Department and CBO estimates

a/ Assumes deductible expenses equal to 23 percent of income.

b/ Assumes deductible expenses equal to 20 percent of income. Includes only $240 personal credit and rate changes. The effects of the President's proposed tax reforms are omitted.

CHAPTER III. EFFECTS ON THE ECONOMY

The effects of a tax reduction on the economy depend critically on the type of tax, economic conditions when the tax cut is implemented, and on the monetary policy accompanying the cut. 1/ The specific question here concerns the macroeconomic effects of substituting a cut in payroll taxes for the same-size cut in personal income taxes or in business income taxes. In this case, as in others, the results will depend on the initial level of economic activity and on the assumptions about monetary policy.

Economists are more easily able to analyze the shortrun economic effects of changes in taxes in general and in personal income taxes rather than those in specific business taxes. Thus, most of the discussion below relates to a comparison of the proposed payroll tax changes and other taxes, though differences among specific business taxes are discussed briefly.

1/ For a detailed discussion of these issues, see Understanding Fiscal Policy, a forthcoming CBO background paper.

Payroll Tax Cuts Versus Individual Income Tax Cuts

The employee share. The macroeconomic effects of a cut in the employee share of the payroll tax and of an across-the-board cut in personal income taxes appear to be similar. In both cases, the take-home pay of the taxpayers increases, since wage rates are not likely to be reduced significantly. Whether derived from a cut in personal income taxes or in payroll taxes, the resulting increase in disposable income should generate about equal increases in personal consumption expenditures and output. In this regard, the two taxes work in roughly the same way.

Some might argue that the overall effects will depend on the relative distribution of the tax cuts among income groups. Although this issue remains controversial among economists, the available evidence indicates that low, medium and high income groups all spend a large fraction of additonal income that they regard as permanent. In any case, as noted in the last chapter, the two proposals differ little in their effects on various income groups.

The employer share. The economic impact of a cut in the employer share of the payroll tax is transmitted through different channels. The employer share of the tax affects production costs directly. (A reduction in personal income taxes or in the employee share of the payroll tax would reduce employer costs only if workers received lower before-tax wages as a result of the tax cut--a seemingly unlikely outcome in the short run.) This reduction in the costs of production is likely to result initially in increased profit margins and perhaps stimulate business spending. Most likely, after a short time, however, the employer will not be able to retain a large portion of the cut in the employer share. Even partial competition in labor and product markets is likely to keep profit margins about where they were.

If a substantial increase in profit margins is considered unlikely, the remaining possibilities are that prices will be held down or that wages will be increased. In either case, household purchasing power would be increased and consumption stimulated.

Considering their desire to increase sales, firms may prefer to hold down prices rather than increasing wages; particularly when labor markets are slack, only a few quite powerful unions can be expected to prevail in obtaining a major portion of the employer payroll tax cut. Thus, a significant portion of a cut in payroll taxes is likely to lead to a reduction in the rate of inflation, at least in the short run. This beneficial effect on prices cannot be expected from a cut in the personal income tax.

The many channels of transmission in addition to boosting household purchasing power make estimating the overall impact of a cut in the employer's share of the tax very complex. Some further consequences include:

1. Components of the employer-paid tax cut that are retained by business firms would increase profits and should strengthen investment somewhat.

2. The moderation of inflation in the U.S. would encourage domestic exports and discourage imports that are sensitive to relative prices. Eventually these effects would be counteracted by a slight strengthening of the dollar as compared to other currencies.

3. All other things (including monetary policy) being equal, the slight decrease of domestic inflation would tend to edge down interest rates, thereby encouraging additional investment and economic expansion generally.

A reasonable assumption would be that the effect on employment and output of reducing the employer share of the payroll tax is about the same and possibly larger than the effect of cutting the employee share. 2/ In addition, some improvement in prices seems likely with the cut in the employer share that is not expected either with a reduction in personal income taxes or in the employee payroll tax.

Table 1 shows the effects on output, unemployment and prices of a $10 billion reduction in personal income taxes, and the effect of an equally large cut in payroll taxes (both employee and employer) as estimated by the CBO multipliers model. 3/ As the table shows, a reduction in the payroll tax is expected to have similar effects per dollar of revenue reduction, with respect to employment and output but prices would be significantly lower with the payroll tax.

2/ This refers to the effect per dollar of revenue lost to the Treasury. Since payroll taxes are a deductible business expense for purposes of calculating business tax liabilities the revenue loss per dollar reduction in the employer share is less than the revenue loss per dollar reduction in the employee share.

3/ The CBO Multipliers Project: A Methodology for Analyzing the Effects of Alternative Economic Policies, CBO Technical Analysis Paper (August 1977).

TABLE 1. APPROXIMATE EFFECTS OF TWO ILLUSTRATIVE $10 BILLION TAX REDUCTIONS a/

	Personal Income Tax	Payroll Tax
After 4 Quarters		
GNP, Billions 1972 $	7	7 b/
Unemployment rate	-0.2	-0.2 b/
Percent Change, General Price Level	c/	-0.2
After 8 Quarters		
GNP, Billions 1972 $	10	10 b/
Unemployment rate	-0.3	-0.3 b/
Percent Change, General Price Level	+0.1	-0.3

a/ Calculations assume the general economic conditions of 1978.

b/ Data shown for GNP and unemployment rate are the estimated effects of a personal tax cut. It is assumed that a payroll tax cut of the same size would have approximately the same GNP and unemployment effects.

c/ Less than +.05 percent.

The deficit and timing. The preceding analysis, as has been mentioned, assumed a change in the composition of tax revenues and thus an unchanged federal deficit. In practice, some differences in the federal deficit would arise, of course, because the alternative tax cuts would occur on somewhat different time schedules. Moreover, even if the two alternative tax cuts were initially of the same magnitude, the effective size of the cuts could be different several years later if the two alternative tax bases were to grow at different rates. This particular point, however, may not have very significant macroeconomic consequences because tax rates--and particularly income tax rates--need to be reviewed every few years in any case, due to the tendency of these taxes to increase substantially faster than incomes. At such times of review, the optimal overall tax yield can be reestablished.

A related problem of size comparison is that the gross and the net yields of the two alternative tax cuts can differ. Suppose the options are to cut either personal taxes or payroll taxes by $10 billion. Half of the payroll tax ($5 billion) would involve payments by employers. This tax cut would reduce employer costs

by the same amount and initially increase before-tax profits by also $5 billion. Corporate income tax liabilities thus might climb by some $2 billion, leaving a net tax reduction of only about $8 billion. Neither the personal income tax nor the employee contributions for the payroll tax are deductible in the way that the employer payroll taxes are. This difference, however, is smaller than it first appears: due to competition, corporations will edge down prices and hence the initial bulge in profits and profits taxes will thus be flattened out.

Payroll Tax Cuts Versus Business Tax Cuts

Economists are uncertain about the size and timing of the economic impacts of cuts in business taxes. 4/ For this reason, no really reliable comparison of the overall effects of cuts in business taxes with cuts

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4/ Congressional Budget Office, The Economic Outlook, A Report to the Senate and House Budget Committee, Part II, February 1978, pp. 31-35 and Appendix A.

in payroll taxes can be made. However, certain generalizations seem appropriate:

1. A cut in the corporate income tax has its immediate effect on increasing after tax profits, while a cut in employer payroll contributions has an immediate impact of reducing production costs.

2. To the extent that business can retain a portion of the benefits of the cut in the employer share, business liquidity is increased and the overall effect should be similar to a reduction in corporate tax rates.

3. Certain business tax cuts, namely the investment tax credit and accelerated depreciation, provide a powerful and direct stimulus to investment spending not available from payroll tax cuts or cuts in corporate tax rates.

4. On the other hand, reduction of payroll taxes might have some effect in increasing the employment of marginal workers because of their reduced costs to employers.

5. Stimulus measures designed to affect investment spending appear to operate with longer lags than measures that stimulate consumer spending.

6. Business tax cuts that increase the capital stock may, over a number of years, increase productivity and thus may also reduce price pressures.

Conclusion

CBO indicated in an earlier publication that a $25 billion cut in personal and business taxes, similar to that proposed by the Administration, would have sizeable

stimulative effects on output and employment in 1979. 5/ If Congress chose instead to cut payroll taxes this too would provide substantial stimulus. Payroll tax cuts and personal income tax cuts seem to be similar in so far as both reductions in the employee and employer share seem to increase purchasing power, one by boosting take home pay and the other by reducing prices. However, it is difficult to make precise comparisons of overall effects because of (1) the uncertainty attached to effects on output of business tax cuts and; (2) the very indirect channels through which cuts in the employer share of payroll taxes are transmitted. In general, the alternative tax cuts are likely to have roughly similar overall short-run output effects. But the cut in payroll taxes would probably have a more favorable effect on prices whereas the reduction in business taxes, particularly the extension of the investment tax credit to industrial structure, would provide greater incentive to business investment.

5/ Congressional Budget Office, The Economic Outlook, A Report to the Senate and House Budget Committees, Part II, page 36.