The original documents are located in Box 63, folder "1976/12/13 - Economic Policy Board" of the James M. Cannon Files at the Gerald R. Ford Presidential Library.

8:30 AM - EPB

Monday, December 13, 1976

THE WHITE HOUSE

WASHINGTON

December 13, 1976

MEMORANDUM FOR ROGER PORTER

FROM: JIM CANNON Jim

SUBJECT: "Tax Policy Issues"

On your December 11, 1976 decision memoranda on "Tax Policy Issues":

Issue 1 -- The Domestic Council favors Option 1

Issue 2 -- The Domestic Council favors approval

Issue 3 -- The Domestic Council takes these positions:

- -- Retain accelerated depreciation in high unemployment areas.
- -- Delete utility relief package reductions
- -- Delete 2 percentage point surtax rate reduction
- -- Delete financial institutions reform
- -- Delete BSOP
- -- Favor ending withholding on dividends to foreigners
- -- Retain sliding scale capital gains tax
- -- Delete home insulation credit
- -- Retain limited Employee Retirement Accounts
- -- Retain education tax credit proposal
- -- Delete exclusion of charitable contributions from minimum tax

Issue 4 -- Domestic Council opposes new stimul~~o~~us

Jmc

THE WHITE HOUSE

WASHINGTON

December 10, 1976

MEMORANDUM FOR ECONOMIC POLICY BOARD
EXECUTIVE COMMITTEE MEMBERS

FROM: L. WILLIAM SEIDMAN LWS

SUBJECT: Tax Policy

A draft memorandum for the President, prepared by the Tax Division of the Treasury, designed to reflect the Thursday Executive Committee discussion is attached.

Treasury will have the tabular material referred to in the draft memorandum ready for distribution tomorrow afternoon.

Please contact my office with any suggestions you have on the paper or if you feel that there is a need for the Executive Committee to meet again on this subject this weekend.

Attachment

12/10/76 5:00 p.m.

DRAFT

MEMORANDUM FOR: The President

SUBJECT: Tax Policy

This memorandum discusses the main tax policy issues which are to be resolved in preparation of the FY 1978 budget and of your Tax and State of the Union Messages. Part 1 of the memorandum reviews the currently outstanding Administration tax initiatives and discusses their implications for the budget. This part also includes a discussion of possible ways of paring down the tax program in order to raise additional revenue. Part 2 considers the issue of the need for additional stimulus to private investment, and includes discussion of possible additions to the tax program which would serve this objective. Part 3 concerns a much longer range issue. This part presents a brief summary of the Basic Tax Reform Study which has been prepared in the Treasury Department and considers the possible position you may wish to take toward the future use of this study.

1. The Administration's Present Tax Position

The starting point for consideration of tax policy is the set of currently outstanding Administration tax proposals. Table A-1 at Tab A summarizes the budget outlook. Under the assumed economic projections and OMB present expenditure estimates, the renewal of all Administration tax initiatives which have not been overtaken by events would yield budget receipts in FY 1979, the year in which you have been aiming for budget balance, of $40.2 billion and a deficit of $27.2 billion.

The economic assumptions play a crucial role in this budgetary outlook. The assumed path of the economy underlying the revenue estimates in Table A-1 and in the other tables of the memorandum are summarized in Table A-2 at Tab A. These are not yet the final economic projections which will be used in the FY 1978 budget. The Council of Economic Advisors feels that the assumptions expressed in Table 1 are probably optimistic; however, there is not a concensus on this on the Economic Policy Board. If the real growth rate is reduced by 0.5 percentage points beginning in the first quarter of 1977, the impact on the budget is as follows:

	Fiscal Years	
	1978	1979
Outlays	+ 0.8	+ 1.5
Receipts	- 3.0	- 6.0
Deficit	+ 3.8	+ 7.5

If the inflation rate is lowered by 0.5 percentage points beginning in the first quarter of 1977, the further impact on the budget is as follows:

	1978	1979
Outlays	- 0.5	- 1.3
Receipts	- 3.0	- 5.8
Deficit	+ 2.5	+ 4.5

Of course, our experience has shown that the economic outlook can change rather rapidly. Table A-3 shows some of these corresponding figures for the forecast made at the time of your budget message of last year and at the mid-session budget review.

The full set of Administration tax proposals, together with the revenue consequences in FY 1978 and 1979, is displayed in Table A-3 at Tab A. The proposals included in Table A-4 consist of all outstanding Administration initiatives that have not been made obsolete by the Tax Reform Act of 1976 or by other legislation. Tax proposals that have been dropped from the list of Administration initiatives because of legislation are: limitation on artificial accounting losses; minimum taxable income provisions; unemployment tax increases; revisions in estate and gift taxes.

In addition, changes have been made in the structure of the individual income tax cuts and the timing of the social security tax rate increases, ~~as~~ This is a result of the individual income tax changes in the Tax Reform Act of 1976 and of Congressional inaction on social security tax increases since the presentation of the FY 1977 budget. Changes in the Administration's individual income tax cut proposal are required because instituting the original proposal would result in tax increases for a great many taxpayers. Changes in the social security tax increases are required to prevent an excessive jump which would take place on January 1, 1978, when the Administration's originally proposed increase of 0.6 percentage points in the tax rate would have coincided with an increase mandated by current law.

Changes in Individual Income Tax Cuts

Your individual tax cut proposal made in October 1975, had three principal components:

- Increasing the personal exemption from $750 to $1,000;

. Changing the standard deduction provisions to a flat standard deduction; and

. Reducing marginal tax rates.

Because of two features of the individual cuts in the Tax Reform Act of 1976, -- the taxable income credit, and increases in the standard deduction -- your original proposal would result in tax increases if it were substituted for current law. The revised version of your proposal has been designed to meet three constraints:

. Increase the personal exemptions from $750 to $1,000.

. Assure that tax liabilities are not increased for anyone relative to the Tax Reform Act of 1976, which you signed this year, except as a result of the repeal of the earned income tax.

. Assure that individual income tax liabilities are reduced at least to the levels you proposed in October 1975.

These three objectives have been accomplished (except for a small number of exceptional cases) by keeping the personal exemption and marginal tax rate features of your original proposal and raising the low income allowance levels of current law to the flat standard deduction levels you originally proposed ($1,800 for single returns and $2,500 for joint returns). Taking this step raises slightly the cost of your individual tax cut package, ~~by~~ giving a further cut of about $0.9 billion in calendar 1977 liabilities ~~or~~ and lowering $1.0 billion in FY 1979 receipts by about $1.0 billion. Without these changes, however, tax liabilities would have increased ~~by~~ on ~~some~~ over 1-1/2 million returns, even disregarding increases resulting from repeal of the earned income credit.

If you should wish to reduce the scale of your individual income tax reductions, it is possible to fulfill the first two objectives, increasing the personal exemption to $1,000 and preventing tax increases from present law, and thereby increase receipts by as much as $3 billion in FY 1979. However, such scaling down will not leave taxpayers in the position you intended in your original proposal.

The tables at Tab B present data on the distribution of the tax changes and the tax burdens on individuals of different income and family sizes under your proposal as revised. Table B-1 shows the distribution of individual income tax liabilities under 1976 law, under your original proposal, and under the revised proposal (at 1976 levels of income). The further tables ~~Tables B-2 through B-4~~ show tax burdens for illustrative cases under current law, your original proposal, and your proposal as revised. 4944

Social Security Rate Increases

Table C-1 at Tab C indicates tax rate and base increases for social security taxes already scheduled under current law. Despite these scheduled social security tax increases, additional increases are necessary if the trust funds are to remain solvent. The increase you recommended in January of this year of 0.6 percentage point (half paid by the employee and half paid by the employer) on January 1, 1978 would result in a full one percentage point increase on January 1, 1978 when combined with the current statutory provisions. It has therefore been assumed that a change in this timing is necessary. The revised recommendation consists of three separate changes: an increase of 0.6 percentage point on January 1, 1979 (the 0.4 point increase scheduled in current law plus a further 0.2 point), a further increase of 0.6 point on January 1, 1979, and a still further increase of something less than 0.6 point on January 1, 1980. 9 7

Further background on the social security tax issue is presented at Tab C. Table C-1 at Tab C summarizes the implications of the proposed scheduling of the social security rate increases for the tax rate paid by the employee. The employer contributes an equal amount. The remaining tables at Tab C show the receipts implications of these alternatives as well as the social security tax burdens implied for workers at various wage levels. Further tables at Tab C provide data on the combined social security and individual income tax liabilities for individuals with different family and income situations.

Other Outstanding Proposals

The other proposals contained in the set of outstanding initiatives summarized in Table A-4 are briefly described at Tab D.

Revenue Raising Options

A good idea of the potential for raising additional revenue can be obtained by examining the list of individual components of the presently outstanding program as summarized in Table A-4. Presented below is a listing of the proposals most likely to be candidates for alteration or elimination in a program designed to ~~pre~~pare the revenue cost.

	Effects on Fiscal Year Receipts ($ billions)		
	1977	1978	1979
Delete utility relief package reductions			
Delete 2 percentage point surtax rate reduction			
Delete financial institutions reform			
Delete BSOP			
Delete proposal to end withholding on dividends to foreigners			
Delete sliding scale capital gains tax			
Delete home insulation credit			
Delete LERAs			
Amend education tax credit proposal			
Potential revenue increases from reducing individual cuts			

2. Options for Additional Stimulus to Provide Incentives for Private Investment

The Troika forecasting group, in its preliminary December forecast, concluded that with no new fiscal initiatives the growth rate in the economy during 1977 is likely to be somewhat slower than had previously been forecast and well below the rate assumed in the mid-year review. Growth that is too slow to make significant reductions in the unemployment rate is undesirable and may lead to a variety of public expenditure programs that interfere with our long-run goals of returning the economy to a stable non-inflationary growth path. Hence some options for additional stimulus have been developed.

A major reason for the lower forecast is a scaling down of earlier optimistic estimates for business fixed investment for 1977. Business fixed investment (BFI) has been running well below its normal share of GNP. Hence the additional stimulus measures considered here are all directed to business fixed investment. Of course, your basic program already includes significant individual tax cuts.

Even if the immediate objective is to provide near term investment incentives, only those tax measures which are regarded as desirable structural changes on a permanent basis should be proposed. This reflects the view that stability in tax policy is essential to orderly long-run investment planning. Three basic methods of lowering business taxes are presented below. The levels of the changes are illustrative. The measures could be adjusted to different scales.

Method 1. Advance the Dividend Deduction Feature of the Integration Proposal

The Administration's proposal to integrate the individual and corporation income taxes includes a schedule for phasing in the deductibility of dividends paid by the corporation in calculating corporation income tax together with a phasing in of the gross up and credit at the corporate shareholder level. One way of providing additional stimulus and cash flow to corporations while maintaining the general thrust of the Administration's tax program would be to speed up the integration. Eliminating the double taxation of corporate dividends will, in the short run, reduce taxes on corporate income and bolster securities markets. Ultimately, the effects will be dispersed over the entire private sector.

A particularly simple way to advance this program would be to start the dividend deductibilty at a higher level immediately (as of January 1, 1977), holding at that level until it would be reached under the original schedule. In all other respects the integration schedule would be as originally proposed. By allowing deductibility of 30 percent of dividends starting January 1, 1977, calendar year 1977 liabilities would be reduced by approximately $4.8

billion. The phase-in into the existing schedule of the integration proposal could be accomplished by maintaining the level of 30 percent dividend deductibility until year 1981.

A second method would be to move up by one year the whole schedule of integration of corporate and personal income taxes. The effect of thus phasing in the integration plan would be a reduction of $1.6 billion in calendar 1977 tax liabilities and a reduction of $___ billion in FY 1979 receipts.

Method 2. Change the Investment Tax Credit

In its present formulation, the investment tax credit is larger for qualifying assets of longer depreciable life up to seven years; beyond that no increase in credit is provided, resulting in a bias against long-lived assets. The amount of credit which may be taken in any year is limited by the asset purchaser's tax liability. The maximum credit is the first $25,000 of tax plus 50 percent of the excess, with certain temporary exceptions for utilities, airlines and railroads which permit greater utilization of current year tax liability. This means that cyclically sensitive businesses, those suffering temporary adversity, and growing enterprises cannot fully utilize the credit.

For these reasons, the effectiveness of the present investment credit is less than its nominal rate of 10 percent (scheduled to revert to 7 percent in 1981) might seem to imply. The following revisions in the investment tax credit would constitute desirable structural reforms and would provide some investment stimulus:

- The full amount of the credit earned by an investor each year would be creditable against all income tax liability and refundable to the extent it is in excess of current tax liability.
- The basis of qualified property--the amount subject to depreciation for tax purposes--would be reduced by the amount of the credit.
- The rate of credit would be increased to 12 percent on assets with useful lives of 12 years or more.
- The investment credit would be made permanent.

The calendar 1977 effect of these changes would be a $2.4 billion liability reduction.

A further possibility would be to combine this structural revision in the investment tax credit while increasing the credit rate schedule to:

. 4 percent on assets with lives 3 or 4 years.

. 8 percent on assets with lives 5 or 6 years.

. 12 percent on assets with lives 7 through 11 years.

. 14 percent on assets with lives 12 years or more.

This plan reduces calendar 1977 liabilities by $4.4 billion.

8956
5971

Method 3. <u>Cut the Corporation Income Tax Rate</u>

Your basic plan includes a cut of two percentage points in the top corporate tax rate, from 48 to 46 percent. A further cut, to 44 percent would lead to a reduction in calendar 1977 liabilities of about $4.4 billion, and a reduction in FY 1979 receipts of $___ billion. It would be possible to combine such a rate cut with a change, such as allowing a carry over of the unused surtax exemption, designed to favor smaller businesses.

These alternatives are summarized in the table, E-1 at Tab E which also includes brief discussion of the comparative merits of these business tax changes.

Small Business Proposals

It may be that, should you decide to adopt one or more of the measure alone, you will wish to include new programs to benefit owners of small businesses. A Treasury Department advisory committee on small business recently submitted a set of proposals they would favor. These have not yet received full Treasury Department review. A brief description of the proposals and available revenue estimates are contained in Table E-2.

3. Treasury Department Basic Tax Reform Report

This section discusses the study conducted by the Treasury Department on BTR -- Basic Tax Reform. A more extended discussion is found at Tab F.

The Treasury report presents proposals representing two approaches to broadening the tax base. The first is comprehensive income taxation, and includes elimination of the corporation income tax and full allocation of corporate income to shareholders, along with inflation correction for capital gains and depreciation. The second approach, called a cash flow tax, would replace the individual and corporation income taxes with a consumption based tax.

The Report (which will be ready for release by the middle of next month) represents a thorough review of the basic fundamentals of taxation. It considers, for example, the concept of income and how it should be defined theoretically, and measured practically. The Report develops a tax system which is simpler, more equitable and easier to understand and justify. This tax system would make the operation of the private economy more efficient, and could achieve any degree of progressiveness desired. The Report finds that even a revised, comprehensive income tax would be inferior, in many respects, to a consumption based tax.

The Present System

The present system is viewed as unnecessarily complex: an instrument of torture designed for the benefit of accountants and tax lawyers. It is seen as inequitable: designed to favor the rich and provide loopholes for special interests with political muscle. It is viewed (mostly by economists) as inefficient: misallocating resources in socially undesirable and sometimes unintended directions.

Proposals

The BTR Report begins by sketching an "ideal base" for a tax system and then proceeds to modify this ideal base in ways which make implementation possible. The most important features of the comprehensive inocme tax are as follows:

Integration of the Corporate and Personal Income Taxes

A corporate tax is inappropriate, because there is no such thing as "corporate income" which does not accrue to individuals. That is, all corporate net receipts belong to individuals, either through being paid out as dividends or being retained as retained earnings and thus increasing the value of shareholders' stock. The present system of taxation provides a rate on retained earnings which is too high for some of these shareholders, and too low for others. For low income individuals, the corporate rate of 48 percent is much higher than they pay on their other income. For individuals in the highest tax brackets on the other hand, the 48 percent rate applied to retained earnings is lower than the rate on their ordinary income. Further taxation will be at capital gains rates, and will be deferred, perhaps forever.

Under the BTR proposals, the corporation income tax would be eliminated and all corporate income would be allocated to individual shareholders with an accompanying step-up in basis. Dividends to shareholders would not be separately taxed, but treated as a reduction in basis. Thus integration would: (1) end the double taxation of dividends, (2) key the effective tax rate on all income to the circumstances of individual taxpayers, and (3) provide a practical method for accrual taxation of this form of capital gains.

<u>Base Broadening</u>

Improved equity and lower tax rates would be achieved by broadening the base of the income tax. This would be done both through expanding the types of income which are taxable and through reducing the types of deductions which are allowed. The Report goes into these matters in considerable detail, discussing the theoretically best approach, and indicating where administrative or practical considerations impel different decisions.

The Report proposes significant changes in the handling of capital gains income. Under an "ideal" tax base, capital gains would be taxed as accrued, not just when realized through sale or exchange of the asset. However, this would necessitate annual asset valuations, and the practical problems raised by this led the BTR Report to recommend against accrual taxation. Thus, the tax benefit from deferring realization of capital gains would be retained, though the proposed corporate integration would considerably reduce the scope of this deferral. While the proposal calls for full taxation of capital gains (abolishing the 50 percent exclusion), it would end the taxation of purely inflationary gains by providing an inflation adjustment, discussed below.

Some other forms of income currently excluded from the tax base would become fully taxable. These include state and local bond interest, social security benefits (though employee contributions would become deductible), private pension benefits and interest earnings thereon, and unemployment compensation payments.

Inflation Corrections

The BTR Report calls for an inflation correction for capital gains and for depreciation allowances. That is, assets which are held over a period of time would have their cost basis adjusted upward to take account of the depreciation of the currency during th r holding period. While under an "ideal" tax system, this inflationary correction would also apply to debts, e.g., adjusting upward the principal of a home mortgage, the BTR recommendation stops short of such a complex step.

Cash Flow Tax

The most significant aspect of the BTR Report is its recommendation of consideration of a cash flow, consumption based tax to replace the present individual income tax. In the past, such a tax has usually been viewed as not worthy of consideration because it would be:

<u>Regressive</u> (like a sales tax)

<u>Radical</u> (a complete change from the present income tax system)

<u>Difficult to administer</u> (who can keep track?)

The BTR Report examines these criticisms and finds them to be invalid.

<u>Regressive</u> -- While a consumption tax is viewed as bearing heavily on the poor (who spend) and not on the rich (who save), in reality through the use of exemptions and progressive rates, a tax on spending can be just as progressive or regressive as the Congress wishes to make it.

<u>Radical</u> -- While it would appear that changing from the present income tax to a cash flow, consumption base tax would be a radical move, the BTR Report finds that the present system is closer to a cash flow tax than to a comprehensive income tax in its treatment of many forms of income from capital. In particular, two important sources of saving for many Americans -- home ownership and contributions to retirement annuities (employer contributions, Keogh Plans, and IRA's) -- are treated under the current law almost exactly the same way they would be treated under a cash flow tax.

<u>Difficult to administer</u> -- When the term "consumption tax" is used, most people think of a sales tax and imagine that such a tax would require keeping records on every bit of expenditure throughout the year. In actual implementation, however, a cash flow consumption base tax would involve tax forms very similar to the present ones with the significant change that net additions to <u>savings</u> would be subtracted from income in arriving at the tax base. Indeed, a cash flow consumption base tax would actually be easier to administer in many respects, primarily in the area of capital income. For example, problems in the measurement of depreciation, in the evaluation of capital gains, and in the allocation of undistributed corporate income could be avoided because changes in net worth (savings) would not be included in the tax base.

Even more significantly, the cash flow tax, by taxing consumption, eliminates disincentives to savings and thus encourages capital formation. This would lead to more capital per worker and higher before tax wages in the long run. Thus the allocative effect of a cash flow consumption base tax makes it very attractive as an alternative to either the present income tax or even to an improved comprehensive base income tax.

1976

Tax Rates

The advantages of base broadening, of course, is that it makes possible the use of much lower tax rates to raise the same total revenue. For example, the "comprehensive income" concept developed by the BTR Report is approximately 20 percent higher than the AGI (Adjusted Gross Income) of individuals, so even after making up for the abolition of the corporate tax, individual tax rates could be cut almost one-fifth across the board, and still raise the same revenue. (Of course, the distribution of taxes across income classes would be quite different.) The BTR Report presents alternative rate structures. The exact rate schedules remain to be worked out but it appears that both individual and corporate income tax receipts could be replaced by structures ranging from a proportional, 15 percent tax with no exemptions, to systems with exemptions, deductions, and various tax brackets up to a top rate of 40 percent. All of these yield the same total revenue; although the graduated structure is required to preserve the present progressivity of the Federal tax system.

Bombshells, Boobytraps, and Pitfalls

There are certain aspects of the BTR Report which you should be aware of, because they will arouse comment and criticism. These include the following proposals:

- Social security benefits and other retirement benefits would be taxed when they are received. (For the most part, they are now exempt.)

- The earnings on retirement and pension funds would be taxed as they accrued. (They are now mostly exempt.)

- Capital gains would be taxed at full rates. (They would be adjusted for inflation, and those arising from corporation earnings would be relieved of double taxation.)

- Unemployment compensation would be taxed. (It is now exempt.)

- Interest on state and local bonds would be taxed.

- The aged and blind exemptions would be abolished.

- The deduction for local taxes on personal property would be abolished.

. The consumption tax proposals will, in spite of the points made above, be viewed by many as a radical, regressive, and impractical proposal.

. Many of what the Report regards as minor and non-controversial loophole closings will produce cries of outrage from small, but vocal, special interests.

7/75

Is the Report a Radical One?

While the Report urges some significant changes in the income tax base, and calls for at least studying a consumption based tax, it should be emphasized that many characteristics of the present tax system would be retained, and many of the changes are presented as options. Specifically, charitable deductions, home mortgage interest, and medical deductions are included as options, although the basic model plans assume they are eliminated. While there is a new "secondary worker" exemption permitted for couples in which both husband and wife work, the basis for taxation remains the family unit as it is today.

Use of the BTR Report

In its present form, the BTR Report provides the research and background information necessary for considering fundamental changes in U.S. tax policy. While it provides two models, a comprehensive income tax and a consumption tax, it does not attempt to "sell" or even to recommend these particular models. There are many details (e.g., deduction items) which are presented on an optional basis rather than a recommended basis. Thus the present Report would not be appropriate, for example, for inclusion in your budget for FY '78.

Your Tax Message will contain a number of specific proposals. The BTR Report is really a drastically different approach, an alternative to piecemeal, patching up of the system. To avoid getting bogged down in details, it sketches its proposals in more general terms, and these are not in the form appropriate for legislative recommendations to the Congress at this time. They are an attempt to describe the tax system of the future. There will be much work and many debates within and between the executive branch, the legislative branch, and the academic community before this new system finally becomes law. The important thing as Secretary Simon has stated, is to get the debate started, and the BTR is designed to do just that.

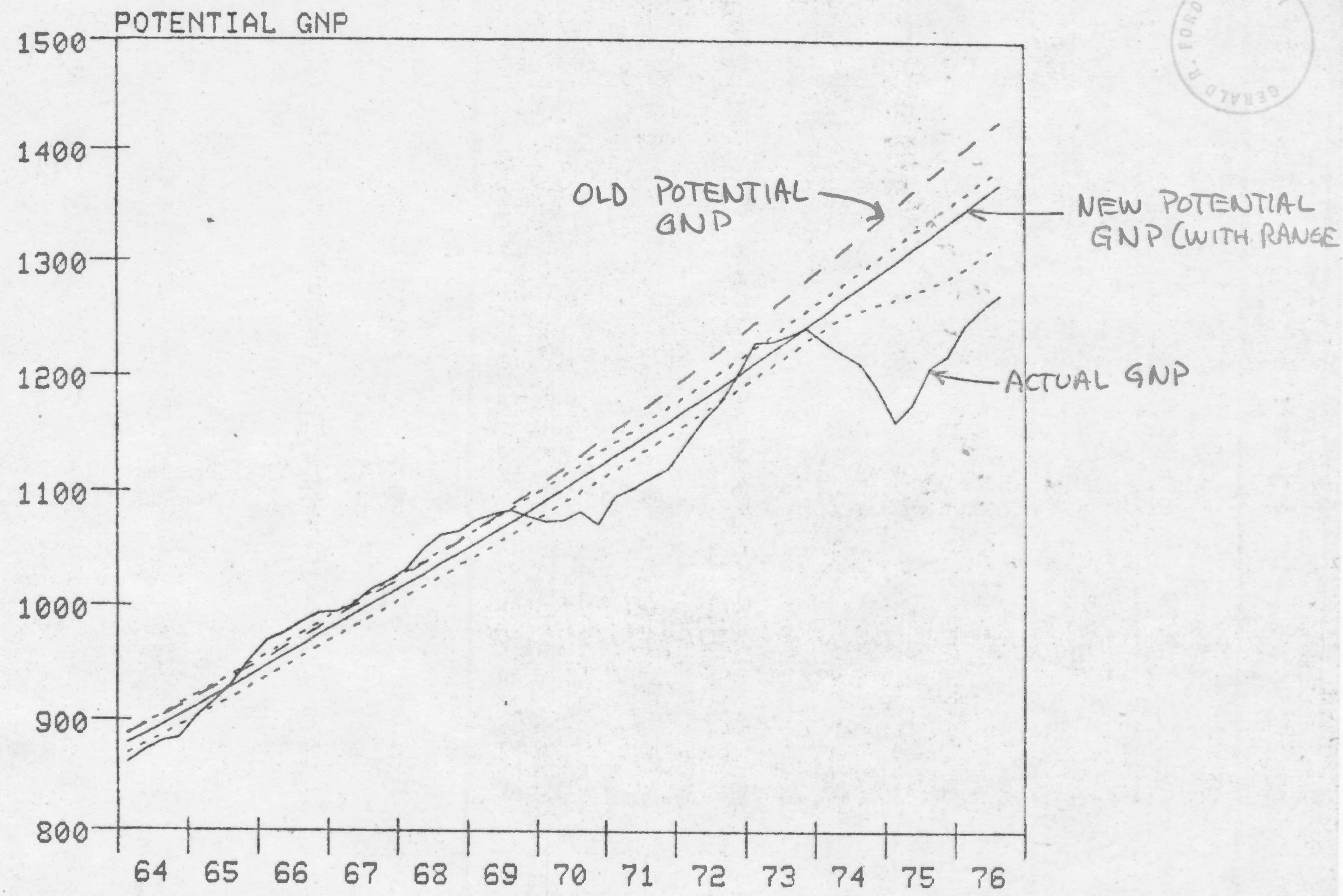
Probably the best use you can make of the Report would be to allude to it in your Tax Message and then issue it as a legacy to future tax policy. You would not have to "endorse" it, but could say that the work represented in it will provide the basis for future Congresses to develop an improved tax system for the U.S. 8974

PC

November 22, 1976

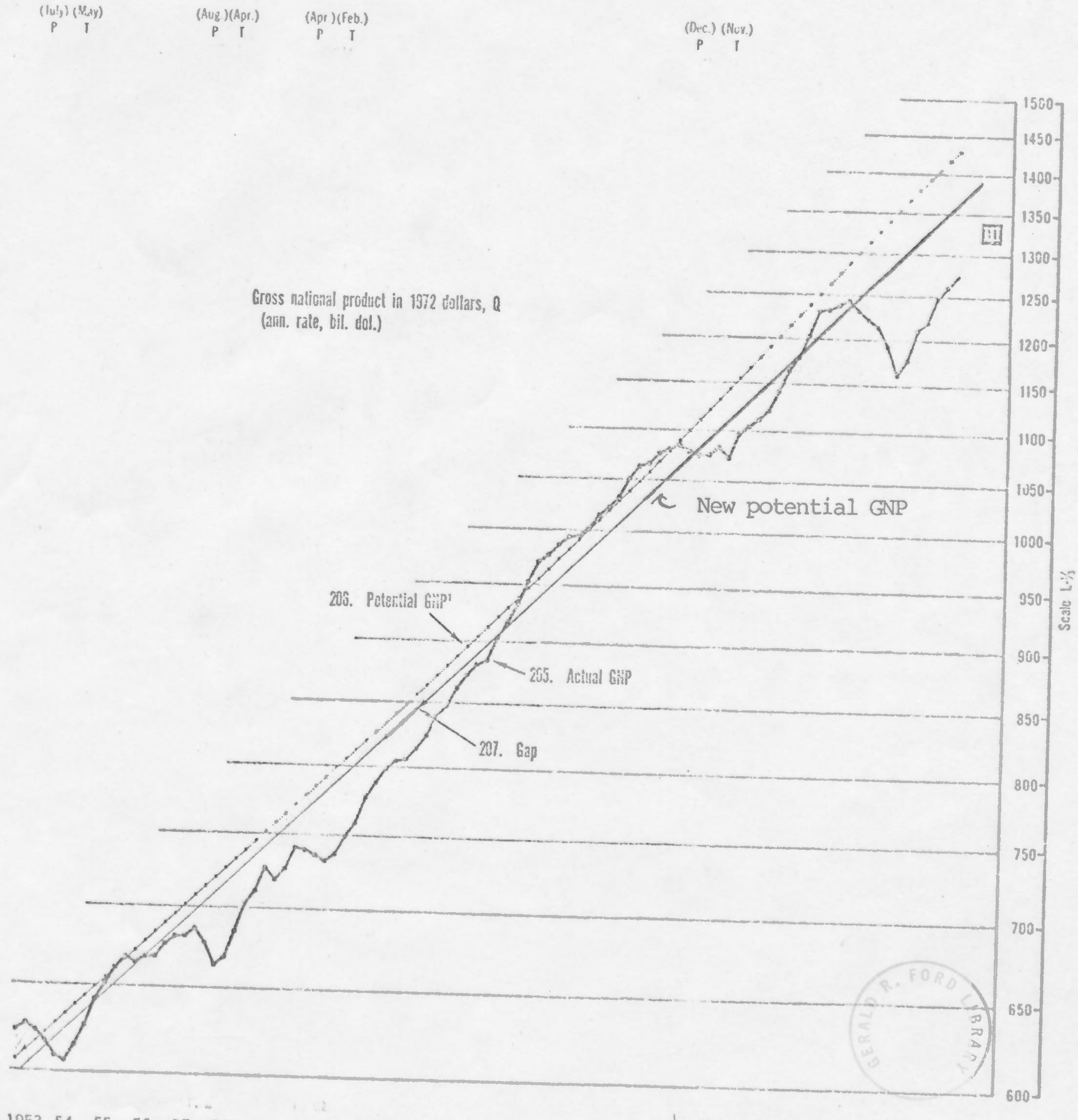
Potential GNP Estimates

	Potential GNP	Potential GNP Range	Unemployment Benchmark
1948	492.8	488-498	4.3
	514.4	509-520	4.2
1950	537.0	531-543	4.2
	560.5	555-567	4.1
	584.9	579-591	4.0
	608.2	602-615	4.0
	629.7	623-636	4.0
1955	651.4	644-658	4.0
	673.9	667-681	4.0
	697.2	690-705	4.0
	721.2	714-729	4.0
	746.2	738-754	4.1
1960	771.9	764-780	4.1
	798.6	790-807	4.1
	826.4	818-835	4.1
	857.1	848-866	4.2
	890.3	881-900	4.3
1965	925.0	915-935	4.4
	960.8	951-971	4.5
	996.3	986-1007	4.4
	1031.7	1021-1043	4.4
	1068.3	1057-1080	4.4
1970	1106.2	1094-1118	4.5
	1145.5	1133-1158	4.6
	1186.1	1173-1199	4.7
	1228.2	1215-1241	4.8
	1271.7	1253-1285	4.8
1975	1316.9	1273-1331	4.8
	1363.6	1305-1378	4.9
	1412.0	1351-1427	4.9
	1462.1	1400-1478	4.9
	1513.9	1451-1530	4.9
1980	1567.7	1503-1585	4.8


POTENTIAL GNP
1500
1400
1300
1200
1100
1000
900
800
64
65
66
67
68
69
70
71
72
73
74
75
76
OLD POTENTIAL GNP
NEW POTENTIAL GNP (WITH RANGE
ACTUAL GNP

E ANALYTICAL MEASURES

Chart E1 **ACTUAL AND POTENTIAL GROSS NATIONAL PRODUCT**



Current data for these series are shown on page 95. [1]Trend line of 3.5 percent per year (intersecting actual line in middle of 1955) from 1st quarter 1952 to 4th quarter 1962, 3.75 percent from 4th quarter 1962 to 4th quarter 1968, 4 percent from 4th quarter 1968 to 4th quarter 1975, and 3.75 percent thereafter. See special note on page 95.

THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

November 23, 1976

MEMORANDUM FOR THE EXECUTIVE COMMITTEE OF THE ECONOMIC POLICY BOARD

Attached for your information is the Council of Economic Advisers' new estimates of "potential gross national product" and of the "full employment rate of unemployment".

Alan Greenspan

AMERICAN REVOLUTION BICENTENNIAL 1776-1976

November 22, 1976

Potential GNP Estimates

	Potential GNP	Potential GNP Range	Unemployment Benchmark
1948	492.8	488-498	4.3
	514.4	509-520	4.2
1950	537.0	531-543	4.2
	560.5	555-567	4.1
	584.9	579-591	4.0
	608.2	602-615	4.0
	629.7	623-636	4.0
1955	651.4	644-658	4.0
	673.9	667-681	4.0
	697.2	690-705	4.0
	721.2	714-729	4.0
	746.2	738-754	4.1
1960	771.9	764-780	4.1
	798.6	790-807	4.1
	826.4	818-835	4.1
	857.1	848-866	4.2
	890.3	881-900	4.3
1965	925.0	915-935	4.4
	960.8	951-971	4.5
	996.3	986-1007	4.4
	1031.7	1021-1043	4.4
	1068.3	1057-1080	4.4
1970	1106.2	1094-1118	4.5
	1145.5	1133-1158	4.6
	1186.1	1173-1199	4.7
	1228.2	1215-1241	4.8
	1271.7	1253-1285	4.8
1975	1316.9	1273-1331	4.8
	1363.6	1305-1378	4.9
	1412.0	1351-1427	4.9
	1462.1	1400-1478	4.9
	1513.9	1451-1530	4.9
1980	1567.7	1503-1585	4.8

THE WHITE HOUSE

WASHINGTON

December 9, 1976

MEMORANDUM FOR: JIM CANNON

FROM: ALLEN MOORE A

SUBJECT: EPB meeting on tax initiatives

The attached memo addresses the basic question of how many, and what kind of optional tax packages should be forwarded to the President for his consideration and subsequent recommendation. Required EPB decisions are identified as follows:

(1) Should the President be given a recommendation on the need for stimulus and preferred revenue target?

(2) Should the social security tax increase be phased in earlier or later?

(3) Should the individual income tax cuts be phased in (under the low revenue-pickup plan) in order to compensate for social security increases, or should the full cuts begin December 1, 1977?

I think you should be aware of the following:

- Economic Stimulus initiative

  The continuing disappointing rate of economic recovery raises the question of whether the President should consider recommending a special economic stimulus initiative.

- Balanced budget, FY '79

  Any additional stimulus seems to interfere with the stated goal of a balanced budget for FY '79 -- a target already generally considered to be infeasible.

- Social Security increases

  Social security taxes are scheduled to increase as follows:

a. Taxable wage base increases from 15,300 to 16,500 on January 1, 1977.

b. Current law requires a .4 percent rate increase on January 1, 1978.

c. Current law requires another wage base increase to an estimated $17,700 on January 1, 1978.

d. The President's proposed .6 percent rate increase to finance the short-term Social Security deficit did not pass. Therefore, the short-term problem is exacerbated. It is now estimated that a .9 percent increase is required to bring short-term cash flow into balance. A combination rate increase and wage base increase could also finance this problem.

e. A .9 percent increase for 1978 added to the already legislated increases would mean a net increase of over $185 for the wage earner receiving $17,700 (and an equivalent $185 increase for the employer).

An increase of this magnitude would have a major dampening effect on the economy and offset currently proposed tax cuts. Therefore, the paper lays out several options for phasing in the Social Security tax increases.

- Phased tax cuts

  The paper also describes options for phasing in the President's proposed tax cuts. The phasing is done in part to help directly offset the Social Security increases. So-called Phase I cuts (assumed effective January 1, 1978) ~~the remaining 30 percent~~ would equal 70% of proposed cuts and Phase II cuts (for January 1, 1978) 30%.

- Increased revenues.

  The paper also discusses two options for increasing Federal revenues (i.e. the balanced budget for FY '79 issue) -- a "low revenue-pickup" and "high revenue-pickup" option.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

December 8, 1976

MEMORANDUM TO THE ECONOMIC POLICY BOARD

From: David F. Bradford DFB

Subject: Tax Options for Forwarding to the President

1. Introduction

As the recent discussions have suggested, a bewildering array of possible tax programs is potentially available for inclusion in the FY 1978 budget. Treasury staff has been asked to prepare this memorandum, in cooperation with OMB and CEA staff, to assist the EPB in narrowing the set of alternatives to be presented to the President.

The decisions required from the EPB are:

- Should the President be given a recommendation on the need for stimulus and preferred revenue target?

- Should the social security tax increase be phased in earlier or later?

- Should the individual income tax cuts be phased in (under the low revenue-pickup plan) in order to compensate for social security increases, or should the full cuts begin December 1, 1977?

These issues are explained below.

2. Background

The starting point is the set of currently outstanding Administration tax proposals. These are listed, together with the revenue consequences in FY 1977, 1978, and 1979, in Table A-1 at Tab A. Under the assumed economic projections and OMB's present expenditure estimates, the renewal of all these tax initiatives would yield budget receipts for FY 1979 of $442.7 billion and a deficit of $26.3 billion.

The proposals included in Table A-1 consist of all outstanding Administration initiatives that have not been made obsolete by the Tax Reform Act of 1976 or by other legislation. Tax proposals that have been dropped from the list of Administration initiatives because of legislation are: limitation on artificial accounting losses; minimum taxable income provisions; unemployment tax increases; revisions in estate and gift taxes.

Further changes must be considered in the structure of the individual income tax cuts and the timing of the social security tax rate increases as a result of the individual income tax changes in the Tax Reform Act of 1976 and of Congressional inaction on social security tax increases since the presentation of the FY 1977 budget. Changes in the Administration's individual income tax cut proposal are required because instituting the original proposal would result in tax increases for a great many taxpayers. Changes in the social security tax increases may be considered desirable to prevent an excessive jump which would take place on December 1, 1978, when the Administration's proposed increase would coincide with an increase mandated by current law. Sections 3 and 4 of this memorandum discuss basic options in these two areas.

Additional changes are called for in the tax program if it is desired to move toward closing the budget deficit in FY 1979. Sections 5 and 6 of this memorandum lay out packages of tax proposals designed to raise, respectively, $4 and $8 billion relative to the program summarized in Table A-1. Two versions at each level are described, differing most importantly in their phasing of the social security tax rate increase. The objective is to enable the EPB to choose a preferred alternative at each budget level, so that one package at each level may be contained in the material presented to the President.

In this memorandum it is assumed that an effort will be made to trim the budget deficit in FY 1979 and therefore it considers only packages of tax proposals which will raise revenues relative to the existing program. However, it may be considered desirable, in view of the development of the economic situation in recent months, to consider a tax program which is less stringent. It may be, for example, that the President will wish to go forward with a tax program at the existing projected revenue, or he may wish to add an additional stimulative element to his program by measures such as are described in the companion memorandum on incentives for private investment. If this is the decision, it would be desirable to review the overall program once again. The tax packages presented in this memorandum express a strategy which emphasizes individual income tax cuts and improvement in incentives for capital formation, centered around the proposal to integrate individual and corporate income taxes. In a similar way, the tax program should be reconsidered as a whole if lower revenue targets are selected than are assumed here.

3. Changes in Individual Income Tax Cuts

The Administration's individual tax cut proposal made in October 1975, had three principal components:

- Increasing the personal exemption from $750 to $1,000;
- Changing the standard deduction provisions to a flat standard deduction; and
- Reducing marginal tax rates.

Because of the taxable income credit feature of the individual cuts in the Tax Reform ACt of 1976, the President's original proposal would result in tax increases if it were substituted for current law. This memorandum includes revised versions of the President's proposal designed to meet two constraints:

- Increase the personal exemptions from $750 to $1,000.
- Assure that tax liabilities are not increased for anyone relative to 1976 law, except as a result of the repeal of the earned income tax.

It is possible to accommodate these objectives at two levels of tax cuts, one roughly equal to the original proposed cut and one at a lower level which could be used to raise additional revenue. These alternatives are described as successive phases in the summary tables which are presented at Tab B. Phase I, accounting for approximately 70 percent of the total tax cut, is assumed effective on January 1, 1977. It consists of replacing the per capita, taxable income, and earned income credits with the $250 increase in the personal exemption and a reduction in tax rates. The second phase, phase II, comprising the remaining 30 percent, would be effective on January 1, 1978, in the low revenue-pickup option. It provides further reduction in the lowest tax rates.

The lesser of these cuts, the phase I cuts, are essentially the minimum amounts compatible with the constraints. In designing the deeper, phase II cuts, an effort was made to take into account the impending increase in social security rates. The deeper cuts are sufficient significantly to mitigate the social security tax increases. The phasing has been designed to time the second income tax cut with the social security rate increase on January 1, 1978. It would be possible, to introduce the full program of income tax cuts at once on January 1, 1977. This would, of course, have revenue implications for FY '77 and '78.

4. <u>Social Security Rate Increases</u>

The way in which the social security system is financed is an important variable in the options presented in this memorandum. Table C-1 at Tab C indicates tax rate and base increases for social security taxes already scheduled under current law. Despite these scheduled social security tax increases, additional increases are necessary if the trust funds are to remain solvent. The increase included in Table 1 of 0.6 percentage point (half paid by the employee and half paid by the employer) on January 1, 1978 would result in a full one percentage point increase on January 1, 1978 when combined with the current statutory provisions. It has therefore been assumed that a change in this timing is necessary. Two alternative recommendations presented here are:

- Increase social security taxes 0.3 percentage points on January 1, 1978, another 0.3 percentage points on January 1, 1979, and a further 0.5 percentage point on January 1, 1980. This is described as <u>Option A</u> in the tables at Tab C and as the <u>Earlier Social Security Tax Increase Program</u> in the tables at Tab A.

. Increases in social security taxes of 0.6 percentage points on January 1, 1979 and of a further 0.6 percentage points on January 1, 1980. This is described as Option B in the tables at Tab C and as Later Social Security Tax Increase Program in the tables at Tab A.

Table C-1 at Tab C summarizes the implications of these alternatives for the tax rate paid by the employee. The employer contributes an equal amount. The remaining tables at Tab C show the receipts implications of these alternatives as well as the social security tax burdens implied for workers at various wage levels. A discussion of other aspects of the social security financing problem is given at Tab E.

The tables at Tab D of this memorandum provide data on the combined social security and individual income tax liabilities for individuals with different family and income situations under the various options which have been presented.

4. Low Revenue-Pickup Options

The two low revenue options are designed to increase budget receipts in FY 1979 by $4 billion above that specified in Table 1. Two alternative packages for generating this additional revenue pickup are presented in Tables A-2 and A-3 at Tab A. These alternatives differ only with respect to the timing of social security tax rate increases and inclusion of the Administration's program of reducing capital gains taxes on individuals by means of a sliding scale mechanism. Table A-2 illustrates the case of earlier social security tax increases which permits the sliding scale proposal, while the program described in Table A-3 has the later social security tax increases but does not include the sliding scale proposal. Tables A-6 and A-7 indicate main ways in which revenues are raised relative to the Administration's previously proposed program.

5. High Revenue-Pickup Options

The two high revenue-pickup options are designed to increase budget receipts in FY 1979 by $8 billion relative to the current tax program as shown in Table 1. These packages are described in Tables A-4 and A-5. Again, these two alternatives differ only with respect to financing the social security system and the inclusion of the sliding scale for capital gains. The ways in which additional receipts are provided are indicated in Tables A-8 and A-9.

As in the low revenue cases, even modifying the previously proposed tax initiatives in the ways suggested here still reduces receipts below those generated by extensions of current law. Thus, the high revenue options still include tax cuts. However, to increase revenues by $8 billion requires that the Administration's tax program must be severely modified.

Tab A

Table A-1

Estimated Unified Budget Receipts Under Current Law and Assuming Enactment as Soon as Practicable of Outstanding Administration Proposals Not Superseded by the Tax Reform Act of 1976 1/

($ billions)

Item	Effective date	Fiscal Years 1977	1978	1979
Current law receipts 2/		357.7	411.1	470.8
Permanent extension of temporary tax provisions:				
Extend Tax Reform Act of 1976 reductions:	1/1/78			
Individuals 3/			-6.8	-11.3
Corporations			-1.0	-2.4
Total			-7.8	-13.7
Receipts after permanent extension of temporary provisions		357.7	403.2	457.1
Proposed legislation:				
Repeal Tax Reform Act of 1976 (Extended) tax reductions and replace with President's proposed reductions:	1/1/77			
Individuals		-7.3	-9.6	-10.2
Corporations		-1.3	-3.0	-3.5
Total		-8.6	-12.6	-13.7
Social security tax rate increase .	1/1/78		3.8	6.0
Railroad retirement tax rate increase	1/1/78		*	0.1
Financial institutions reform:	1/1/77			
Individuals		-*	-0.1	-0.1
Corporations		-0.3	-0.6	-0.7
Total		-0.3	-0.7	-0.7
Stock ownership incentives:	1/1/77			
Individuals			-0.4	-0.5

Table A-1 Cont.

($ billions)

Item	Effective date	Fiscal Years 1977	1978	1979
Accelerated depreciation in high unemployment areas:	1/1/77			
Individuals		-*	-*	-0.1
Corporations		-*	-0.1	-0.3
Total		-*	-0.2	-0.4
Corporation tax integration:	1/1/78			
Individuals				-0.1
Corporations			-1.1	-3.0
Total			-1.1	-3.1
Write-off liability on silver certificates	9/15/77	0.2		
Fees for regulatory and judicial services	1/1/77	0.1	0.1	0.1
Miscellaneous (waterway) fees	1/1/77	0.1	0.1	0.2
Repeal withholding on portfolios of foreigners	1/1/77	-0.1	-0.2	-0.3
Exclude charitable contributions from minimum tax	1/1/77		-0.1	-0.1
Reduce administrative fees on foundations	1/1/77		-*	-*
Capital gains of individuals ..	1/1/77	0.1	-0.6	-0.9
Taxable municipal bond option 4/ .	1/1/78		*	*
Industrial development bonds 5/ ...	1/1/78		*	*
Home insulation credit	1/1/77		-0.2	-0.2
Limited employee retirement accounts 6/	1/1/77	-0.1	-0.4	-0.5
Education tax credit	7/1/77		-0.3	-0.4
Receipts after proposed legislation ..		349.1	390.3	442.7

Table A-1 Cont.

($ billions)

	Effective date	1977	1978	1979
		Fiscal Years		
Changes in receipts from current law:				
Due to permanent extensions of temporary tax provisions			-7.8	-13.7
Due to proposed legislation		-8.6	-12.9	-14.4
Total		-8.6	-20.7	-28.1

Office of the Secretary of the Treasury, Office of Tax Analysis December 3, 1976

*Less than $50 million.
Note: Details may not add to totals because of rounding.

1/ Based on an economic forecast which assumes high unemployment and low inflation.
2/ Includes impact of the Tax Reform Act of 1976, recent administrative action to triple import duties on sugar and H.R. 10210 which increases unemployment taxes on employers.
3/ Assumes no change in withholding rates. Excludes outlay effects of permanently extending the earned income credit.
4/ Excludes outlays, estimated to be $13 million in 1978 and $31 million in 1979.
5/ Excludes outlays, estimated to be $20 million in 1978 and $50 million in 1979.
6/ Endorsement of House plus Senate provisions, tentative estimates.

Table A-2

Treasury Recommended Tax Program for the Fiscal Year 1978 Budget
(Low Revenue Option) Earlier Social Security Tax Increases
($ billions)

Proposal	Effective date	Fiscal Years 1977	1978	1979
Current law receipts		357.7	411.1	470.8
Assumed permanent extension of temporary tax reductions:	1/1/78			
Individuals 1/			-6.8	-11.3
Corporations 2/			-1.0	-2.4
Total			-7.8	-13.7
Treasury proposed tax legislation:				
Excess of new proposed tax reductions for individuals over current law reductions extended. 3/	1/1/77	-5.8	-9.3	-10.9
Social security tax rate increase of 0.3 percentage points . in 1978 and .3 percentage points in 1979.	1/1/78		1.9	5.1
Railroad retirement tax rate increase	1/1/78		*	*
Stock ownership incentives (individuals)	1/1/77		-0.4	-0.4
Repeal ESOP	1/1/77	0.1	0.3	0.3
Total		0.1	-0.1	-0.2
Accelerated depreciation in areas of high unemployment	1/1/77			
Individuals		-*	-*	-0.1
Corporations		-*	-0.1	-0.3
Total		-*	-0.2	-0.4
Corporation tax integration:	1/1/78			
Individuals				-0.1
Corporations			-1.1	-3.0
Total			-1.1	-3.1
Write-off liability on silver certificates .	9/15/77	0.2		
Fees for regulatory and judicial services ...	1/1/77	0.1	0.1	0.1
Miscellaneous (waterway) fees	1/1/77	0.1	0.1	0.2

Table A-2 Cont.

(Low Revenue Option) Earlier Social Security Tax Increases-Cont.
($ billions)

Proposal	Effective date	Fiscal Years 1977	1978	1979
Exclude charitable contributions from minimum tax	1/1/77		0.1	0.1
Reduce administrative fees on foundations ..	1/1/77		-*	-*
Capital gains of individuals...........	1/1/77	0.1	-0.6	-0.9
Taxable municipal bond option	1/1/78			*
Industrial development bonds	1/1/78			*
Education tax credit ..	1/1/78			-0.2
Receipts after Treasury proposed legislation .		352.4	393.8	446.7

Office of the Secretary of the Treasury, Office of Tax Analysis December 8, 1976

* Less than $50 million.

1/ Treasury's proposals include substituting the President's tax reduction for these individual extensions.

2/ Part of the Administration's proposals.

3/ Consists of replacing the per capita, taxable income and earned income credits with a $250 increase in the personal exemption (from $750 to $1,000); and reducing selected tax rates (see appendix for detail).

Table A-3

Treasury Recommended Tax Program for the Fiscal Year 1978 Budget
(Low Revenue Option) Later Social Security Tax Increases
($ billions)

Proposal	Effective date	Fiscal Years 1977	1978	1979
Current law receipts		357.7	411.1	470.8
Assumed permanent extension of temporary tax reductions:	1/1/78			
Individuals 1/			-6.8	-11.3
Corporations 2/			-1.0	-2.4
Total			-7.8	-13.7
Treasury proposed tax legislation:				
Excess of new proposed tax reductions for individuals over current law reductions extended. 3/	1/1/77	-5.8	-9.3	-10.9
Social security tax rate increase of 0.6 percentage points .	1/1/79			4.2
Railroad retirement tax rate increase	1/1/79			*
a. Stock ownership incentives (individuals)	1/1/77		-0.4	-0.5
b. Repeal ESOP	1/1/77	0.1	0.3	0.3
Total		0.1	-0.1	-0.2
Accelerated depreciation in areas of high unemployment	1/1/77			
Individuals		*	*	-0.1
Corporations		*	-0.1	-0.3
Total		*	-0.2	-0.4
Corporation tax integration:	1/1/78			
Individuals				-0.1
Corporations			-1.1	-3.0
Total			-1.1	-3.1
Write-off liability on silver certificates .	9/15/77	0.2		
Fees for regulatory and judicial services ...	1/1/77	0.1	0.1	0.1
Miscellaneous (waterway) fees	1/1/77	0.1	0.1	0.2

Table A-3 Cont.

(Low Revenue Option) Later Social Security Tax Increases-Cont.
($ billions)

Proposal	Effective date	Fiscal Years 1977	1978	1979
Exclude charitable contributions from minimum tax	1/1/77		-0.1	-0.1
Reduce administrative fees on foundations ..	1/1/77		*	*
Taxable municipal bond option	1/1/78		*	*
Industrial development bonds	1/1/78		*	*
Education tax credit ...	1/1/78	___	___	-0.2
Receipts after Treasury proposed legislation .		352.4	392.5	446.7

Office of the Secretary of the Treasury, Office of Tax Analysis December 8, 1976

* Less than $50 million.

1/ Treasury's proposals include substituting the President's tax reduction for these individual extensions.

2/ Part of the Administration's proposals.

3/ Consists of replacing the per capita, taxable income and earned income credits with a $250 increase in the personal exemption (from $750 to $1,000); and reducing selected tax rates (see appendix for detail).

Table A-4

Treasury Recommended Tax Program for the Fiscal Year 1978 Budget

(High Revenue Option) Earlier Social Security Tax Increases

($ billions)

Proposal	Effective date	Fiscal Years 1977	1978	1979
Current law receipts		357.7	411.1	470.8
Assumed permanent extension of temporary tax reductions:	1/1/78			
Individuals 1/			-6.8	-11.3
Corporations 2/			-1.0	-2.4
Total			-7.8	-13.7
Treasury proposed tax legislation:				
Excess of new proposed tax reductions for individuals over current law reductions extended. 3/	1/1/77	-5.8	-7.2	-7.7
Social security tax rate increase of 0.3 percentage points in 1978 and .3 percentage points in 1979.	1/1/78		1.9	5.1
Railroad retirement tax rate increase	1/1/78		*	*
Repeal ESOP	1/1/77	0.1	0.3	0.3
Accelerated depreciation in areas of high unemployment	1/1/77			
Individuals		-*	-*	-0.1
Corporations		-*	-0.1	-0.3
Total		-*	-0.2	-0.4
Corporation tax integration:	1/1/78			
Individuals				-0.1
Corporations			-1.1	-3.0
Total			-1.1	-3.1
Write-off liability on silver certificates .	9/15/77	0.2		
Fees for regulatory and judicial services ...	1/1/77	0.1	0.1	0.1
Miscellaneous (waterway) fees	1/1/77	0.1	0.1	0.2

Table A-4 Cont.

(High Revenue Option) Earlier Social Security Tax Increases-Cont.

($ billions)

Proposal	Effective date	Fiscal Years 1977	1978	1979
Exclude charitable contributions from minimum tax	1/1/77		0.1	0.1
Reduce administrative fees on foundations ..	1/1/77		-*	-*
Capital gains of individuals...........	1/1/77	0.1	-0.6	-0.9
Taxable municipal bond option	1/1/78			*
Industrial development bonds	1/1/78			*
Receipts after Treasury proposed legislation .		352.4	396.3	450.6

Office of the Secretary of the Treasury, Office of Tax Analysis — December 8, 1976

* Less than $50 million.

1/ Treasury's proposals include substituting the President's tax reduction for these individual extensions.

2/ Part of the Administration's proposals.

3/ Consists of replacing the per capita, taxable income and earned income credits with a $250 increase in the personal exemption (from $750 to $1,000); and reducing selected tax rates (see appendix for detail).

Table A-5

Treasury Recommended Tax Program for the Fiscal Year 1978 Budget
(High Revenue Option) Later Social Security Tax Increases
($ billions)

Proposal	Effective date	Fiscal Years 1977	1978	1979
Current law receipts		357.7	411.1	470.8
Assumed permanent extension of temporary tax reductions:	1/1/78			
Individuals 1/			-6.8	-11.3
Corporations 2/			-1.0	-2.4
Total			-7.8	-13.7
Treasury proposed tax legislation:				
Excess of new proposed tax reductions for individuals over current law reductions extended. 3/	1/1/77	-5.8	-7.2	-7.7
Social security tax rate increase of 0.6 percentage points .	1/1/79			4.2
Railroad retirement tax rate increase	1/1/79			*
Repeal ESOP	1/1/77	0.1	0.3	0.3
Accelerated depreciation in areas of high unemployment	1/1/77			
Individuals		*		-0.1
Corporations		*	-0.1	-0.3
Total			-0.2	-0.4
Corporation tax integration:	1/1/78			
Individuals				-0.1
Corporations			-1.1	-3.0
Total			-1.1	-3.1
Write-off liability on silver certificates .	9/15/77	0.2		
Fees for regulatory and judicial services ...	1/1/77	0.1	0.1	0.1
Miscellaneous (waterway) fees	1/1/77	0.1	0.1	0.2

Table A-5 Cont.

(High Revenue Option) Later Social Security Tax Increases-Cont.
($ billions)

Proposal	Effective date	Fiscal Years 1977	1978	1979
Exclude charitable contributions from minimum tax	1/1/77		-0.1	-0.1
Reduce administrative fees on foundations ..	1/1/77		-*	-*
Taxable municipal bond option	1/1/78		*	*
Industrial development bonds	1/1/78		*	*
Receipts after Treasury proposed legislation .		352.4	395.1	450.6

Office of the Secretary of the Treasury, Office of Tax Analysis December 8, 1976

*Less than $50 million.

1/ Treasury's proposals include substituting the President's tax reduction for these individual extensions.

2/ Part of the Administration's proposals.

3/ Consists of replacing the per capita, taxable income and earned income credits with a $250 increase in the personal exemption (from $750 to $1,000); and reducing selected tax rates (see appendix for detail).

Table A-6

TAX POLICY OPTIONS DESIGNED TO RAISE $4 BILLION IN F.Y. 1979
(LOW REVENUE OPTION) EARLIER SOCIAL SECURITY TAX INCREASES

	($billions)		
	F.Y.		
	1977	1978	1979
Receipts under outstanding Administration proposals	349.1	390.3	442.7
Proposed modifications:			
Modify individual income tax reductions	+1.4	-*	-1.1
Delete utility relief and 2 percentage point surtax rate reduction	+1.3	+3.3	+3.8
Modify social security and railroad retirement tax rate increase	-	-1.9	-0.9
Delete financial institutions reform	+0.2	+0.7	+0.7
Repeal ESOP	+0.1	+0.3	+0.3
Delete foreign withholding	+0.1	+0.2	+0.3
Delete home insulation credit	-	+0.2	+0.2
Delete LERA's	+0.1	+0.4	+0.5
Postpone and more gradually phase in education tax credit	-	+0.3	+0.2
Total modifications	+3.2	+3.4	+4.1
Budget receipts under modified tax program	352.4	393.8	446.7

Office of the Secretary of the Treasury
Office of Tax Analysis

December 8, 1976

* Less than $50 million.

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

Table A-7

TAX POLICY OPTIONS DESIGNED TO RAISE $4 BILLION IN F.Y. 1979
(LOW REVENUE OPTION) LATER SOCIAL SECURITY TAX INCREASES

	($billions) F.Y. 1977	($billions) F.Y. 1978	($billions) F.Y. 1979
Receipts under outstanding Administration proposals	349.1	390.3	442.7
Proposed modifications:			
Modify individual income tax reductions	+1.4	-*	-1.1
Delete utility relief and 2 percentage point surtax rate reduction	+1.3	+3.3	+3.8
Modify social security and railroad retirement tax rate increase	-	-3.8	-1.8
Delete financial institutions reform	+0.2	+0.7	+0.7
Repeal ESOP	+0.1	+0.3	+0.3
Delete foreign withholding	+0.1	+0.2	+0.3
Delete capital gains of individuals	-0.1	+0.6	+0.9
Delete home insulation credit	-	+0.2	+0.2
Delete LERA's	+0.1	+0.4	+0.5
Postpone and more gradually phase in education tax credit	-	+0.3	+0.2
Total modifications	+3.2	+2.2	+4.0
Budget receipts under modified tax program	352.4	392.5	446.7

Office of the Secretary of the Treasury
Office of Tax Analysis

December 8, 1976

* Less than $50 million.

Note: Details may not add to totals because of rounding

Table A-8

Tax Policy Options Designed to Raise $8 billion in Fiscal Year 1979

(High Revenue Option)

Earlier Social Security Tax Increases

($ billions)

	Fiscal Years 1977	1978	1979
Receipts under outstanding Administration proposals	349.1	390.3	442.7
Proposed modifications:			
Modify individual income tax reductions	+1.4	+2.1	+2.2
Delete utility relief and 2 percentage point surtax rate reduction	+1.3	+3.3	+3.8
Modify social security and railroad retirement tax rate increase	--	-1.9	-0.9
Delete financial institutions reform	+0.3	+0.7	+0.7
Repeal BSOP	--	+0.4	+0.5
Repeal ESOP	+0.1	+0.3	+0.3
Delete foreign withholding	+0.1	+0.2	+0.3
Delete home insulation credit	--	+0.2	+0.2
Delete LERAs	+0.1	+0.4	+0.5
Delete education tax credit	--	+0.3	+0.4
Total modifications	+3.3	+6.0	+8.0
Budget receipts after modified tax program	352.4	396.3	450.6

Office of the Secretary of the Treasury
Office of Tax Analysis

December 8, 1976

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

Table A-9

Tax Policy Options Designed to Raise $8 billion in Fiscal Year 1979

(High Revenue Option)

Later Social Security Tax Increases

($ billions)

	Fiscal Years		
	1977	1978	1979
Receipts under outstanding Administration proposals	349.1	390.3	442.7
Proposed modifications:			
Modify individual income tax reductions	+1.4	+2.1	+2.2
Delete utility relief and 2 percentage point surtax rate reduction	+1.3	+3.3	+3.8
Modify social security and railroad retirement tax rate increase	--	-3.8	-1.8
Delete financial institutions reform	+0.3	+0.7	+0.7
Repeal BSOP	--	+0.4	+0.5
Repeal ESOP	+0.1	+0.3	+0.3
Delete foreign withholding	+0.1	+0.2	+0.3
Delete capital gains of individuals	-0.1	+0.6	+0.9
Delete home insulation credit	--	+0.2	+0.2
Delete LERAs	+0.1	+0.4	+0.5
Delete education tax credit	--	+0.3	+0.4
Total modifications	+3.2	+4.7	+7.9
Budget receipts after modified tax program	352.4	395.1	450.6

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Office of Tax Analysis

December 8, 1976

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

Tab B

Table B-1
Proposed Net Changes in Individual Taxes 1/

(1976 law, 1976 levels of income)
($millions)

Adjusted Gross Income Class ($ 000)	Phase I Effective January 1, 1977 2/	Phase II Effective January 1, 1978 3/	Total Phase I and Phase II
Less than 5	- 30	- 139	- 169
5 - 10	- 122	- 602	- 724
10 - 15	- 756	- 679	-1,435
15 - 20	-1,405	- 548	-1,953
20 - 30	-2,267	- 478	-2,745
30 - 50	-1,169	- 159	-1,328
50 - 100	- 474	- 45	- 519
100 or more	- 119	- 10	- 129
TOTALS	-6,342	-2,661	-9,003

Office of the Secretary of the Treasury
Office of Tax Analysis
Dec. 7, 1976

1. Excludes effects from repeal of earned income credit transfers.

2. Replace the per capita, taxable income and earned income credits with a $250 increase in the personal exemption (from $750 to $1,000) and reduce tax rates.

3. Further reduction of the lowest tax rates to mitigate payroll tax increases.

Table B-2

Proposed Income Tax Burdens 1/

Single Individual

(dollars)

Wage income	Current law 1976 tax	Proposed Tax 1977 Tax	1977 Change from prior year	1978 Tax	1978 Change from prior year	1978 Change from current law
5,000	363	356	-8	331	-24	-32
7,000	714	712	-2	687	-25	-27
10,000	1,331	1,321	-10	1,296	-25	-35
15,000	2,409	2,387	-22	2,362	-25	-47
20,000	3,667	3,633	-34	3,608	-25	-59
30,000	6,790	6,735	-55	6,710	-25	-80
40,000	10,535	10,455	-80	10,430	-25	-105
50,000	14,897	14,805	-92	14,780	-25	-117
100,000	41,420	41,295	-125	41,270	-25	-150

Office of the Secretary of the Treasury
Office of Tax Analysis

December 8, 1976

1/ Tax calculations assume deductible expenses equal 16 percent of income.

Table B-3

Proposed Income Tax Burdens 1/

Married Couple, No Children

(dollars)

Wage income	Current law 1976 tax	Proposed Tax 1977 Tax	1977 Change from prior year	1978 Tax	1978 Change from prior year	1978 Change from current law
5,000	130	126	-4	99	-27	-31
7,000	448	434	-14	384	-50	-64
10,000	948	933	-15	883	-50	-65
15,000	1,882	1,830	-52	1,780	-50	-102
20,000	2,905	2,782	-123	2,732	-50	-173
30,000	5,384	5,174	-210	5,124	-50	-260
40,000	8,522	8,274	-248	8,224	-50	-298
50,000	12,200	11,910	-290	11,860	-50	-340
100,000	34,610	34,270	-340	34,220	-50	-390

Office of the Secretary of the Treasury
Office of Tax Analysis

December 8, 1976

1/ Tax calculations assume deductible expenses equal 16 percent of income.

Table B-4

Proposed Income Tax Burdens 1/

Married Couple, Two Children 2/

(dollars)

Wage income	Current law 1976 tax	Proposed Tax 1977 Tax	1977 Change from prior year	1978 Tax	1978 Change from prior year	1978 Change from current law
5,000	--	--	--	--	--	--
7,000	135	126	-9	99	-27	-36
10,000	651	594	-57	544	-50	-107
15,000	1,552	1,430	-122	1,380	-50	-172
20,000	2,530	2,302	-228	2,252	-50	-278
30,000	4,904	4,534	-370	4,484	-50	-420
40,000	7,934	7,494	-440	7,444	-50	-490
50,000	11,510	11,010	-500	10,960	-50	-550
100,000	33,740	33,110	-630	33,060	-50	-680

Office of the Secretary of the Treasury
Office of Tax Analysis

December 8, 1976

1/ Tax calculations assume deductible expenses equal 16 percent of income.

2/ Tax calculations assume no earned income credit under current law.

Table B-5

Single Tax Rates

Taxable Income Bracket ($ 000)	Marginal Tax Rate: Current Law Rates	Proposed Law 1977: Change from prior year	Proposed Law 1977: Rates	Proposed Law 1978: Change from prior year	Proposed Law 1978: Rates
0 - .5	14		14	-3	11
.5 - 1	15		15	-2	13
1 - 1.5	16		16		16
1.5 - 2	17	-1	16		16
2 - 3	19	-2	17		17
3 - 4	19	-1	18		18
4 - 6	21	-2	19		19
6 - 8	24	-2	22		22
8 - 10	25	-1	24		24
10 - 12	27		27		27
Above 12	(..........same as current law ....)				

Office of the Secretary of the Treasury
Office of Tax Analysis

Dec. 7, 1976

Table B-6

Joint Tax Rates

Taxable Income Bracket	Marginal Tax Rate: Current Law Rates	Proposed Law 1977: Change from prior year	Proposed Law 1977: Rates	Proposed Law 1978: Change from prior year	Proposed Law 1978: Rates
($ 000)					
0 - 1	14		14	-3	11
1 - 2	15		15	-2	13
2 - 3	16		16		16
3 - 4	17	-1	16		16
4 - 6	19	-2	17		17
6 - 8	10	-1	18		18
8 - 12	22	-2	20		20
12 - 16	25	-1	24		24
16 - 20	28	-1	27		27
20 - 24	32		32		32
Above 24	(.......same as current law ....)				

Office of the Secretary of the Treasury
Office of Tax Analysis

Dec. 7, 1976

Table B-7

Head of Household Tax Rates

Taxable Income Bracket ($ 000)	Marginal Tax Rate: Current Law Rates	Proposed Law 1977: Change from prior year	Proposed Law 1977: Rates	Proposed Law 1978: Change from prior year	Proposed Law 1978: Rates
0 - 1	14		14	-3	11
1 - 2	16		16	-2	14
2 - 4	18	-1	17		17
2 - 6	19	-1	18		18
6 - 8	22	-2	20		20
8 - 10	23	-1	22		22
10 - 12	25	-1	24		24
12 - 14	27	-1	26		26
14 - 16	28	-1	27		27
16 - 18	31	-1	30		30
18 - 20	32		32		32
Above 20	(..........same as current law ....)				

Office of the Secretary of the Treasury
Office of Tax Analysis

Dec. 7, 1976

Tab C

Table C-1

Proposed Social Security Tax Structure

Rate of Tax on Employee Wages

Year	Taxable Wage Base 1/	OAHSDI Rates		
		Current Law	Proposed	
			Option A	Option B
1976	15,300	5.85	5.85	5.85
1977	16,500	5.85	5.85	5.85
1978	17,700	6.05	6.20	6.05
1979	19,200	6.05	6.35	6.35
1980	20,700	6.05	6.60	6.65
1981	22,500	6.30	6.85	6.90
1982	24,000	6.30	6.85	6.90

Office of the Secretary of the Treasury
Office of Tax Analysis

Dec. 7, 1976

1/ Current law wage base assuming the Case I forecast.

Table C-2
Estimated Receipts Resulting from Proposed
Social Security Tax Rate Increases

($ millions)

Proposal	Fiscal Years 1978	1979	1980	1981	1982
Option A:					
0.3 percentage point combined rate increase 1/1/78..	1,877	2,978	3,288	3,592	3,874
0.3 percentage point combined rate increase 1/1/79..		2,085	3,288	2,592	3,874
0.5 percentage point combined rate increase 1/1/80..			3,836	5,987	6,457
TOTAL	1,877	5,063	10,412	13,171	14,205
Option B:					
0.6 percentage point combined rate increase 1/1/79..		4,169	6,576	7,184	7,748
0.6 percentage point combined rate increase 1/1/80..			4,603	7,184	7,748
TOTAL		4,169	11,179	14,368	15,496

Office of the Secretary of the Treasury
Office of Tax Analysis

Dec. 7, 1976

Table C-3

Proposed Social Security (OASDHI) Tax Burdens

(Dollars)

Taxable Wages	Current Law 1976	Current Law 1977	Proposed Law 1978 Option A	Proposed Law 1978 Option B 1/	Proposed Law 1979 Option A	Proposed Law 1979 Option B	Proposed Law 1980 Option A	Proposed Law 1980 Option B	Proposed Law 1981 1/ Option A	Proposed Law 1981 1/ Option B
3,000	176	176	186	182	190	190	198	200	206	207
5,000	292	292	310	302	318	318	330	332	342	345
7,000	410	410	434	424	444	444	462	466	480	483
10,000	585	585	620	605	635	635	660	665	685	690
15,000	878	878	930	908	952	952	990	998	1,028	1,035
20,000	895	965	1,097	1,071	1,219	1,219	1,320	1,330	1,370	1,380
30,000	895	965	1,097	1,071	1,219	1,219	1,366	1,377	1,541	1,552
40,000	895	965	1,097	1,071	1,219	1,219	1,366	1,377	1,541	1,552
50,000	895	965	1,097	1,071	1,219	1,219	1,366	1,377	1,541	1,552

Office of the Secretary of the Treasury
Office of Tax Analysis

December 7, 1976

1/ Increase over prior year attributable entirely to current law.

Tab D

Table D-1

Proposed Combined Income Tax and Social Security (OASDHI) Tax Burdens 1/

Single Individual

(Dollars)

Wage income	Current law 1976 taxes	Proposed taxes											
		Low revenue package						High revenue package					
		Social security option A			Social security option B			Social security option A			Social security option B		
		1977	1978	1979	1977	1978	1979	1977	1978	1979	1977	1978	1979
5,000	655	648	641	649	648	633	649	648	666	674	648	658	674
7,000	1,124	1,122	1,121	1,131	1,122	1,111	1,131	1,122	1,146	1,156	1,122	1,136	1,156
10,000	1,916	1,906	1,916	1,931	1,906	1,901	1,931	1,906	1,941	1,956	1,906	1,926	1,956
15,000	3,287	3,265	3,292	3,314	3,265	3,270	3,314	3,265	3,317	3,339	3,265	3,295	3,339
20,000	4,562	4,598	4,705	4,827	4,598	4,679	4,827	4,598	4,730	4,852	4,598	4,704	4,852
30,000	7,685	7,700	7,807	7,929	7,700	7,781	7,929	7,700	7,832	7,954	7,700	7,806	7,954
40,000	11,430	11,420	11,527	11,649	11,420	11,501	11,649	11,420	11,552	11,674	11,420	11,526	11,674
50,000	15,792	15,770	15,877	15,999	15,770	15,851	15,999	15,770	15,902	16,024	15,770	15,876	16,024
100,000	42,315	42,260	42,367	42,489	42,260	42,341	42,489	42,260	42,392	42,514	42,260	42,366	42,514

Office of the Secretary of the Treasury
Office of Tax Analysis

December 8, 1976

1/ Tax calculations assume deductible expenses equal 16 percent of income.

Table D-2

Proposed Combined Income Tax and Social Security (OASDHI) Tax Burdens 1/

Married Couple, No Children

(Dollars)

Wage income	Current law 1976 taxes	Proposed taxes											
		Low revenue package						High revenue package					
		Social security option A			Social security option B			Social security option A			Social security option B		
		1977	1978	1979	1977	1978	1979	1977	1978	1979	1977	1978	1979
5,000	422	418	409	417	418	401	417	418	436	444	418	428	444
7,000	858	844	818	828	844	808	828	844	868	878	844	858	878
10,000	1,533	1,518	1,503	1,518	1,518	1,488	1,518	1,518	1,553	1,568	1,518	1,538	1,568
15,000	2,760	2,708	2,710	2,732	2,708	2,688	2,732	2,708	2,760	2,782	2,708	2,738	2,782
20,000	3,800	3,747	3,829	3,951	3,747	3,803	3,951	3,747	3,879	4,001	3,747	3,853	4,001
30,000	6,279	6,139	6,221	6,343	6,139	6,195	6,343	6,139	6,271	6,393	6,139	6,245	6,393
40,000	9,417	9,239	9,321	9,443	9,239	9,295	9,443	9,239	9,371	9,493	9,239	9,345	9,493
50,000	13,095	12,875	12,957	13,079	12,875	12,931	13,079	12,875	13,007	13,129	12,875	12,981	13,129
100,000	35,505	35,235	35,317	35,439	35,235	35,291	35,439	35,235	35,367	35,489	35,235	35,341	35,489

Office of the Secretary of the Treasury
Office of Tax Analysis

December 8, 1976

1/ Tax calculations assume deductible expenses equal 16 percent of income.

Table D-3

Proposed Combined Income Tax and Social Security (OASDHI) Tax Burdens 1/

Married Couple, Two Children 2/

(Dollars)

Wage income	Current law 1976 taxes	Proposed taxes											
		Low revenue package						High revenue package					
		Social security option A			Social security option B			Social security option A			Social security option B		
		1977	1978	1979	1977	1978	1979	1977	1978	1979	1977	1978	1979
3,000	176	176	186	190	176	182	190	176	186	190	176	182	190
5,000	292	292	310	318	292	302	318	292	310	318	292	302	318
7,000	545	536	533	543	536	523	543	536	560	570	536	550	570
10,000	1,236	1,179	1,164	1,179	1,179	1,149	1,179	1,179	1,214	1,229	1,179	1,199	1,229
15,000	2,430	2,308	2,310	2,332	2,308	2,288	2,332	2,308	2,360	2,382	2,308	2,338	2,382
20,000	3,425	3,267	3,349	3,471	3,267	3,323	3,471	3,267	3,399	3,521	3,267	3,373	3,521
30,000	5,799	5,499	5,581	5,703	5,499	5,555	5,703	5,499	5,631	5,753	5,499	5,605	5,753
40,000	8,829	8,459	8,541	8,663	8,459	8,515	8,663	8,459	8,591	8,713	8,459	8,565	8,713
50,000	12,405	11,975	12,057	12,179	11,975	12,031	12,179	11,975	12,107	12,229	11,975	12,081	12,229
100,000	34,635	34,075	34,157	34,279	34,075	34,131	34,279	34,075	34,207	34,329	34,075	34,181	34,329

Office of the Secretary of the Treasury
Office of Tax Analysis

December 8, 1976

1/ Tax calculations assume deductible expenses equal 16 percent of income.

Tab E

December 8, 1976

Social Security Payroll Tax Options

The revenues provided by current payroll tax law are not sufficient to finance the current old age, survivors, and disabilty benefits provided by the social security system. If the tax law remains unchanged, the combined old age and disability trust funds will be exhausted by the end of 1982 given the economic assumptions used in the 1976 Trustees Report. This disability fund will be exhausted during 1979.

The 1977 Budget proposed a 0.6 percentage point increase in the combined tax rate for employers and employees (0.3 percentage point increase in both the employers and employee share) bringing the total 1977 OASDHI tax rate to 12.3 percent. An increase of 0.9 percentage points was proposed for the self-employed.

The Congress failed to act on this proposal. Because of the delay, a larger tax increase is now required to keep the trust fund solvent. Assuming an effective date of January 1, 1978, the required tax increase is 0.9 percent. Current law already schedules a 0.4 percent increase on January 1, 1978, in the portion of the payroll tax dedicated to hospital insurance. At the same time, the wage base will rise automatically from $16,500 in 1977 to an estimated $17,700 in 1978. If an increase of 0.9 percentage points is added to the increases already scheduled, a major tax increase is imposed on wage earnings. A family with a single wage earner receiving $17,700 or above would experience an increase of over $185. An equal increase is imposed on the employer of this wage earner and most economists believe that a portion or all of the employee's share of the payroll tax is ultimately passed on to workers and consumers. A payroll tax increase of this magnitude will also have a major dampening impact on the economy and will impose cost push inflationary pressures by increasing labor costs for the businessman.

For these reasons we have phased in the payroll tax increases in the options presented in the main body of this paper and have integrated the payroll tax increase with the Administration's proposed personal income tax reductions so as to offset the burden imposed on taxpayer's in various income classes.

The options discussed above rely solely on tax rate increases to provide sufficient revenues for the social security system. The same revenues could be obtained with a lower tax rate if the payroll tax base were increased. Options involving a higher tax base were considered last year, but were rejected because, given the current benefit structure or the structure proposed under the Administration's decoupling option, a higher tax base results in higher benefit payments in the long run thus worsening the social security's financial problems in the future. A higher tax base is favored by those who would like to see a larger share of the costs of the system in the short and long run paid by higher income taxpayers. This paper assumes no change in last year's decision that base increases are not desirable, and we have made no attempt to integrate a set of base increase options with personal tax reductions.

The Social Security Administration has estimated that the following combinations of base and rate increases would solve the short-run financial problems of the trust fund.

1. A base increase to $18,300 in 1978 (compared to current law's $17,700) combined with a rate increase of 0.7 percent in 1978 and 0.2 percent in 1980.

2. A base increase of $22,800 in 1978 combined with a rate increase of 0.3 percent in 1978.

3. A base increase to $28,500 in 1978 with no rate increase.

If last year's decisions is reversed and if base increases are deemed desirable, additional options should be investigated to reduce the tax increase implied for 1978 and to improve the integration with personal income tax reductions. A base increase would also require a re-examination of the benefit structure recommended in the Administration's decoupling proposal.

ART QUERN

THE WHITE HOUSE

WASHINGTON

December 10, 1976

MEMORANDUM FOR ECONOMIC POLICY BOARD
EXECUTIVE COMMITTEE MEMBERS

FROM: L. WILLIAM SEIDMAN LWS

SUBJECT: Tax Policy

A draft memorandum for the President, prepared by the Tax Division of the Treasury, designed to reflect the Thursday Executive Committee discussion is attached.

Treasury will have the tabular material referred to in the draft memorandum ready for distribution tomorrow afternoon.

Please contact my office with any suggestions you have on the paper or if you feel that there is a need for the Executive Committee to meet again on this subject this weekend.

Attachment

12/10/76 5:00 p.m.

DRAFT

MEMORANDUM FOR: The President

SUBJECT: Tax Policy

This memorandum discusses the main tax policy issues which are to be resolved in preparation of the FY 1978 budget and of your Tax and State of the Union Messages. Part 1 of the memorandum reviews the currently outstanding Administration tax initiatives and discusses their implications for the budget. This part also includes a discussion of possible ways of paring down the tax program in order to raise additional revenue. Part 2 considers the issue of the need for additional stimulus to private investment, and includes discussion of possible additions to the tax program which would serve this objective. Part 3 concerns a much longer range issue. This part presents a brief summary of the Basic Tax Reform Study which has been prepared in the Treasury Department and considers the possible position you may wish to take toward the future use of this study.

1. The Administration's Present Tax Position

The starting point for consideration of tax policy is the set of currently outstanding Administration tax proposals. Table A-1 at Tab A summarizes the budget outlook. Under the assumed economic projections and OMB's present expenditure estimates, the renewal of all Administration tax initiatives which have not been overtaken by events would yield budget receipts in FY 1979, the year in which you have been aiming for budget balance, of $44.2 billion and a deficit of $27.2 billion.

The economic assumptions play a crucial role in this budgetary outlook. The assumed path of the economy underlying the revenue estimates in Table A-1 and in the other tables of the memorandum are summarized in Table A-2 at Tab A. These are not yet the final economic projections which will be used in the FY 1978 budget. The Council of Economic Advisors feels that the assumptions expressed in Table 1 are probably optimistic; however, there is not a concensus on this on the Economic Policy Board. If the real growth rate is reduced by 0.5 percentage points beginning in the first quarter of 1977, the impact on the budget is as follows:

	Fiscal Years	
	1978	1979
Outlays	+ 0.8	+ 1.5
Receipts	- 3.0	- 6.0
Deficit	+ 3.8	+ 7.5

If the inflation rate is lowered by 0.5 percentage points beginning in the first quarter of 1977, the further impact on the budget is as follows:

	1978	1979
Outlays	- 0.5	- 1.3
Receipts	- 3.0	- 5.8
Deficit	+ 2.5	+ 4.5

Of course, our experience has shown that the economic outlook can change rather rapidly. Table A-3 shows some of these corresponding figures for the forecast made at the time of your budget message of last year and at the mid-session budget review.

The full set of Administration tax proposals, together with the revenue consequences in FY 1978 and 1979, is displayed in Table A-3 at Tab A. The proposals included in Table A-4 consist of all outstanding Administration initiatives that have not been made obsolete by the Tax Reform Act of 1976 or by other legislation. Tax proposals that have been dropped from the list of Administration initiatives because of legislation are: limitation on artificial accounting losses; minimum taxable income provisions; unemployment tax increases; revisions in estate and gift taxes.

In addition, changes have been made in the structure of the individual income tax cuts and the timing of the social security tax rate increases~~, as~~ This is a result of the individual income tax changes in the Tax Reform Act of 1976 and of Congressional inaction on social security tax increases since the presentation of the FY 1977 budget. Changes in the Administration's individual income tax cut proposal are required because instituting the original proposal would result in tax increases for a great many taxpayers. Changes in the social security tax increases are required to prevent an excessive jump which would take place on January 1, 1978, when the Administration's originally proposed increase of 0.6 percentage points in the tax rate would have coincided with an increase mandated by current law.

Changes in Individual Income Tax Cuts

Your individual tax cut proposal made in October 1975, had three principal components:

- Increasing the personal exemption from $750 to $1,000;

. Changing the standard deduction provisions to a flat standard deduction; and

. Reducing marginal tax rates.

Because of two features of the individual cuts in the Tax Reform Act of 1976, -- the taxable income credit, and increases in the standard deduction -- your original proposal would result in tax increases if it were substituted for current law. The revised version of your proposal has been designed to meet three constraints:

. Increase the personal exemptions from $750 to $1,000.

. Assure that tax liabilities are not increased for anyone relative to the Tax Reform Act of 1976, which you signed this year, except as a result of the repeal of the earned income tax.

. Assure that individual income tax liabilities are reduced at least to the levels you proposed in October 1975.

(except for a small number of exceptional cases)

These three objectives have been accomplished by keeping the personal exemption and marginal tax rate features of your original proposal and raising the low income allowance levels of current law to the flat standard deduction levels you originally proposed ($1,800 for single returns and $2,500 for joint returns). Taking this step raises slightly the cost of your individual tax cut package, giving a further cut of ~~by~~ about $0.9 billion in calendar 1977 liabilities and lowering ~~or~~ $1.0 billion in FY 1979 receipts by about $1.0 billion. Without these changes, however, tax liabilities would have increased ~~by~~ on ~~some~~ over 1-1/2 million returns, even disregarding increases resulting from repeal of the earned income credit.

If you should wish to reduce the scale of your individual income tax reductions, it is possible to fulfill the first two objectives, increasing the personal exemption to $1,000 and preventing tax increases from present law, and thereby increase receipts by as much as $3 billion in FY 1979. However, such scaling down will not leave taxpayers in the position you intended in your original proposal.

The tables at Tab B present data on the distribution of the tax changes and the tax burdens on individuals of different income and family sizes under your proposal as revised. Table B-1 shows the distribution of individual income tax liabilities under 1976 law, under your original proposal, and under the revised proposal (at 1976 levels of income). The further tables ~~Tables B-2 through B-4~~ show tax burdens for illustrative cases under current law, your original proposal, and your proposal as revised.

4994

Social Security Rate Increases

Table C-1 at Tab C indicates tax rate and base increases for social security taxes already scheduled under current law. Despite these scheduled social security tax increases, additional increases are necessary if the trust funds are to remain solvent. The increase you recommended in January of this year of 0.6 percentage point (half paid by the employee and half paid by the employer) on January 1, 1978 would result in a full one percentage point increase on January 1, 1978 when combined with the current statutory provisions. It has therefore been assumed that a change in this timing is necessary. The revised recommendation consists of three separate changes: an increase of 0.6 percentage point on January 1, 1979 (the 0.4 point increase scheduled in current law plus a further 0.2 point), a further increase of 0.6 point on January 1, 1979, and a still further increase of something less than 0.6 point on January 1, 1980.

9 / 7

Further background on the social security tax issue is presented at Tab C. Table C-1 at Tab C summarizes the implications of the proposed scheduling of the social security rate increases for the tax rate paid by the employee. The employer contributes an equal amount. The remaining tables at Tab C show the receipts implications of these alternatives as well as the social security tax burdens implied for workers at various wage levels. Further tables at Tab C provide data on the combined social security and individual income tax liabilities for individuals with different family and income situations.

Other Outstanding Proposals

The other proposals contained in the set of outstanding initiatives summarized in Table A-4 are briefly described at Tab D.

Revenue Raising Options

A good idea of the potential for raising additional revenue can be obtained by examining the list of individual components of the presently outstanding program as summarized in Table A-4. Presented below is a listing of the proposals most likely to be candidates for alteration or elimination in a program designed to ~~pre~~pare the revenue cost.

	:Effects on Fiscal Year Receipts ($ billions)		
	: 1977	: 1978	: 1979
Delete utility relief package reductions			
Delete 2 percentage point surtax rate reduction			
Delete financial institutions reform			
Delete BSOP			
Delete proposal to end withholding on dividends to foreigners			
Delete sliding scale capital gains tax			
Delete home insulation credit			
Delete LERAs			
Amend education tax credit proposal			
Potential revenue increases from reducing individual cuts			

2. Options for Additional Stimulus to Provide Incentives for Private Investment

The Troika forecasting group, in its preliminary December forecast, concluded that with no new fiscal initiatives the growth rate in the economy during 1977 is likely to be somewhat slower than had previously been forecast and well below the rate assumed in the mid-year review. Growth that is too slow to make significant reductions in the unemployment rate is undesirable and may lead to a variety of public expenditure programs that interfere with our long-run goals of returning the economy to a stable non-inflationary growth path. Hence some options for additional stimulus have been developed.

A major reason for the lower forecast is a scaling down of earlier optimistic estimates for business fixed investment for 1977. Business fixed investment (BFI) has been running well below its normal share of GNP. Hence the additional stimulus measures considered here are all directed to business fixed investment. Of course, your basic program already includes significant individual tax cuts.

Even if the immediate objective is to provide near term investment incentives, only those tax measures which are regarded as desirable structural changes on a permanent basis should be proposed. This reflects the view that stability in tax policy is essential to orderly long-run investment planning. Three basic methods of lowering business taxes are presented below. The levels of the changes are illustrative. The measures could be adjusted to different scales.

Method 1. Advance the Dividend Deduction Feature of the Integration Proposal

The Administration's proposal to integrate the individual and corporation income taxes includes a schedule for phasing in the deductibility of dividends paid by the corporation in calculating corporation income tax together with a phasing in of the gross up and credit at the corporate shareholder level. One way of providing additional stimulus and cash flow to corporations while maintaining the general thrust of the Administration's tax program would be to speed up the integration. Eliminating the double taxation of corporate dividends will, in the short run, reduce taxes on corporate income and bolster securities markets. Ultimately, the effects will be dispersed over the entire private sector.

A particularly simple way to advance this program would be to start the dividend deductibilty at a higher level immediately (as of January 1, 1977), holding at that level until it would be reached under the original schedule. In all other respects the integration schedule would be as originally proposed. By allowing deductibility of 30 percent of dividends starting January 1, 1977, calendar year 1977 liabilities would be reduced by approximately $4.8

billion. The phase-in into the existing schedule of the integration proposal could be accomplished by maintaining the level of 30 percent dividend deductibility until year 1981.

A second method would be to move up by one year the whole schedule of integration of corporate and personal income taxes. The effect of thus phasing in the integration plan would be a reduction of $1.6 billion in calendar 1977 tax liabilities and a reduction of $___ billion in FY 1979 receipts.

Method 2. <u>Change the Investment Tax Credit</u>

In its present formulation, the investment tax credit is larger for qualifying assets of longer depreciable life up to seven years; beyond that no increase in credit is provided, resulting in a bias against long-lived assets. The amount of credit which may be taken in any year is limited by the asset purchaser's tax liability. The maximum credit is the first $25,000 of tax plus 50 percent of the excess, with certain temporary exceptions for utilities, airlines and railroads which permit greater utilization of current year tax liability. This means that cyclically sensitive businesses, those suffering temporary adversity, and growing enterprises cannot fully utilize the credit.

For these reasons, the effectiveness of the present investment credit is less than its nominal rate of 10 percent (scheduled to revert to 7 percent in 1981) might seem to imply. The following revisions in the investment tax credit would constitute desirable structural reforms and would provide some investment stimulus:

- The full amount of the credit earned by an investor each year would be creditable against all income tax liability and refundable to the extent it is in excess of current tax liability.

- The basis of qualified property--the amount subject to depreciation for tax purposes--would be reduced by the amount of the credit.

- The rate of credit would be increased to 12 percent on assets with useful lives of 12 years or more.

- The investment credit would be made permanent.

The calendar 1977 effect of these changes would be a $2.4 billion liability reduction.

A further possibility would be to combine this structural revision in the investment tax credit while increasing the credit rate schedule to:

. 4 percent on assets with lives 3 or 4 years.

. 8 percent on assets with lives 5 or 6 years.

. 12 percent on assets with lives 7 through 11 years.

. 14 percent on assets with lives 12 years or more.

This plan reduces calendar 1977 liabilities by $4.4 billion.

8906
9971

Method 3. Cut the Corporation Income Tax Rate

Your basic plan includes a cut of two percentage points in the top corporate tax rate, from 48 to 46 percent. A further cut, to 44 percent would lead to a reduction in calendar 1977 liabilities of about $4.4 billion, and a reduction in FY 1979 receipts of $___ billion. It would be possible to combine such a rate cut with a change, such as allowing a carry over of the unused surtax exemption, designed to favor smaller businesses.

These alternatives are summarized in the table, E-1 at Tab E which also includes brief discussion of the comparative merits of these business tax changes.

Small Business Proposals

It may be that, should you decide to adopt one or more of the measure alone, you will wish to include new programs to benefit owners of small businesses. A Treasury Department advisory committee on small business recently submitted a set of proposals they would favor. These have not yet received full Treasury Department review. A brief description of the proposals and available revenue estimates are contained in Table E-2.

3. Treasury Department Basic Tax Reform Report

This section discusses the study conducted by the Treasury Department on BTR -- Basic Tax Reform. A more extended discussion is found at Tab F.

The Treasury report presents proposals representing two approaches to broadening the tax base. The first is comprehensive income taxation, and includes elimination of the corporation income tax and full allocation of corporate income to shareholders, along with inflation correction for capital gains and depreciation. The second approach, called a cash flow tax, would replace the individual and corporation income taxes with a consumption based tax.

The Report (which will be ready for release by the middle of next month) represents a thorough review of the basic fundamentals of taxation. It considers, for example, the concept of income and how it should be defined theoretically, and measured practically. The Report develops a tax system which is simpler, more equitable and easier to understand and justify. This tax system would make the operation of the private economy more efficient, and could achieve any degree of progressiveness desired. The Report finds that even a revised, comprehensive income tax would be inferior, in many respects, to a consumption based tax.

The Present System

The present system is viewed as unnecessarily complex: an instrument of torture designed for the benefit of accountants and tax lawyers. It is seen as inequitable: designed to favor the rich and provide loopholes for special interests with political muscle. It is viewed (mostly by economists) as inefficient: misallocating resources in socially undesirable and sometimes unintended directions.

Proposals

The BTR Report begins by sketching an "ideal base" for a tax system and then proceeds to modify this ideal base in ways which make implementation possible. The most important features of the comprehensive inocme tax are as follows:

Integration of the Corporate and Personal Income Taxes

A corporate tax is inappropriate, because there is no such thing as "corporate income" which does not accrue to individuals. That is, all corporate net receipts belong to individuals, either through being paid out as dividends or being retained as retained earnings and thus increasing the value of shareholders' stock. The present system of taxation provides a rate on retained earnings which is too high for some of these shareholders, and too low for others. For low income individuals, the corporate rate of 48 percent is much higher than they pay on their other income. For individuals in the highest tax brackets on the other hand, the 48 percent rate applied to retained earnings is lower than the rate on their ordinary income. Further taxation will be at capital gains rates, and will be deferred, perhaps forever.

Under the BTR proposals, the corporation income tax would be eliminated and all corporate income would be allocated to individual shareholders with an accompanying step-up in basis. Dividends to shareholders would not be separately taxed, but treated as a reduction in basis. Thus integration would: (1) end the double taxation of dividends, (2) key the effective tax rate on all income to the circumstances of individual taxpayers, and (3) provide a practical method for accrual taxation of this form of capital gains.

Base Broadening

Improved equity and lower tax rates would be achieved by broadening the base of the income tax. This would be done both through expanding the types of income which are taxable and through reducing the types of deductions which are allowed. The Report goes into these matters in considerable detail, discussing the theoretically best approach, and indicating where administrative or practical considerations impel different decisions.

The Report proposes significant changes in the handling of capital gains income. Under an "ideal" tax base, capital gains would be taxed as accrued, not just when realized through sale or exchange of the asset. However, this would necessitate annual asset valuations, and the practical problems raised by this led the BTR Report to recommend against accrual taxation. Thus, the tax benefit from deferring realization of capital gains would be retained, though the proposed corporate integration would considerably reduce the scope of this deferral. While the proposal calls for full taxation of capital gains (abolishing the 50 percent exclusion), it would end the taxation of purely inflationary gains by providing an inflation adjustment, discussed below.

Some other forms of income currently excluded from the tax base would become fully taxable. These include state and local bond interest, social security benefits (though employee contributions would become deductible), private pension benefits and interest earnings thereon, and unemployment compensation payments.

Inflation Corrections

The BTR Report calls for an inflation correction for capital gains and for depreciation allowances. That is, assets which are held over a period of time would have their cost basis adjusted upward to take account of the depreciation of the currency during th r holding period. While under an "ideal" tax system, this inflationary correction would also apply to debts, e.g., adjusting upward the principal of a home mortgage, the BTR recommendation stops short of such a complex step.

Cash Flow Tax

The most significant aspect of the BTR Report is its recommendation of consideration of a cash flow, consumption based tax to replace the present individual income tax. In the past, such a tax has usually been viewed as not worthy of consideration because it would be:

Regressive (like a sales tax)

Radical (a complete change from the present income tax system)

Difficult to administer (who can keep track?)

The BTR Report examines these criticisms and finds them to be invalid.

Regressive -- While a consumption tax is viewed as bearing heavily on the poor (who spend) and not on the rich (who save), in reality through the use of exemptions and progressive rates, a tax on spending can be just as progressive or regressive as the Congress wishes to make it.

Radical -- While it would appear that changing from the present income tax to a cash flow, consumption base tax would be a radical move, the BTR Report finds that the present system is closer to a cash flow tax than to a comprehensive income tax in its treatment of many forms of income from capital. In particular, two important sources of saving for many Americans -- home ownership and contributions to retirement annuities (employer contributions, Keogh Plans, and IRA's) -- are treated under the current law almost exactly the same way they would be treated under a cash flow tax.

Difficult to administer -- When the term "consumption tax" is used, most people think of a sales tax and imagine that such a tax would require keeping records on every bit of expenditure throughout the year. In actual implementation, however, a cash flow consumption base tax would involve tax forms very similar to the present ones with the significant change that net additions to savings would be subtracted from income in arriving at the tax base. Indeed, a cash flow consumption base tax would actually be easier to administer in many respects, primarily in the area of capital income. For example, problems in the measurement of depreciation, in the evaluation of capital gains, and in the allocation of undistributed corporate income could be avoided because changes in net worth (savings) would not be included in the tax base.

Even more significantly, the cash flow tax, by taxing consumption, eliminates disincentives to savings and thus encourages capital formation. This would lead to more capital per worker and higher before tax wages in the long run. Thus the allocative effect of a cash flow consumption base tax makes it very attractive as an alternative to either the present income tax or even to an improved comprehensive base income tax.

Tax Rates

The advantages of base broadening, of course, is that it makes possible the use of much lower tax rates to raise the same total revenue. For example, the "comprehensive income" concept developed by the BTR Report is approximately 20 percent higher than the AGI (Adjusted Gross Income) of individuals, so even after making up for the abolition of the corporate tax, individual tax rates could be cut almost one-fifth across the board, and still raise the same revenue. (Of course, the distribution of taxes across income classes would be quite different.) The BTR Report presents alternative rate structures. The exact rate schedules remain to be worked out but it appears that both individual and corporate income tax receipts could be replaced by structures ranging from a proportional, 15 percent tax with no exemptions, to systems with exemptions, deductions, and various tax brackets up to a top rate of 40 percent. All of these yield the same total revenue; although the graduated structure is required to preserve the present progressivity of the Federal tax system.

Bombshells, Boobytraps, and Pitfalls

There are certain aspects of the BTR Report which you should be aware of, because they will arouse comment and criticism. These include the following proposals:

. Social security benefits and other retirement benefits would be taxed when they are received. (For the most part, they are now exempt.)

. The earnings on retirement and pension funds would be taxed as they accrued. (They are now mostly exempt.)

. Capital gains would be taxed at full rates. (They would be adjusted for inflation, and those arising from corporation earnings would be relieved of double taxation.)

. Unemployment compensation would be taxed. (It is now exempt.)

. Interest on state and local bonds would be taxed.

. The aged and blind exemptions would be abolished.

. The deduction for local taxes on personal property would be abolished.

. The consumption tax proposals will, in spite of the points made above, be viewed by many as a radical, regressive, and impractical proposal.

. Many of what the Report regards as minor and non-controversial loophole closings will produce cries of outrage from small, but vocal, special interests.

8/75

Is the Report a Radical One?

While the Report urges some significant changes in the income tax base, and calls for at least studying a consumption based tax, it should be emphasized that many characteristics of the present tax system would be retained, and many of the changes are presented as options. Specifically, charitable deductions, home mortgage interest, and medical deductions are included as options, although the basic model plans assume they are eliminated. While there is a new "secondary worker" exemption permitted for couples in which both husband and wife work, the basis for taxation remains the family unit as it is today.

Use of the BTR Report

In its present form, the BTR Report provides the research and background information necessary for considering fundamental changes in U.S. tax policy. While it provides two models, a comprehensive income tax and a consumption tax, it does not attempt to "sell" or even to recommend these particular models. There are many details (e.g., deduction items) which are presented on an optional basis rather than a recommended basis. Thus the present Report would not be appropriate, for example, for inclusion in your budget for FY '78.

Your Tax Message will contain a number of specific proposals. The BTR Report is really a drastically different approach, an alternative to piecemeal, patching up of the system. To avoid getting bogged down in details, it sketches its proposals in more general terms, and these are not in the form appropriate for legislative recommendations to the Congress at this time. They are an attempt to describe the tax system of the future. There will be much work and many debates within and between the executive branch, the legislative branch, and the academic community before this new system finally becomes law. The important thing as Secretary Simon has stated, is to get the debate started, and the BTR is designed to do just that.

27

Probably the best use you can make of the Report would be to allude to it in your Tax Message and then issue it as a legacy to future tax policy. You would not have to "endorse" it, but could say that the work represented in it will provide the basis for future Congresses to develop an improved tax system for the U.S. 8974

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THE WHITE HOUSE

WASHINGTON

December 6, 1976

MEMORANDUM FOR ECONOMIC POLICY BOARD
EXECUTIVE COMMITTEE MEMBERS

FROM: L. WILLIAM SEIDMAN LWS

SUBJECT: Basic Tax Reform Report

A paper, prepared by the Treasury, summarizing the Basic Tax Reform Preliminary Report is attached. This paper will be reviewed at the Tuesday, December 7, 1976 Executive Committee meeting.

Due to the sensitive nature of the material in the paper, I would appreciate you keeping its distribution strictly limited.

Attachment

Summary of Preliminary BTR Report

I. Overview

The report presents two proposals for broad-based reform of the individual and corporate income taxes. The proposals embody practical applications of two different conceptions of ideal tax systems. In so doing, they show how the tax system can be made simpler, more equitable, easier to understand and justify, and more conducive to the efficient operation of the private economy within a framework that permits maintenance of the vertical progressivity of the current rate structure.

Development of the plans for radical tax reform were motivated in part by the widespread dissatisfaction with the current tax system. In particular, criticisms of the current system have focussed on the appropriateness of current provisions on what items belong in the tax base. Numerous special features of the current law, relating both favorably and adversely to different sources and uses of income, introduce complexity into the system and raise questions about its fairness. In addition, many provisions of the code provide subsidies for special industries and for some forms of investment and consumption which are rarely justified explicitly and which may, in some cases, be unintentional. These subsidies, in many instances, tend to alter the pattern of economic activity in ways which may lower the social value of total output produced in the private sector. Further, although broadly speaking the present Federal tax system relates tax burdens to individual ability to pay, many details of the tax code do not reflect any consistent philosophy about the objectives of the system. The resulting confusion and complexity in the current tax code has led Secretary Simon to suggest that we should "have a tax system which looks like someone designed it on purpose."

Towards that end, the report presents two alternative model proposals for broad-based tax reform: (1) a comprehensive income tax, and (2) a cash flow, consumption based tax. Both proposals seek to treat individual items in the tax code in ways which would achieve consistency with an ideal base, departing from the ideal only where necessary for administrative feasibility, simplicity or what seems to be compelling social policy reasons. Where subsidies are

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Towards that end, the report presents two alternative model proposals for broad-based tax reform: (1) a comprehensive income tax, and (2) a cash flow, consumption based tax. Both proposals seek to treat individual items in the tax code in ways which would achieve consistency with an ideal base, departing from the ideal only where necessary for administrative feasibility, simplicity or what seems to be compelling social policy reasons. Where subsidies are maintained in the proposals, they are identified explicitly as such and justification is provided. The difference between the proposals is in the definition of the ideal base. The comprehensive income tax proposal uses as the conceptual tax base an accretion concept of income, where income in any year is defined as the sum of the individual's consumption and change in net worth. The cash flow tax uses consumption as the ideal base, excluding all positive and negative changes in net worth from tax.

Both proposals cover all of the major individual areas where changes from the current tax code merit consideration. In all cases where there are ambiguities about defining either the consumption or change in wealth components of income or where social values embodied in exclusions or deductions from income under the current law appear to merit continued consideration, specific policy judgments are made in the report for the purpose of presenting complete proposals. The report identifies those features of the proposal which are essential for definition of the ideal tax base, distinguishing them from the parts of the proposal which can legitimately be handled in different ways and still remain consistent with a reasonable definition of either the accretion or consumption ideal.

The report shows that it is feasible to have a broad-based tax reform which departs in major ways from the current tax law. By providing two specific alternative plans -- even if preliminary -- it sets out a guide for possible future tax legislation aimed at sweeping reform, and also points out some of the main issues which remain to be resolved where social policy judgment, ultimately based on political and other considerations, must supplement technical analysis. Finally, in presenting a plan for a tax system based on the consumption ideal, the report points towards a promising alternative approach to tax reform which merits strong consideration.

II. Comprehensive Income Tax (Accretion Base)

Adoption of a more comprehensive definition of income in the tax base has received the most attention from reformers.

Income is defined by tax specialists as the sum of consumption and change in net worth in a given time period. Though income is defined conceptually in terms of uses of resources, it is not practical to measure an individual's annual income by adding up all of his individual purchases of consumer goods and the change in value of all the items on his balance sheet. Rather, income is measured by using the simple accounting concept that the sum of receipts from all sources within a given time period must equal the sum of all uses. To compute income, it is simply necessary to subtract from sources some expenditures which represent neither consumption nor additions to net worth. These expenditures for an individual include costs of operating his business (payment of salaries, rent, interest, etc.). They may also include direct costs of earning labor income (union dues, work clothing, etc), and perhaps some other expenditures such as interest, charitable contributions, State and local income, and sales taxes. For some items, e.g., large non-discretionary medical expenditures, there is some ambiguity as to whether or not they should be regarded as consumption and included in income (i.e., not deductible).

The tax base under current law departs from an ideal comprehensive tax base both in its measurement of sources of receipts and in its exclusion of some uses. Examples of the former are the exclusion of State and local bond interest and the double taxation of dividends of corporations. Examples of the latter include tax depreciation schedules which do not approximate actual changes in asset values, inclusion of only one-half of realized capital gains in the tax base and deferral of unrealized gains, and deductions for some types of consumption expenditures.

The comprehensive income tax proposal sets out a practical plan designed to approximate an accretion base as closely as possible. The major features of the comprehensive income tax are:

- <u>integration of the corporate and personal income taxes</u>

A separate tax on corporations does not fit into the ideal of a comprehensive tax base. Corporations do not "consume" or have a standard of living in the sense that individuals do; all corporate income can ultimately be accounted for either as consumption or an increase in the value of claims of individuals who own corporate shares. The burden of the corporation income tax falls on individuals, but in ways which are difficult to determine. These burdens are almost certainly not systematically related to individual ability to pay.

Under the comprehensive income tax proposal the corporation income tax would be eliminated and all corporate income would be allocated to individual shareholders with an accompanying step-up in basis. Corporate distributions to shareholders are not separately taxed, but are treated as a reduction in basis.

The proposal contians a set of rules for allocating corporate income to individuals which are practically effective and come close to measuring annual income earned by shareholders as it accrues.

The advantages of integration are that 1) it ends the incentive to accumulate income within corporations by ending the double taxation of dividends, 2) it enables the effective tax rate on income earned within corporations to be keyed to the circumstances of individual taxpayers, and 3) it provides a practical method for accrual taxation of capital gains. Capital gains which result from retianed earnings of corporations are automatically taxed under the proposal as they accrue, although capital gains resulting from changed expectations are only taxed when assets are sold.

. <u>treatment of capital gains</u>

Under an ideal comprehensive tax base, capital gains which represent an increase in real wealth should be taxed even though not realized by sale or exchange of the asset. The proposal moves in that direction by adopting the integration concept, and by advocating taxation of captial gains, though only upon realization, at full rates and allowing a step-up in basis for inflation. Thus, the proposal, while ending the current provision for exclusion of one-half of capital gains from the base, will also end the taxation of purely inflationary gains. Compared to present law, taxation of capital gains would be lower during periods of rapid inflation and higher during periods of relative price stability. The proposal does not recommend taxation of gains as accrued, i.e. prior to realization, because of the administrative cost of annual asset valuations. Thus, the tax benefits from deferring realization of capital gains are retained. However, the corporate integration proposal does enable a major fraction of individual income which was previously reflected in realized capital gain to be taxed as it accrues.

. <u>depreciation rules</u>

The proposal defines some general principles for measuring depreciation of assets for tax purposes. It is recommended that ADR be made mandatory for machinery and equipment. New rules for calculating depreciation are recommended for structures. Cost depletion is recommended in place of percentage depletion for mineral deposits.

. <u>state and local bond interest</u>

The proposal recommends that interest from state and local bonds be included in the computation of the tax base on the grounds that those receipts can be used for consumption or increases in net worth as well as receipts from any other source. The report mentions some alternative and less costly ways of providing the same subsidy to state and local governments as is presently provided by the interest exemption if such subsidization is viewed to be socially desirable.

. <u>imputed income from consumer durables</u>

Under an ideal comprehensive tax base, the imputed return in the form of the rental value of consumption services from ownership of consumer durables would be taxed. The exclusion of imputed income from tax provides an especially large subsidy to owner-occupied homes. This proposal does <u>not</u> recommend taxation of the imputed interest from homes <u>and</u> consumer durables, both because of difficulties of measurement and because the subsidization of home ownership appears to be a valid social policy. However, it is recommended that the deductibility of local taxes on personal property, including homes, be ended.

. <u>itemized deductions</u>

The report recommends revisions in treatment of major deductions, including deductions for medical expenses (replace with a catastrophic insurance program), charitable contributions (continue the deduction), state and local sales and income taxes (deductible), and casualty losses (will be eliminated in revision of the report). The major issues in deciding whether, and in what form, major personal deductions should be maintained concern whether or not a particular item of expenditure should be viewed as consumption and whether or not particular types of economic activities ought to be subsidized. While the report sets up specific proposals for treatment of all of these categories, it is noted that other rules are also consistent with the general ideal of a comprehensive income base. The deduction of interest is maintained, as is, in modified form, the deduction of child care expenses. The report recommends elimination of the standard deduction.

. retirement income

Under a comprehensive income tax, both contributions to retirement pensions and the interest earned on such contributions should be included in the base. However, a roughly equivalent result is achieved by taxing retirement income and currently accrued earnings on pension funds and allowing employer and employee contributions to pensions to be deducted from the tax base. This procedure is preferable because it minimizes income averaging problems. Rules for making different types of pension accounts conform to this principle are outlined in the report. In contrast, social security taxes are not viewed as a purchase of a retirement annuity because of the looser connection between contributions made and retirement benefits received. For social security, it is proposed to allow deduction of both employee and employer contributions and to include all social security retirement income in the tax base.

The proposal also recommends that unemployment compensation payments be included in the tax base.

. choice of a filing unit and exemptions for family size

The report recommends family filing with rate brackets slightly less than twice as wide as the brackets for individual taxpayers. The decision on the appropriate filing unit represents a compromise between two objectives which cannot be met simultaneously when the rate structure is progressive: a system in which families with equal size with equal incomes should pay equal taxes and a system in which the total tax liability of two individuals is not altered when they marry. To reduce the work disincentive features caused by taxation of secondary earners at marginal rates to determine the income of a spouse, the plan also proposes that only 75 percent of the first $10,000 of earnings of secondary workers be included in the tax base. Alternative possible treatments of the filing unit which are also consistent with the general principles of an accretion base are presented.

The report discusses the issues in the choice between exemptions and tax credits for family size, and recommends a per-member exemption. Again alternative methods of adjusting for family size described in the report may also be viewed as consistent with the accretion base.

In summary, the comprehensive income tax proposal is a complete plan for radical alteration of the tax system which eliminates many of the inconsistencies of the present law. Some provisions of the plan fall short of the accretion ideal because of practical considerations. However, the plan demonstrates the feasibility of major improvements in the simplicity, efficiency, and fairness in the income tax.

III. Cash Flow, Consumption Based Tax

A cash flow, or consumption base tax, is less widely advocated in discussions of tax reform but deserves serious consideration as an alternative ideal for the tax base. The cash flow tax differs from the comprehensive income tax by excluding changes in net worth from the tax base. In practical terms, this means that net saving, as well as gifts and current purchases which are not regarded as consumption, are subtracted from gross receipts to compute the tax base.

The report shows that a cash flow tax has a number of advantages over a comprehensive income tax on simplicity grounds. A cash flow tax avoids the most difficult problems of measurement under a comprehensive income tax, such as depreciation rules, inflation adjustment, allocation of undistributed corporate income, and measurement of unrelaized capital gains. These can be avoided because changes in net worth are not included in the tax base. In addition, the report demonstrates that the cash flow tax is more equitable because, unlike a comprehensive income tax, it treats individuals beginning their working years with equal wealth and the same present value of future labor earnings the same. They are treated differently under an income tax, depending on the time pattern of their earnings and the way they choose to allocate consumption expenditures among time periods. The cash flow tax, by eliminating disincentives to savings by taxing consumption, would encourage capital formation, leading to higher growth rates in the short-run and more capital per worker and higher before-tax wages in the long-run.

The report also points out that the current tax system, though riddled with inconsistencies, is in many ways closer to a cash flow tax than a comprehensive income tax in its treatment of many forms of income from capital. In particular, two important sources of saving for many Americans--home-ownership and employer contributions to retirement annuities (or contributions of individuals to Keogh Plans and IRA's)--are treated under the current law almost exactly the same way they would be treated under a cash flow tax.

One way of designing a cash flow tax is to have an individual compute his tax base by including all monetary receipts in a given time period in the tax base and subtracting purchases of assets, itemized gifts, and certain itemized expenditures also allowed as deductions under the comprehensive income tax. In the plan presented in this report purchases of assets are eligible for deduction only if made through qualified accounts and interest and dividends earned outside of qualified accounts would not be taxed. Each year net contributions (withdrawals) to (from) qualified accounts would be computed and subtracting from (added to) the individual's tax base. Thus, the proceeds from an investment made through a qualified account would be subject to tax <u>only when withdrawn for the purpose of consumption</u>.

Savings not deposited in a qualified account would not be eligible for deductions but the interest and capital gains from investments financed by such saving would not be included in the tax base. The report shows that pre-payment of taxes on savings combined with exclusion of capital income from tax is in an important sense equivalent to deductibility of savings and inclusion of principal and interest in the tax base upon withdrawal for consumption. The two alternative ways of treating assets do not alter the present value of the tax base; deferral of tax in the present leads to payment of the same tax plus interest at the time the asset is sold for consumption. However, inclusion of a part of income in the tax base can be delayed by purchasing a qualified asset.

The report spells out the consequences of allowing a taxpayer to choose at will between two alternative ways of being taxed on income from assets, providing specific examples of how the tax would work. It is shown how allowing two alternative treatments for both assets and loans provides a simple device for the taxpayer to average the tax base over a number of years, thus avoiding the inequities associated with applying a progressive rate system to individuals with different annual variation in the level of consumption expenditures. The report also shows how allowing alternative treatment of assets and loans simplifies the measurement of the tax base.

Under the proposal, all consumer durables would be treated as tax prepaid assets. No deductions would be allowed for the purchase of a consumer durable and receipts from the sale of a consumer durable would not be included in the tax base.

Gifts would be treated differently under the cash flow tax than under both the comprehensive income tax and the current tax system. In the cash flow tax proposal, gifts and inheritances received are included in the tax base while gifts given are deducted. It is assumed that the cash flow tax would be supplemented by a separate tax on transfers of assets by gift or bequest.

The proposal describes in detail how specific items of capital income, including dividends, interest, capital gains, income from personal business, and accumulation of retirement pensions would be treated in accordance with the principles outlined above. The corporate income tax would be eliminated because there would no longer be a need to tax undistributed corporate income. Purchases of corporate stocks through qualified accounts would be tax deductible while all withdrawals from qualified accounts would be included in the tax base. Sale proceeds of corporate stock, dividends, and interest, if remaining in the qulaified account, would not be taxed.

The cash flow tax, like the comprehensive income tax, would move towards neutrality in the tax treatment of different kinds of investments. By doing this, both proposals would have the effect of encouraging the best use of available capital. In addition, however, the cash flow tax eliminates the discouragement to capital formation inherent in the accretion concept.

The cash flow tax proposal treats definition of the filing unit, exemptions for family size, and deductions of personal consumption items the same way as the comprehensive income tax proposal. The only differences between the two proposals are the difference in the treatment of items which represent a change in net worth, and the difference in the treatment of gifts and inheritances.

IV. Transition Problems

Reforming the existing tax system poses a different set of problems than designing a new tax system from scratch. While the report concentrates on the design of approximations to ideal tax systems, the problems of transition have also been examined and embodied in specific proposals.

Transition to a new set of tax rules poses two separate, but related problems. First, changes in rules for taxing income from capital will lead to changes in relative asset values. Problems of fairness exist when investors who have purchased a particular type of asset in light of the present tax system would be subjected to losses by rapid and major changes in tax policy. Similarly, changes in tax policy may provide some investors with windfall gains. Second, changes in the tax law raise questions of what to do about income earned before the effective date, but not yet subject to tax. For example, the comprehensive income tax, which proposes full inclusion of capital gains in the base, requires a transiton rule for taxing capital gains accumulated before, but realized after the effective date.

The report outlines a series of specific transition proposals for handling income earned before the effective date, but not yet taxed. It also describes two methods for moderating the wealth effects of tax reform--"grandfathering", or exempting existing assets from the new tax provisions and phasing-in the new rules. Specific proposals for use of these instruments for different projected changes in the tax code are presented. The report also presents a transition proposal for phasing-in a cash flow tax.

Transition will be a major problem in any significant reform of the tax system. The analysis of transition issues, and the rules proposed for specific changes in the code in this report can be applicable to a number of alternative plans for future changes in the tax system.

V. How An Individual Would Calculate Tax Liability Under the Reform Plans

The method of calculation of tax liabilities under the broad-based reform plans is basically similar to the method under the current personal income tax. A form similar to a Form 1040 with boxes indicating family status and number of exemptions will be filled out. There will, however, be no standard deduction under either plan; any taxpayer with any positive amounts of eligible deductions would choose to itemize. To reduce the number of itemizers generally deductions would be subject to floor amounts.

Taxable income would be calculated on the form, and the relevant tax rate schedule, determined by the status of the filing unit (i.e., single, married, head of household), would be applied to taxable income to compute tax liability. Taxes owed, or refunds due, would depend on the difference between tax liability and taxes withheld as reported on W-2 statements.

The wages and salaries of the primary wage-earner would remain the biggest item in computing taxable income of most households and would be entered into the calculation of income the same way as under the current system.

Some items in the computation of tax would change under both reform plans. The first $10,000 of wages and salaries of secondary wage-earners in any family would be multiplied by .75 before being added into the computation of taxable income. The rules for calculating some deductions (e.g., child care) would be changed and other deductions (e.g., property and gasoline taxes) would be eliminated.

Under the comprehensive income tax, some additional items would be added to the computation of taxable income. Corporations would supply to all stockholders a statement giving the amount of profit attributed to that stockholder in the previous year, and an adjustment to basis which would rise with earnings and fall with distributions. (The integration proposal includes procedures for handling changes in shareholders during the year and audit adjustments to the corporation's income.) Similar statements of attributions of earnings would be supplied by pension funds and insurance companies. The individual would include the income reported in those statements in his computation of taxable income. Also, interest income from state and local bonds, unemployment compensation, and social security retirement income would be included in the computation of taxable income.

All capital gains (or losses) would be entered in full in the computation of taxable income. In computing capital gains, the individaul would be allowed to adjust his basis for inflation. A table of allowable percentage basis adjustments would be provided in the tax form. In addition, the individual would use statements received from corporations to adjust his basis upward for corporate profits attributed to him and downward for distributions received.

The major change under the cash-flow tax is that the taxpayer would receive each year statements from all of his qualified accounts on net withdrawals or deposits in the previous year. The source of an individual's deposits to qualified accounts are current savings and past accumulated capital and the source of withdrawals are past deposits and interest, capital gains, and dividends received on investments made through the qualified accounts. Net withdrawals from (positive) and deposits to (negative) all qualified accounts would be shown on a separate form and the sum would be added to, if positive, or subtracted from, if negative other items included in the computation of taxable income.

Interest, dividends, and capital gains realized on investments made outside of qualified accounts would not be reported on the tax form and would not be included in taxable income. Deductions would not be allowed for interest paid on loans outside of qualified accounts.

Gifts and inheritances received would be included in taxable income (but if deposited in a qualified account would have an offsetting deduction), and separate lines will be provided for them on the tax form. A deduction would be allowed for gifts given. On the form for itemized deductions, the identity of the recipient of all deductible gifts and his social security number would be recorded.

VI. Chapter-by-Chapter Outline of Tax Reform Report

Chapter 1--Introduction

Chapter 1 sets out the objectives of a reformed tax system: equity, efficiency, and simplicity. The scope of the study is defined to include only the Federal income tax and the corporation tax. The relationship of the income and corporation taxes to other taxes in the system, notably the payroll tax, and to means-tested grant programs is briefly explored. The content of the remainder of the report is outlined.

Chapter 2--What is to be the Tax Base?

Chapter 2 reviews the main issues in choosing an appropriate tax base, and presents the case for considering a cash flow tax based on consumption as a serious alternative to a reformed comprehensive income tax. General issues of equity in design of a tax system are discussed and the concepts of consumption and income are explained in detail. It is shown that the current tax system contains some elements of a consumption base and some elements of a comprehensive income base. The alternative tax bases are then compared on the grounds of equity, simplicity, and effects on economic efficiency.

Chapter 3--A Model Comprehensive Income Tax

A plan for a model comprehensive income tax is presented in Chapter 3. The major innovations in the plan relate to integration of the corporation and personal income taxes, tax treatment of capital gains, treatment of State and local bond interest, taxation of income accumulated in pensions and life insurance funds, and treatment of retirement income and unemployment compensation. Suggested changes in many personal deductions are presented, and are related to the concept of income. Important recommendations for changes in the filing unit, adjustment for family size, and taxation of secondary wage earners are set forth. International considerations in income taxation are briefly discussed. The Chapter concludes with a description of a sample form for an individual's tax calculation under the comprehensive income tax.

<u>Chapter 4--A Model Cash Flow Tax</u>

In Chapter 4, a plan for a model cash flow tax based on consumption is presented. The major innovation in the cash-flow tax is that savings may be deducted from the tax base. A plan for using the device of qualified accounts to measure the flow of saving and consumption is presented. The equivalence between deductibility of saving and exclusion of capital earnings from tax is explained, and a plan for alternative treatment of assets following from this equivalence is presented. Treatment of specific items under the model cash flow tax is proposed in detail, and compared with treatment of the corresponding items under the comprehensive income tax. Arguments against the cash-flow tax on grounds of progressivity and effect on the wealth distribution are evaluated, and the possible use of a supplementary wealth transfer tax is explored. The Chapter concludes with a description of a sample individual tax form under the cash flow tax.

<u>Chapter 5--Transition Rules Under Basic Tax Reform</u>

Chapter 5 proposes a set of transition rules to accompany introduction of each one of the model tax plans. Problems which may arise in <u>changing</u> tax laws are explained, and some instruments to ameliorate adjustment problems, including exempting existing assets from the tax change and phasing-in the new rules, are described and evaluated. Specific proposals are presented for transition to both a comprehensive income base and a cash flow base which cover the timing of the application of the new rules to specific proposed changes in the tax code.

<u>Chapter 6--Quantitative Analyses</u>

Chapter 6 presents preliminary simulations of the effects of adoption of the proposed model tax reform plans on the tax liability of different groups of taxpayers. The Chapter includes examples of how taxpayers in different categories would calculate their taxes under the model plans.