Active Employment. Consistent with current budgetary priorities, the 1982 budget counters past trends by slating the Defense Department for a sizable manpower increase and nondefense agencies for slightly larger decreases. Relative to 1980, the civilian workforce for nondefense agencies is projected to decline by 3.4 percent through September 30, 1982 while the civilian workforce for the Defense Department increases by 1.5 percent. Overall, it is assumed that the workforce will therefore decline slightly, but the Defense Department's share will rise by 1.2 percentage points over its 1980 share. The near-term savings from cutbacks in civilian agency employment are likely to be partly offset by layoff expenses, including severance pay, refunds of employees' accumulated contributions to the federal retirement plan, and by other layoff benefits. In calendar year 1981, for example, nondefense agencies cut back some 68,000 jobs by not filling vacated positions and by laying off some 11,800 workers. The cost of payments to the laid-off workers will, according to a conservative estimate, shrink the full-year employment reduction savings from $1.5 billion to $1.3 billion (estimates annualized on a 12-month basis). 5/

Baseline Projections, 1983-1987

During the 1983-1987 period, if no changes in current policy are effected, combined outlays for federal civilian pay and retirement are projected to grow from $77.1 billion to about $102.4 billion. This represents an average annual increase in payroll expenditures of 6.5 percent and a 7.5 percent average increase in annual benefit costs for CSR.

The five-year projections for federal civilian payroll costs reflect no reductions in the size of the workforce beyond those already achieved in 1982. The estimates also reflect an extension of the 1982 budget resolution assumptions, which call for continued restraint in federal pay adjustments and no comparability catch-up. The 1983-1987 pay raise projections, however, slightly exceed estimated increases in the cost of living--suggesting a 3.1 percent total real growth in income during the next five years.

Between 1982 and 1987, CSR outlays are projected to grow from $19.8 billion to $31.6 billion--an increase of 60 percent--with

5. In addition to CBO's estimates, other estimates of layoff costs have been prepared by some individual Executive Branch agencies, including the Department of Education.

about three-fifths of this growth resulting from automatic COLAs. The remaining outlay rise will come about because of increases in the number of CSR annuitants and, to a somewhat lesser degree, because of larger average annuities earned by new civil service retirees. (The projections also assume COLAs will continue on a once-a-year basis.)

BUDGET STRATEGIES

Despite recent budgetary reductions enacted by the Congress, federal compensation still offers potential for further savings. In particular, annual civilian pay adjustments and the CSR program remain obvious targets. (Federal compensation costs might also be reduced by individual program cutbacks identified in the other chapters and the Appendix items in this report. 6/) In debating what course of action to take concerning federal pay and retirement, the Congress will want to consider both the budgetary effects and the workforce implications of measures that could accelerate federal retirement.

With regard to federal pay, the CBO baseline--consistent with the 1982 budget resolution--assumes that annual pay increases will continue to be restrained in 1983 and subsequent years. The Congress may decide, of course, that federal pay adjustments must be further reduced in response to economic and budgetary concerns. Also, additional savings could be conceivably justified under a "total compensation" approach (discussed in this chapter), which would compare federal and nonfederal pay and benefits. In essence, the government's cost of providing superior retirement benefits would be offset by reducing the size of future pay increases. Such pay reform, as well as a continuation of limits on pay increases, would encourage federal workers to retire as soon as they are eligible for pension benefits. Thus, the government could lose the skills, productivity, and experience of senior federal employees who elect early retirement. The repercussions from this behavior would increase in the long run as the number of younger workers entering the job market declines.

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6. The reduction examples in this report having impact on payroll expenditures include elimination of various farm payments and support programs, small business loan guarantees, transportation grants and subsidies, and limiting the number of veterans eligible for certain benefits and the number of veterans' health facilities.

As an alternative to further limits on pay increases, the Congress could consider changing the Civil Service Retirement program. Such consideration would be hampered, however, by the absence of any statutory or generally agreed-on criteria for evaluating the reasonableness of current CSR benefits, contribution rates, and associated federal costs. Under current policy, CSR can be construed as a model program that sets an example for other employers. This perspective could be replaced by one that sought to bring federal costs of CSR into alignment with what would prevail if the government adopted retirement practices more like those of the private sector. If the Congress took this approach two possible courses of action for CSR could be considered: reducing CSR benefits (see Appendixes A-600-d, A-600-j and A-600-l), or raising the payroll withholding rates that partly fund the system (see Appendix B-600-h).

Reducing CSR Benefits

Compared with the two-part retirement income of private-sector retirees--an employer-provided pension plan, plus Social Security--benefits under CSR are relatively large. The two areas in which differences have the most significant cost effects are age of eligibility and COLAs. Enrollees in CSR may draw unreduced pensions as young as age 55, and their benefits are kept abreast of inflation through annual adjustments that fully reflect changes in the CPI. In the past, COLAs were effected more than once a year, and each adjustment equaled the change in the CPI plus a one-percentage-point add-on. The add-on was enacted in 1969 to compensate for the lag between benefit adjustments and increases in the cost of living, but it had the effect of instituting permanent overcompensation. As of October 1976, the Congress eliminated the COLA add-on; but the legislation did not apply retroactively to adjustments already received.

The cost of COLAs to the federal government has become progressively higher every year because of increases in the numbers of annuitants, the upward trend of wages, and the intrinsic compounding of new COLAs on top of previous ones. In 1970, for example, each one-percentage-point adjustment caused annual outlays to increase by $24 million; in 1981, however, each such one-percent adjustment added some $190 million to annual outlays. The cost of COLAs is neither recognized in nor funded by the employee contribution to CSR (7.0 percent of pay for most workers). This omission has been a major factor in federal cost increases for CSR.

Benefit changes other than COLA and early-retirement limitations that would bring CSR benefits into closer alignment with private sector practices include basing initial benefits on employees' average salaries for five rather than three years of highest earnings; and requiring retirees with living spouses to accept an actuarial reduction in their initial annuity or waive survivor protection for their spouses.

COLA Limitations. Because CSR COLAs have exceeded the pay raises awarded to federal employees still in active service, many CSR retirees already on the rolls now receive greater pensions than they would if they retired today at the same grade level and with the same length of service. For example, the pension of an employee who retired in 1970 is at least 30 percent greater than would be the pension of a worker electing to retire in 1983 with the same work history. The difference narrows for more recent retirees--some 6 percent for employees who retired in 1980. This "extra" income results from two aspects of CSR indexation: COLAs from 1970 through 1976 included the one percentage-point add-on to changes in the CPI; and second, COLAs during the last decade have usually exceeded annual pay adjustments for white-collar workers.

A relatively easy correction for the extra CSR income could be achieved by temporarily reducing future COLAs for persons who have already retired. For example, if a 50 percent cap were applied to future COLAs for employees who retired since 1970--the primary group benefiting from overindexation--CSR outlays would fall by $0.2 billion in 1983 and $1.8 billion in 1987, yielding a five-year total of some $5.0 billion. Because the amount of excess benefits (income over what would be received if retirement occurred in 1983) relates to date of retirement, the temporary COLA reduction would terminate at different times, depending on year of retirement; none would last beyond 1992. 7/

Using COLA reductions to reduce gradually the "excess" CSR benefits would avoid both administrative problems and the costs of recalculating benefits for some 1.4 million retirees. On the other hand, temporary COLA limits or detailed recalculation would most certainly be opposed as a largely unprecedented action that would amount to a retroactive, downward benefit adjustment.

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7. A similar temporary COLA reduction is proposed for retired military pay (see Chapter III).

Patterning CSR after common private-sector treatment of retirement increases could bring down the level of federal outlays. Aligning future CSR adjustments to estimated COLAs received in the private sector--for current as well as new annuitants--would reduce 1983 benefit outlays by $0.3 billion and accumulate outlay savings of some $8.2 billion through 1987. This departure would entail limiting the size of annual COLAs for federal retirees.

Throughout much of the private sector, pensions are increased on an ad hoc basis to reflect rises in the cost of living; only a handful of private firms offer any guaranteed COLA. Private sector retirees aged 62 and over, however, are eligible for Social Security, which, under current law, is automatically indexed to recover 100 percent of changes in the CPI. Nonetheless, revised CSR pensions modeled on the dual private-sector annuity package would provide a far less ample cushion against inflation than CSR offers today. The data available suggest that prevailing private-sector retirement income recovers an estimated 33 percent of CPI for annuitants under age 62 and roughly 70 percent when Social Security benefits become available. If such adjustments applied to CSR, a typical federal retiree and survivor--receiving projected 1983 annual CSR benefits of $14,400 and $6,100--would suffer income reductions of some $240 and $100, respectively.

Early Retirement. Under current law, CSR benefits are available, without reduction, to persons aged 55 after at least 30 years of federal service or to those aged 60 after 20 years of service. Reducing earned benefits for federal workers who retire before age 65 would be more consistent with the present provisions of the Social Security program.

A 2 percent per year reduction could be phased in, eventually reaching 10 percent at age 60 and 20 percent at age 55. The maximum early-retirement reduction would still be less severe than that required by the Social Security program. Social Security's provisions, which grant no retirement benefits to persons younger than age 62, impose primary annuity reductions of 6 2/3 percent per year for persons retiring between ages 62 and 65. Because Social Security represents a large part of most retirees' incomes, few workers can afford earlier retirement even if private pension benefits are available. The Social Security limitations are especially significant because a number of private pension plans reduce the earned annuity only if retirement occurs before age 62 or in some instances, age 55.

Reducing CSR's early-retirement benefits over a 20-year phase-in period would decrease outlays by only about $5 million in the first year of implementation--1983--but it would have a greater long-term impact. Cumulative savings between 1983 and 1987 would reach $0.3 billion. Without the phase-in period, however, CSR costs would rise sharply, since employees would accelerate their retirement plans to avoid benefit reductions.

Calculation of Initial Benefits. Under current law, the size of initial CSR benefits is determined in part by the employees' three years of highest earnings--commonly referred to as "high-three." 8/ A high-five basis is much more common in the private sector--at least for white-collar employees--and was the basis used prior to 1970 in computing CSR annuities. Reinstatement of a five-year average for calculating initial benefits for new retirees could save an estimated $0.05 billion in 1983 and generate savings of $1.4 billion through 1987.

Survivor Coverage. In accordance with CSR provisions, some 70 percent of the 100,000 federal employees retiring each year elect reduced benefits in order to allow for coverage for their surviving wives or husbands. To receive this coverage, the initial employee annuity is reduced by 2.5 percent for the first $3,600 and by 10 percent for CSR pension income over $3,600. This reduction is the same for all annuitants, regardless of differences in the ages of annuitants and spouses. The current reduction formula differs markedly from private pension practices.

In order to conform with the private sector, the CSR reduction for survivor coverage could be based on actuarial factors that would vary the reduction according to the ages of the retiree and the spouse. This would remove a certain inequity in the current system that benefits some spouses and married annuitants and disadvantages single retirees. Because actuarial reductions would be greater for most new retirees than under current law, this change would save $0.8 billion between 1983 and 1987. (Implementing legislation for changes in initial benefits and reductions for survivor coverage would need to be effective a short time before

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8. Under current law, the size of the initial CSR pension (without reduction for survivor coverage) is determined by multiplying average salary for the highest three years of earnings times a percentage rate that usually includes 16.25 percent for the first ten years of service and 2.0 percent for each additional year of service.

enactment in order to limit accelerated retirements and their associated costs. On the other hand, some critics would maintain that these changes should be phased in over a number of years, because many employees have undoubtedly planned their retirement already.)

Increasing CSR Contributions

As an alternative to reducing CSR benefits, the Congress could choose to increase CSR contributions to help defray the costs of the program's superior provisions. In particular, an increase in the employee contribution rate from 7 percent to 9 percent of pay would fund about half the margin of indexed federal pensions over private ones. 9/ If the employee contribution rate were increased to 9 percent over three years, five-year savings in federal costs for CSR could reach $5.8 billion. The increase in the matching agency contribution would also generate further budgetary savings because of the added income from the USPS and other off-budget agencies. The combined increase in funding from external CSR income (contributions from employees and off-budget agencies) could accumulate to $6.9 billion through 1987.

Increasing CSR contribution rates would cover some of the high cost of COLA increases. Furthermore, the increase in employing agency contributions also offers a step toward better recognition of retirement costs in operating programs. In particular, the increased payments from the USPS and other public enterprises could reduce what now amount to unrecognized subsidies for their operations. Proponents of raising contribution rates point out that the CSR fund would be depleted this year were it not for federal payments that have been centrally appropriated from the general fund of the U.S. Treasury.

Increased CSR withholdings would reduce the take-home pay of the nearly 2.7 million employees, including postal workers,

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9. The estimated 2 percent increase is drawn from long-term (50 year) economic and cost assumptions for CSR prepared by the system's Board of Actuaries and from other data concerning cost-of-living adjustments awarded in private sector. The estimates are highly sensitive to the long-term economic assumptions. Changes in private-sector COLA practices could also affect the two percent estimate; but current data suggest that the amount of indexation in private-sector plans has not changed much in recent years.

currently participating in the system. About 85 percent of these workers receive annual salaries ranging between $10,000 and $30,000. This proposal would also exert upward pressure on postage rates. (Over the next five years, postage rates might rise by as much as 0.8 percent to recoup higher agency costs for CSR withholdings.) Opponents argue that active employees cannot afford an increase in contribution rates in light of inflation and past limits on annual federal pay raises. In addition, they observe that most private-sector plans, albeit less generous, require no employee contributions.

In view of recent limitations on federal pay, increasing the mandatory retirement contributions could also create employee recruitment and retention problems in some sectors of the federal workforce. For example, in an agency such as the Defense Department, where employment is slated to expand, recruitment problems could ensue, because qualified employees or job applicants might prefer take-home pay at the expense of lower deferred benefits such as retirement. On the other hand, recruitment problems for most civilian agencies would not likely occur at this time, in view of high unemployment in the national economy and current or forthcoming cutbacks in federal jobs.

Total Compensation

A major federal reform debated in recent years would require the value of fringe benefits to be considered when determining compensation comparability between federal and nonfederal jobs. Such a departure from existing procedures, which determine federal pay and benefit levels independently, is termed the "total compensation" approach. Current law provides that federal pay rates should be comparable with private enterprise rates for equivalent work. But in recent years, the government has essentially departed from this principle, as budgetary and economic considerations have kept federal pay raises below those of the private sector. A total compensation approach would basically trade the advantage from superior federal retirement benefits against the size of future federal pay adjustments. 10/

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10. Total compensation legislation proposed by the Administration for the 1982 budget also included a federal comparability standard that would eventually equate federal compensation to 94 percent of nonfederal pay and benefits. The Administration justified the 94 percent standard as a way to recognize certain intangible advantages of federal employment such as promotion potential and job security.

The Congressional Budget Office has observed that total compensation comparisons are highly uncertain and subject to a wide degree of discretion in the mechanics and design of a comparative framework. Thus, different methodology (mechanics and design) could lead to different pay adjustments--either below or above the 7.0 percent projected by CBO under current policy. A reduced 1983 pay adjustment, however it might be constructed, could be justified either as a necessary measure to accommodate budgetary constraints or as a refinement of a total compensation proposal. If the size of annual federal pay adjustments were one percentage point lower for each of the next five years, annual federal payroll expenditures would fall by $0.4 billion in 1983 and by $2.5 billion in 1987. During this period, payroll reductions would accumulate to some $7.1 billion.

CONCLUDING COMMENTS

Limiting federal compensation costs for civilian pay and retirement benefits could yield significant budgetary savings. Although CBO projections assume federal pay adjustments will remain below private-sector increases, the President may recommend a still lower pay figure for 1983. A one-percentage-point reduction enacted in the 1983 pay raise--from 7 to 6 percent--would accumulate a five-year savings of $1.7 billion. But continuing to hold down federal active-service pay adjustments, in lieu of reducing retirement benefits, could prompt federal managers and experienced employees with valuable skills to accelerate their retirement plans.

The Congress could always take a different course of action and modify federal retirement provisions. The CSR program remains the single most costly federal fringe benefit, and the one that differs most markedly from practices in the private sector--allowing employees to retire earlier and affording them greater protection against inflation. If the federal costs of the CSR system are viewed as excessive in light of private-sector practices, there are only two ways to decrease them: either reduce benefit levels, or raise contributions paid by employees and off-budget agencies.

Post-retirement COLAs have the most significant cost effect on CSR outlays. The Congress could also consider other CSR benefit modifications, including reductions for early retirement, changing the formula for calculating initial benefits, or redistributing the cost of survivor coverage. All of these changes would help align the federal retirement system with private-sector practices and reduce annual expenditures. But such changes would counter long-standing policy that favors protection of income received by retired persons. 11/

Raising retirement contribution rates would reduce the government's cost for CSR benefits at the expense of federal employees' take-home pay. But in view of continued limitations on federal pay adjustments, increased payroll withholdings could create recruitment and retention problems. The short-run impact would be moderated, however, by relatively high general unemployment rates and reductions in force in many federal agencies.

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11. Federal policy favoring protection of retirement income is reflected in various programs and tax provisions. Examples include Social Security and its indexation, Medicare, the Employee Retirement Income Security Act, extra federal income tax exemption at age 65; and certain tax credits.

CHAPTER XII. TAX REVENUES

Federal government revenues come principally from individual income taxes (currently about 47 percent of total revenues), social insurance taxes (about 33 percent), and corporate income taxes (about 8 percent). The remaining 12 percent of federal revenues comes from excise taxes, estate and gift taxes, user charges, and various other sources.

The Economic Recovery Tax Act of 1981 (ERTA) will reduce tax revenues by large amounts in future years--by an estimated $95 billion in fiscal year 1983, rising to $294 billion in 1987. These tax reductions pose a sharp dilemma for the Congress and the President. Unless federal spending is cut further, or revenues are increased, there is little prospect of a balanced budget in the foreseeable future.

This chapter discusses a variety of ways in which revenues could be increased. More detail on a number of options for cutting tax expenditures--special tax provisions intended to encourage certain activities and to assist certain groups--is included in Appendix B.

BUDGET HISTORY AND PROJECTIONS

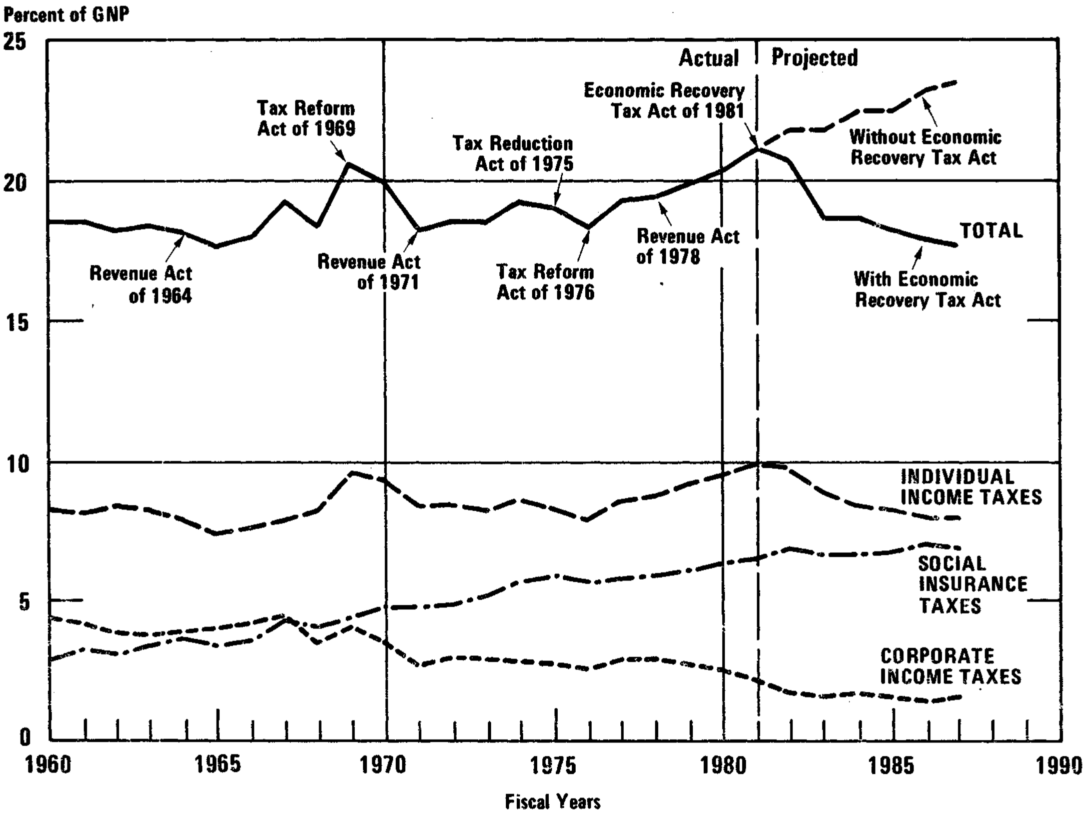
Total federal revenues have remained relatively constant as a percentage of gross national product (GNP) since 1970, although an upward trend was discernible in the last several years. This trend was reversed by the Economic Recovery Tax Act of 1981, which will ultimately reduce revenues as a percentage of GNP to levels comparable to the lowest levels of the 1950s and 1960s.

The composition of total revenues has changed substantially in the past decade, however, with social insurance taxes making up an increasingly larger share and the corporate income tax share declining steadily. These trends will continue during the 1983-1987 period.

Historical Trends, 1970-1981

Total federal revenues rose from $193.7 billion or 20.0 percent of GNP in fiscal year 1970 to $602.6 billion or 21.1 percent of GNP in fiscal year 1981. Revenues as a percentage of GNP dipped as low as 18.2 percent during the 1970s, however, and did not reach a level above 20 percent again until 1980 (see Figure XII-1). Inflation and economic growth tend to increase revenues as a percent of GNP, but this tendency was largely offset by the tax cuts enacted in 1969, 1971, 1975, 1976, 1977, and 1978.

Figure XII-1.
Federal Revenues as a Percentage of GNP, 1960 to 1987



While the individual income tax share of total revenues has remained quite constant over this period, the social insurance tax share has grown from 23 percent of the total in 1970 to 31 percent in 1981, and the corporate income tax share has declined from 17 percent in 1970 to 10 percent in 1981 (see Table XII-1). The growth in the social insurance share has resulted from the need to finance large increases in Social Security benefits enacted during the 1970s, especially the enactment in 1972 of an immediate 20 percent benefit increase, followed by automatic annual cost-of-living increases. The largest Social Security tax increase during the period was that of 1977, which provided for steep increases in the Social Security tax base and a schedule of rate increases extending into the next century. The decline in the corporate income tax share has resulted mainly from increases in the investment tax credit, more liberal depreciation allowances, and other special tax provisions aimed at stimulating particular kinds of investment. The top corporate rate was also reduced from 48 percent to 46 percent during the period.

The Economic Recovery Tax Act of 1981

CBO estimates that the Economic Recovery Tax Act will reduce revenues below what they otherwise would have been by $95 billion in fiscal year 1983, and $294 billion in fiscal year 1987. The largest share of this reduction ($65 billion in 1983 and $147 billion in 1987) is due to a 23 percent cut in individual income tax rates that will be phased in over three years. The next largest share ($19 billion in 1983 and $60 billion in 1987) results from the new capital cost recovery system for business depreciation.

The reduction in income taxes in the 1981 act will lower individual income tax revenues to 8.0 percent of GNP by 1987, a level equal to the lowest year in the 1970s, but above the 7.4 percent level reached in the lowest year of the 1960s. As discussed later in the chapter, for taxpayers as a whole this reduction in income taxes will more than offset the tax increases from inflation if these increases are measured from late 1981, but not if the starting point is January 1979, the effective date of the last tax cut. The tax cuts enacted during the 1970s approximately offset the effects of inflation for taxpayers as a whole.

The corporate income tax reductions in the 1981 Act are much larger than those of earlier years, and will reduce corporate income tax revenues as a percentage of GNP to below 2 percent for the first time since 1941. This reduction in corporate income taxes continues a trend that has extended over the last three decades. Corporate income tax revenues averaged 5 percent of GNP during the 1950s, 4 percent during the 1960s, and less than 3 percent during the 1970s.

TABLE XII-1. BUDGET REVENUES BY SOURCE, SELECTED FISCAL YEARS, 1960 TO 1987

Source	1960	1970	1981	1982	1983	1987
			(Billions of dollars)			
Individual Income Taxes	40.7	90.4	285.6	299.9	302.7	396.3
Corporate Income Taxes	21.5	32.8	61.1	50.4	50.7	73.0
Social Insurance Taxes and Contributions	14.7	45.3	186.4	208.9	227.4	339.0
Excise Taxes	11.7	15.7	40.8	41.4	39.8	39.8 a/
Other	3.9	9.5	28.7	30.7	31.0	33.8
Total	92.5	193.7	602.6	631.3	651.6	881.9
			(As a percent of total revenues)			
Individual Income Taxes	44.0	46.7	47.4	47.5	46.5	44.9
Corporate Income Taxes	23.2	16.9	10.1	8.0	7.8	8.3
Social Insurance Taxes and Contributions	15.9	23.4	30.9	33.1	34.9	38.4
Excise Taxes	12.6	8.1	6.8	6.6	6.1	4.5 a/
Other	4.2	4.9	4.7	4.9	4.8	3.8
Total	100.0	100.0	100.0	100.0	100.0	100.0
			(As a percent of GNP)			
Individual Income Taxes	8.2	9.3	10.0	9.8	8.8	8.0
Corporate Income Taxes	4.3	3.4	2.1	1.6	1.5	1.5
Social Insurance Taxes and Contributions	2.9	4.7	6.5	6.8	6.6	6.8
Excise Taxes	2.3	1.6	1.4	1.4	1.2	0.8 a/
Other	0.8	1.0	1.0	1.0	0.9	0.7
Total	18.5	20.0	21.1	20.6	19.0	17.7

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

a. CBO's baseline revenue projections for 1987 include the extension of highway trust fund taxes. This adds $4.5 billion to excise taxes in 1987.

Baseline Projections, 1983-1987

The revenue outlook for the period from 1983 to 1987 is dominated by the effects of the Economic Recovery Tax Act. Total revenues as a percentage of GNP are projected to decline from 21.1 percent in 1981 to 19.0 percent in 1983 and 17.7 percent in 1987, the lowest level since 1965 (see Table XII-1 and Figure XII-1). All major sources of revenue are projected to level off or decline as a percentage of GNP from 1983 to 1987 except for social insurance taxes. The increases in Social Security taxes scheduled during this period--an increase in the rate from 6.7 percent in 1983 to 7.05 percent in 1985 and 7.15 percent in 1986, and automatic increases in the wage base each year--will push social insurance taxes as a percentage of GNP from 6.6 percent in 1983 to 6.8 percent in 1987. As a share of total revenues, social insurance taxes will climb from 35 percent in 1983 to over 38 percent in 1987.

Corporate income tax revenues are projected to drop to 8.3 percent of total revenues and 1.5 percent of GNP by 1987, the lowest percentage of GNP since 1940. The major reason for this drop is the Accelerated Cost Recovery System (ACRS) of business depreciation. The depreciation deductions provided by ACRS, in combination with the investment tax credit, are so large that they will frequently more than offset a firm's current earnings. Such firms will thus pay no corporate income taxes, and will in addition have deductions and credits that they will be unable to use to offset current income. To give such firms the same tax incentive to make new investments as firms that have enough income to use all their deductions and credits, ACRS includes a provision that substantially liberalizes the rules for leasing business assets. Under these new leasing rules, firms with extra deductions and credits can, in effect, sell them to firms that have enough income to use them. The payments the selling firms receive approximate the tax savings they would receive if they were able to make full use of the deductions and credits themselves. By reducing the amount of unused deductions and credits, leasing increases the federal revenue loss from ACRS by about 20 percent over what it would otherwise have been. These anticipated effects of leasing have been included in the revenue projections for 1983-1987 in this chapter.

BUDGET STRATEGIES

There is a potential conflict between the goal of reducing the federal deficit and that of reducing the role of the federal government in allocating resources. The goal of reducing the federal deficit can be achieved either by increasing revenues or by reducing outlays. Reducing outlays also reduces the federal role in the allocation of resources, but raising revenues may allow the federal role to be maintained or increased. Currently, total revenues are projected to fall to just 17.7 percent of GNP by 1987, a lower level than outlays have reached in any year since 1956. To reach a balanced budget at that level of revenues would require an extraordinary reduction in outlays from their post-World War II high of 23.1 percent of GNP in 1981. Combining some increase in revenues with further cuts in outlays would thus still permit a substantial reduction in the current role of the federal government.

Some ways of increasing revenues may reduce the role of the federal government in the economy. Increases in user charges, for example, could reduce the federal role in resource allocation by requiring the beneficiaries of federal facilities and services to pay their full cost rather than having part of the cost subsidized by the taxpayers at large. Similarly, increasing revenues by reducing tax expenditures would reduce federal intervention in the allocation of resources.

There are three general ways of reducing the deficit through revenue measures:

- Some of the multiyear individual and business tax cuts enacted in 1981 could be reduced, postponed, or repealed.

- Existing tax law could be tightened by reducing tax expenditures, eliminating obsolete incentives, and reducing tax abuse and avoidance.

- New or increased taxes could be enacted, such as a windfall profit or excise tax on natural gas; tariffs or fees on imported oil; higher excise taxes on alcohol, tobacco, and gasoline, and other items; expanded user fees for federally provided services; or a national value-added or sales tax.

Going beyond these kinds of incremental changes, a more fundamental restructuring of the income tax system could also be considered, such as a broader-based income tax with fewer deductions, exclusions, and exemptions, thus permitting substantially lower rates, or replacement of the income tax altogether with a broad-based consumption or expenditure tax. These approaches would not necessarily increase revenues, however. Attempts to cushion the inevitably difficult transition to a wholly new tax system by softening its impact on groups of taxpayers to prevent possible hardship could easily result in reduced total revenues.

Scaling Back the 1981 Tax Cut

Since the major individual income tax cuts in the Economic Recovery Tax Act are scheduled to be phased in over time, substantial amounts of revenue could be raised by postponing, reducing, or eliminating some of them. Postponing the scheduled July 1983 10 percent rate cut by one year, for example, would increase revenues by $27 billion in fiscal 1984 (see Table XII-2). The scheduled rate cuts could also be reduced. As shown in Table XII-2, reducing the 1983 rate cut to 5 percent would increase revenues by $18 billion in fiscal year 1984 and $20 billion in fiscal year 1985. The act also provides for annual indexing of the individual income tax for inflation, starting in 1985. Eliminating this provision would increase revenues by $12 billion in fiscal year 1985 and $51 billion in 1987, using CBO inflation assumptions. Other options for scaling back the 1981 individual income tax cuts are also shown in Table XII-2.

In considering any of these possible reductions in the individual income tax cuts, it is important to keep in mind that some or all of the cuts simply offset the tax increases that would otherwise occur as inflation, pushing taxpayers into higher tax brackets. As shown in Table XII-3, if these tax increases from "bracket creep" are measured from October 1, 1981, the date of the first installment of the rate cuts enacted in 1981, 40 to 65 percent of the rate cuts are offset by inflation. If the base for measuring bracket creep is taken back to January 1, 1979, the effective date of the last income tax reduction prior to the 1981 act, the 1981 rate cuts are more than offset in the aggregate by the accumulated tax increases from bracket creep. For many individual taxpayers, especially those with lower incomes, the scheduled income tax reductions will not be enough to offset bracket creep even when measured from October 1981; reducing or postponing the scheduled reductions would leave even more taxpayers with higher real tax burdens than they had in 1981.

TABLE XII-2. REVENUE INCREASES FROM SCALING BACK THE INDIVIDUAL INCOME TAX CUTS IN THE ECONOMIC RECOVERY TAX ACT OF 1981 (By fiscal year, in billions of dollars)

Modification	1983	1984	1985	1986	1987
Delay 1983 Rate Cut by					
Three months	8	a/	---	---	---
Six months	9	8	---	---	---
One year	9	27	---	---	---
Reduce 1983 Rate Cut to 5 Percent	4	18	20	22	24
Reduce 1983 Rate Cut to 5 Percent on July 1, 1983 and 5 Percent on July 1, 1984	4	14	1	1	1
Eliminate 1983 Rate Cut	9	37	40	44	47
Eliminate Indexing	---	---	12	30	51
Eliminate 1983 Rate Cut and Indexing	9	37	54	76	102

NOTE: The act provides for an across-the-board reduction in individual income tax rates of 10 percent on July 1, 1982, and another 10 percent on July 1, 1983. Starting in 1985, rate brackets, the zero bracket amount (standard deduction), and personal exemptions will be indexed annually for inflation.

a. Less than $0.5 billion.

As discussed earlier, the business tax reductions in ERTA will reduce corporate income tax revenues to their lowest share of GNP in more than 40 years. These tax reductions could be scaled back by, for example, keeping the maximum allowable depreciation under the capital cost recovery system at the current 150 percent declining balance rate rather than allowing it to increase to a 175 percent rate in 1985 and 200 percent in 1986 and thereafter. This would increase revenues by $14 billion in fiscal year 1986 and $19

TABLE XII-3. REVENUE EFFECTS OF 1981 INCOME TAX RATE CUTS COMPARED WITH INFLATION-INDUCED INCOME TAX INCREASES (By fiscal year, in billions of dollars)

	1982	1983	1984	1985	1986	1987
ERTA Individual Income Tax Rate Cuts a/	25	65	102	128	161	198
Income Tax Increases from Bracket Creep b/						
Starting October 1, 1981	11	26	48	71	98	128
Starting January 1, 1979	70	93	121	151	184	222

a. Includes $12 billion for indexing in 1985, $30 billion in 1986, and $51 billion in 1987.

b. Estimated by calculating the difference between the income tax revenues that would be collected in the absence of the Economic Recovery Tax Act, and those that would be collected if the income tax were indexed for inflation beginning on October 1, 1981, or January 1, 1979. Assumes increases in the Consumer Price Index of 11.3 percent in calendar year 1979, 13.5 percent in 1980, 10.3 in 1981, 7.5 in 1982, 6.9 in 1983, 6.9 in 1984, 6.4 in 1985, 6.0 in 1986, and 5.7 in 1987.

billion in 1987. Another option would be to eliminate the increase in the investment tax credit for short-lived assets that was enacted in 1981. Reducing the credit from 6 percent to 3-1/3 percent for three-year assets, and from 10 percent to 6-2/3 percent for five-year assets, would increase revenues by $2 billion in 1983 and $10 billion in 1987.

The leasing provisions of ERTA account for about $4 billion of the estimated $19 billion capital cost recovery revenue loss in 1983, and about $9 billion of the estimated $60 billion loss in

1987. Some revenue could thus be saved by tightening up or eliminating these leasing provisions. To do so, however, would place firms with low current profits and/or large investment plans at a competitive disadvantage in financing their capital investments. Scaling back the underlying depreciation and investment tax credit provisions would have a more even effect on overall investment than a cutback in leasing, since cutting back leasing would exclude only selected firms from depreciation tax savings.

A number of smaller provisions of ERTA have also been suggested as possible candidates for repeal or scaling back, including the exemptions from the windfall profit tax ($1.6 billion revenue loss in 1983 and $3.2 billion in 1987) and the reductions in the estate and gift tax ($2.3 billion in 1983 and $7.4 billion in 1987).

Reducing Tax Expenditures, Obsolete Incentives, and Tax Avoidance

Increasing tax revenues by cutting tax expenditures or removing obsolete incentives would at the same time reduce federal intervention in the economy. Tax expenditures are subsidies in the form of special tax provisions designed to stimulate particular kinds of economic activity or to relieve hardship. The Domestic International Sales Corporation (DISC) tax provisions, for example, are intended to stimulate exports, while the extra $1,000 personal exemption for persons over age 65 is intended to reduce the tax burden on a part of the population that tends to have lower incomes. Like federal spending programs, these special tax provisions are a way of allocating resources to some groups or sectors of the economy at the expense of others.

This chapter includes a variety of options for reducing tax expenditures. They are listed in Table XII-4, along with the estimated revenue gains that would result in fiscal years 1983 and 1987. Each option is discussed in more detail in Appendix B.

Some or all of the revenues raised from cutting back these special provisions could be used to finance across-the-board cuts in individual and corporate tax rates or other broad forms of tax reduction, such as general increases in business depreciation allowances. Since large multiyear individual and business tax cuts have already been enacted, selective changes in the tax structure would help fill the revenue gap left by these general tax cuts. Repealing the income tax deduction for state and local sales taxes, for example, would raise about $0.8 billion in new revenue in