EFFECTS OF TAX AND BENEFIT REDUCTIONS ENACTED IN 1981 FOR HOUSEHOLDS IN DIFFERENT INCOME CATEGORIES

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Senator Ernest F. Hollings
and
Chairman James R. Jones

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SUMMARY

This memorandum examines the impact of the revenue and spending changes enacted during the first session of the 97th Congress on households in different income categories.

The analysis is limited by the complexity of the tax and expenditure programs involved and by the lack of complete data about them. The estimates include only changes in those federal taxes and benefits that directly affect specific households.[1] Thus, for example, changes in spending in areas such as defense have not been included, since the benefits arising from these expenditures are not directly allocable to specific households. In addition, the reductions in grants-in-aid to state and local governments (other than those for individual assistance) have not been allocated to particular income categories, although the characteristics of those affected by these cuts are discussed.[2]

Similarly, only the major individual income tax cuts enacted in the Economic Recovery Tax Act are included in the detailed analysis. The tax cuts for businesses are not included because it is not known whether the tax savings will be passed on to shareholders, and because data regarding the ownership of corporate stock are not available.

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1. Household income as defined in this study includes cash benefits and food stamps, but excludes all other benefits provided in kind, although the distribution of changes in in-kind benefits over the five income categories has been estimated.

2. The estimates of reductions in grants to state and local governments discussed in the second part of this memorandum represent changes in budget authority, rather than in outlays as for individual assistance programs, since estimating outlay changes for these grants is often not feasible. Further, these estimates are for fiscal years rather than calendar years.

Federal benefits for individuals are valued at the cost to the federal government of providing them, which may either exaggerate or understate their value to individuals. This is especially likely if the assistance is provided as goods or services rather than in cash. A reduction in federal outlays for a medical care program, for example, may reduce the perceived well-being of the recipients less than an equal dollar reduction of cash benefits.

The estimates of changes in taxes and benefits are averages for large income categories. Those who receive tax cuts and those who experience benefit reductions in a given income category are often not the same, particularly in the lowest income group. Moreover, some households will be affected by several changes and others by none. Therefore, the impact of the tax and benefit reductions upon those who receive them may be substantially greater than the averages for the entire income group would indicate.

A final caution with respect to the findings is that the analysis does not include any assumed macroeconomic impact of the tax and benefit reductions. If the program changes taken together should significantly raise the rate of economic growth and reduce unemployment, then they would provide higher incomes (beyond the tax cuts) that would offset the reductions in benefits.

The major conclusions of this study are:

- o <u>Gains from federal tax reductions rise substantially with household income.</u> In 1983, for example, households with incomes less than $10,000 will pay on average about $120 less in taxes than they would have under prior law, while households with incomes over $80,000 will pay on average about $15,000 less. Total federal revenue losses will be about $82 billion in 1983, and about 85 percent of these reductions will benefit households with incomes over $20,000.

- Reductions in federal benefit payments for individuals will be greatest for households with incomes below $10,000. In 1983, households with incomes less than $10,000 will lose on average about $360 in federal benefits, while those with incomes over $80,000 will lose on average about $120. Total federal savings will be about $17 billion in 1983, about two-thirds of which will come from reductions affecting households with incomes below $20,000.

- About 60 percent of the savings from reductions in grants to state and local governments will come from programs targeted toward low-income individuals or those receiving public assistance. Total reduction in grants to state and local governments (excluding grants for direct benefit programs) will range from $12 billion to $14 billion annually during fiscal years 1982 through 1984.

These results are in part determined by the distributions of tax liabilities and of benefit payments under prior law. Cuts in the federal income tax will be greater in dollar terms for those with higher incomes, who pay more in taxes. Likewise, because government benefit payments for individuals in the programs that were cut were often targeted at those with low incomes, reductions tend to be concentrated upon that group. While the income tax reductions are approximately proportional to prior law liabilities, however, the reductions in outlays for means-tested programs are generally proportionately larger than the reductions in programs that are not means-tested.

Summary Table 1 illustrates the changes in direct taxes and benefit payments in 1983, the first full year in which all of the expenditure changes enacted in the first session of the 97th Congress will be in effect. The table shows total federal savings or revenue losses, average federal savings or losses per household, and savings or losses as a percentage of income for each of five income categories. The impact of the tax cut rises over time for all income categories, as it is phased in. Corresponding information for 1982, 1984, and 1985 is presented in the text.

SUMMARY TABLE 1. NET CHANGE IN FEDERAL INDIVIDUAL INCOME TAXES AND FEDERAL BENEFIT PAYMENTS FOR INDIVIDUALS BY HOUSEHOLD INCOME[a]: CALENDAR YEAR 1983 (in 1983 dollars)

		Household Income (in 1982 dollars)				
	All Households	Less than $10,000	$10,000- $20,000	$20,000- $40,000	$40,000- $80,000	$80,000 or more
Change in Total Federal Taxes and Benefits (in millions of dollars)						
Cash benefits	-11,950	-5,190	-2,960	-2,740	-990	-80
Taxes	82,130	2,340	9,290	28,720	25,780	16,000
Net	70,180	-2,850	6,330	25,980	24,790	15,920
In-kind benefits	-5,560	-1,680	-1,610	-1,430	-790	-50
Net including in-kind benefits	64,620	-4,530	4,720	24,550	24,000	15,870
Change in Average Federal Taxes and Benefits per Household (in dollars)						
Cash benefits	-140	-270	-140	-90	-70	-70
Taxes	940	120	440	950	1,830	15,250
Net	800	-150	300	860	1,760	15,180
In-kind benefits	-60	-90	-80	-50	-60	-50
Net including in-kind benefits	740	-240	220	810	1,700	15,130
Change in Federal Taxes and Benefits as a Percentage of Income						
Cash benefits	-0.5	-3.0	-0.6	-0.3	-0.2	b
Taxes	3.5	1.3	1.9	3.2	4.6	6.7
Net	3.0	-1.7	1.3	2.9	4.4	6.7

SOURCE: Congressional Budget Office

(Continued)

SUMMARY TABLE 1 (Continued)

Footnotes.

a. Household income as defined in this study includes cash benefits and food stamps but excludes all other benefits provided in kind. The reductions in benefits for individuals allocated over these income categories are estimates of projected outlay savings by calendar year. These estimates represent the differences between currently projected spending levels and the levels of spending which would have occurred in the absence of any legislative changes. The baseline from which these savings are measured assumes that program authorizations would be extended into the future and that, in the case of entitlement programs, spending would otherwise have risen consistent with CBO's economic assumptions and with anticipated demographic changes. Appropriated accounts are assumed to rise with inflation at the rate necessary to provide the basic year's level of services, except where they have been capped by legislation. The convention followed here is to denote reductions in benefits with a negative sign, and reductions in taxes with a positive sign.

b. Less than 0.05.

INTRODUCTION

This memorandum examines the relative impact for households in different income categories of the revenue and spending changes enacted during the first session of the 97th Congress. The analysis concentrates on those changes in federal taxes and expenditures which directly affect household incomes, although reductions in business taxes and in grants to state and local governments are also discussed.

The findings of this study are presented in two parts. The first section looks at the impact of changes in direct federal taxes and in federal spending on benefit payments for individuals. The distributional effect of reductions enacted in each of these areas is examined, and then the net impact of the revenue and expenditure cuts together is considered.

The second part of this memorandum discusses the impact on state and local governments of changes in federal taxes and grants-in-aid. This section outlines the major reductions enacted in federal grant-in-aid programs and discusses the options available to state and local governments in adjusting to these reductions. Since it is difficult to predict the responses of state and local governments to changes in their revenues, however, the distributional impact of these changes has been examined in much less detail.

The findings outlined in the second section are not directly comparable to those presented in the first section for two reasons. First, the savings estimates given in the first section represent projected reductions in outlays resulting from the legislative actions of the first session of

the 97th Congress. The baseline from which these savings are measured assumes that program authorizations would be extended into the future and that, except where capped by legislation, spending would rise at the rate necessary to provide the base year's services in each year thereafter. The savings estimates presented in the second part of this memorandum are also calculated from a baseline that assumes the current level of services will be maintained unless funding is capped by legislation, but the savings shown represent changes in budget authority rather than in outlays. Since states have a great deal of discretion in determining how and when to change their outlays in response to changes in federal funding, and since in many programs states make outlays for which they are reimbursed at some later date, changes in outlays in any given year that result from legislated changes in budget authority cannot always be estimated.

Second, since tax liabilities are incurred for calendar rather than fiscal years, the reductions in benefit payments for individuals have also been estimated for calendar years in order to allow comparison. This has not been possible for the reductions in nonindividual assistance grants to state and local governments, however, which have been estimated on a fiscal year basis.

ASSESSING CHANGES IN DIRECT TAXES AND BENEFIT PAYMENTS FOR INDIVIDUALS

This analysis of changes in federal taxes and benefit payments enacted in the first session of the 97th Congress concentrates on those that directly affect the incomes of specific persons and families. The study estimates the distributional impact of the reductions enacted in the personal income tax and in programs providing benefit payments for

individuals. It does not attempt to estimate the effect on the distribution of income that might result from policy changes that indirectly affect individual incomes. For example, the distributional effects of macroeconomic policies which may result in higher or lower unemployment or inflation are not discussed. The analysis does not include changes in areas such as defense, since the benefits arising from these expenditures are not directly allocable to specific households. Reductions in indirect taxes such as the corporate income tax and in grants to state and local governments (other than individual assistance grants) have also been excluded from the estimates, although each of these areas is discussed separately.

In order to examine the impact of reductions in federal taxes and benefit payments, the resulting revenue losses and outlay savings have been distributed over five income categories. (Table 1 shows the current distribution of households over these categories.) For the purposes of this study, all cash payments received by households, including for example welfare and Social Security benefits, have been included in household income. In addition, food stamps have been treated as if they were a cash benefit and are also included in income.[1] All other in-kind benefits, however, have been excluded from the income base. In order to maintain

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1. Food stamps have been treated as a cash benefit because they provide a large part of total purchasing power for many households in the lower-income categories. Counting them as cash, however, implicitly assumes that the amount received in food stamps will not generally be larger than the amount that would have been spent on food, if the household had received cash rather than food stamps. For a discussion of this point and a presentation of the effects of alternate classifications, see the Appendix.

approximately the same composition of households in the income categories over time, the income brackets used have been defined in constant 1982 dollars.

TABLE 1. HOUSEHOLDS BY INCOME CATEGORY (in 1982 dollars)

Income Category	Number of Households (in thousands)	Percent of All Households	Average Household Size
All Households	84,045	100.0	2.7
Less than $10,000	18,890	22.5	2.2
$10,000 - 20,000	20,808	24.8	2.5
$20,000 - 40,000	29,613	35.2	2.9
$40,000 - 80,000	13,711	16.3	3.3
$80,000 and above	1,023	1.2	3.2

SOURCE: Current Population Survey, March 1981, projected to 1982.

Distributions of tax and expenditure changes by income category may be misleading in some respects. Mean household size varies somewhat by income group, as Table 1 shows, so that a distribution of taxes or benefits by income category will not take into account differences in the relative needs of households in different income categories. Also, although the overall distribution of households by income group stays fairly constant over time, individual households may move between groups relatively frequently. Such movement may be particularly likely for households in the bottom category, which contains a comparatively large share of single persons who are attending school. Similarly, other events such as marriage, divorce, and retirement cause households to move between income groups over time.

In addition, the estimates presented here are average changes in taxes and benefits for all households in each income category. Within each category, the households that receive tax cuts and those that suffer benefit reductions are not necessarily the same, particularly in the lowest income group. Therefore, the impact of the tax and benefit reductions upon those who receive them may be substantially greater than the averages for the entire income category would indicate.

The results of this study are presented in the form of distributions of total federal revenue losses and outlay savings by income category. Changes in each of these areas are discussed separately, and then net savings or losses by income category are presented. Savings and losses have been estimated without any attempt to include the secondary budget effects that may result when one tax or benefit cut causes compensating changes in other taxes or benefits. Where these effects are potentially large, however, their magnitudes and distributions are discussed.

CHANGES IN DIRECT TAXES

The first session of the 97th Congress sharply reduced income taxes for both individuals and corporations. Unlike the myriad of small outlay reductions, each of which affect relatively small groups of people, the tax cuts involve only a few provisions but touch the great bulk of the population. This section includes quantitative estimates of the distributional effects of the three major individual income tax provisions. It also discusses the likely effects of the other individual income tax provisions, the savings incentives, the business tax reductions, and the changes in the estate and gift taxes.

Individual Income Tax Cuts

Major Provisions. The most highly visible tax cuts of 1981 were the across-the-board reductions in individual income tax rates. Tax rates for individuals were cut 1-1/4 percent in 1981, and the cuts increase to 10 percent in 1982, 19 percent in 1983, and 23 percent in 1984. Withholding rates applied to wages and salaries were reduced 5 percent as of October 1, 1981. This reduction increases to 14 percent on July 1, 1982 and to 23 percent on July 1, 1983—resulting in reductions in withholding rates that equal the tax rate cuts in each calendar year. While these cuts in income tax rates generally reduce all taxpayers' liabilities by the same proportion, several features of both prior and current law alter that distributional effect somewhat.

The marginal tax rate on the earnings of the highest-income taxpayers was not reduced by the across-the-board cuts, because the maximum tax rate on earned income has been limited to approximately 50 percent since 1969 through a complex legal provision known as the maximum tax. On the other hand, effective January 1, 1982, the maximum statutory tax rate on all income was reduced to 50 percent; and so taxpayers in the very highest brackets who received no marginal rate reduction for earned income received immediate and larger than average reductions for income from property. This reduction of the highest marginal tax rates had the effect of reducing the highest tax rate on long-term capital gains to 20 percent (the 40 percent of long-term gains subject to tax times the 50 percent highest rate). The Congress made this reduction retroactive to June 9, 1981, to avoid any incentive to postpone realizations until after the tax cut took effect. The

CBO projects all of these rate cut provisions to reduce revenues by $35 billion in 1982 and by $119 billion in 1985 (here and hereafter revenue change estimates refer to calendar years unless otherwise specified).

The second major individual income tax provision was the introduction of a special deduction for two-earner married couples. Many two-earner couples have paid higher taxes than they would have paid if they were taxed as single persons, as a result of the $3,400 standard deduction for married taxpayers (compared to two $2,300 standard deductions that two single persons could claim) and the lower tax rate schedule for single persons (reduced in 1969 in response to complaints of single persons that they were overtaxed). The new law provides two-earner couples with a deduction equal in 1982 to 5 percent of the earnings of the lesser earning spouse (with a maximum deduction of $1,500). This deduction increases to 10 percent (up to a $3,000 maximum) for 1983 and later years. The second earner deduction is expected to reduce revenues by $3 billion in 1982, with the revenue loss increasing sharply to $8 billion in 1985 as the provision phases in.

The third major individual income tax provision is indexing. Beginning on January 1, 1985, the personal exemptions and tax rate brackets will be increased each year according to the rate of inflation. This change is intended to eliminate the increase in effective real tax rates due to the erosion of the exemptions and zero bracket amounts and further "bracket creep" caused by inflation. The CBO projects the revenue loss due to indexing at $17 billion in 1985.

The combined distributional effects of these programs are shown in Tables 2 through 4. Table 2 shows that the largest tax cut in dollar terms

TABLE 2. TOTAL INDIVIDUAL INCOME TAX CUTS BY INCOME CATEGORY, CALENDAR YEARS 1982-1985a (in millions of current dollars)

		Household Income (in 1982 Dollars)				
Calendar Year	All Households	Less Than $10,000	$10,000-20,000	$20,000-40,000	$40,000-80,000	$80,000 and over
1982	38,080	1,240	4,500	13,460	10,250	8,630
1983	82,130	2,340	9,290	28,720	25,780	16,000
1984	112,980	3,320	12,950	39,650	36,260	20,800
1985	144,120	5,000	17,060	52,340	45,620	24,100

SOURCE: Congressional Budget Office.

a. Individual income tax cuts from the Economic Recovery Tax Act of 1981 included in this table are the rate cuts, the deduction for two-earner married couples, and indexing.

TABLE 3. INDIVIDUAL INCOME TAX CUTS PER HOUSEHOLD BY INCOME CATEGORY, CALENDAR YEARS 1982-1985a (in current dollars)

		Household Income (in 1982 Dollars)				
Calendar Year	All Households	Less Than $10,000	$10,000-20,000	$20,000-40,000	$40,000-80,000	$80,000 and over
1982	450	70	220	450	750	8,430
1983	940	120	440	950	1,830	15,250
1984	1,280	170	590	1,280	2,520	19,350
1985	1,600	250	760	1,650	3,100	21,950

SOURCE: Congressional Budget Office.

a. Individual income tax cuts from the Economic Recovery Tax Act of 1981 included in this table are the rate cuts, the deduction for two-earner married couples, and indexing.

goes to the $20,000 to $40,000 middle-income group, which as a group also has the most households and the most income. However, Table 3 shows that the tax cut per household increases sharply with income, because those who pay the most taxes in the first instance benefit the most in dollar terms from an across-the-board tax cut. Finally, the tax cut as a percentage of income (Table 4) increases as income rises. This occurs because the progressive tax system causes taxes to be a higher proportion of income when income is higher. Therefore, the across-the-board tax cut, which is approximately proportional to prior law tax liability, increases with income as well. The highest income category receives a slightly lower cut relative to previous tax liability, because of the 50 percent limit under prior law on the tax rate for earned income.

TABLE 4. INDIVIDUAL INCOME TAX CUTS AS A PERCENTAGE OF INCOME, BY INCOME CATEGORY, CALENDAR YEARS 1982-1985[a]

		Household Income (in 1982 Dollars)				
Calendar Year	All Households	Less Than $10,000	$10,000-20,000	$20,000-40,000	$40,000-80,000	$80,000 and over
1982	1.9	0.8	1.0	1.7	2.5	4.6
1983	3.5	1.3	1.9	3.2	4.6	6.7
1984	4.3	1.7	2.4	4.0	5.7	7.9
1985	5.2	2.3	3.0	4.9	6.7	8.4

SOURCE: Congressional Budget Office.

a. Individual income tax cuts from the Economic Recovery Tax Act of 1981 included in this table are the rate cuts, the deduction for two-earner married couples, and indexing.

A substantial portion of the tax cuts through 1984 in fact merely offsets the recent and expected increases in tax liabilities due to inflation. However, the new tax law was not designed to offset those effects precisely for each income group. A fully indexed tax law would have provided larger tax cuts (in dollars) to low-income taxpayers, and smaller ones to those with higher incomes. Precise estimates of the relative magnitudes of the tax cuts and bracket creep by income category were unobtainable for this analysis.[2]

Other Provisions. Beyond the rate cuts, the second earner deduction, and indexing, there were several other individual income tax provisions in the Economic Recovery Tax Act (ERTA). However, all of these provisions were much smaller in revenue impact, and the distributional effects of most were highly uncertain. Accordingly, these provisions were omitted from the quantitative analysis above.

Included among these provisions were a liberalization of the child- and dependent-care credit, a broadening of the charitable contributions deduction to apply to nonitemizers, an increase in the exclusion of capital gain from the sale of a principal residence, liberalization of the tax treatment of foreign earned income, broadening of the Individual Retirement Account (IRA) and liberalization of the Keogh retirement saving provisions, establishment of the "All Savers" certificates, and the 15 percent net interest exclusion. The charitable deductions provision could be characterized as more beneficial to low-income taxpayers, while the foreign earned income and

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2. For an account of how typical taxpayers fare given the tax rate cuts and inflation, see Congressional Research Service, "The Effects of Inflation and Social Security Tax Increases on the Tax Liabilities of Typical Taxpayers in 1980 Through 1984," February 3, 1982.

saving incentive provisions might be more beneficial to upper-income taxpayers. Whatever their distibutional effects, the very small revenue impact of these provisions (only about one-twentieth of the major provisions) suggests that they would not discernably change the results seen in Tables 2 through 4.

Business Tax Cuts

The ERTA tax cuts aimed primarily at businesses were also quite large. Reductions due to the Accelerated Cost Recovery System (ACRS), a more rapid depreciation system, will amount to $12 billion in fiscal year 1982 and $39 billion in fiscal year 1985, according to CBO estimates. Other business provisions will benefit firms making research and development expenditures, rehabilitating structures, or producing oil.

Even though businesses are ultimately owned by people, attributing business tax cuts to individuals is theoretically and practically difficult. Economists do not agree on who actually pays the corporate income tax—whether it is borne by shareholders out of profits, or passed on to consumers through higher prices, or to workers through lower wages. If the popular perception that the tax is actually paid by shareholders is correct (and it is likely that this proposition receives more support from economists than the alternatives), then individual shareholders will ultimately benefit. However, even this conclusion is somewhat complicated by the holding of corporate shares by pension funds, through which many individuals who own no stock directly will benefit from the business tax cuts. Any measure of benefits to individuals would be confused by the lack of precise data on share ownership and on the corporate income implicitly received by individuals (out of which the corporate tax is paid).

Because it is impossible to compute an actual distribution of the business tax cuts among individuals who benefit, a very approximate view is supplied. As a proxy measure of share ownership, Table 5 presents the distribution of receipt of dividends among taxpayers in 1979. This distribution probably bears some resemblance to the distribution of share ownership. Its major limitations are:

- dividend yields are not identical for all shares, and so high yield shares are overrepresented in the distribution while zero yield growth stocks do not appear at all;

- low-income non-tax filers who own small blocks of shares (such as the retired elderly) are not represented in the table; and

- there is no information on shares held by pension funds.

TABLE 5. DISTRIBUTION OF DIVIDENDS REPORTED ON INDIVIDUAL INCOME TAX RETURNS, CALENDAR YEAR 1979, BY ADJUSTED GROSS INCOME (AGI) IN 1979 DOLLARSa

	Household Adjusted Gross Income				
	Less Than $10,000	$10,000-20,000	$20,000-40,000	$40,000 75,000	$75,000 and over
All Returns (in thousands)	39,962	25,819	21,777	3,669	864
Adjusted Gross Income (in millions of dollars)	197,365	377,392	594,027	183,836	118,983
Returns with Dividends (in thousands)	3,055	3,288	5,050	1,891	655
Percent of All Returns	7.6	12.7	23.2	51.6	75.8
Percent of Returns with Dividends	21.9	23.6	36.2	13.6	4.7
Dividends Received (in millions of dollars)	2,765	4,220	7,276	6,430	13,932
Percent of Dividends	8.0	12.2	21.0	18.6	40.2
Percent of AGI	1.4	1.1	1.2	3.5	11.7

SOURCE: U.S. Department of the Treasury, Internal Revenue Service, Statistics of Income Bulletin, Summer 1981.

a. Note that AGI differs from the household income measure used in the other tables in this memorandum in that AGI excludes nontaxable government benefits, such as Social Security.

Given these limitations, the strongest inference possible from Table 5 is that cuts in business taxes that are ultimately paid out of profits might be expected to benefit upper-income persons disproportionately. This effect would reinforce the distributional patterns in Tables 2, 3, and 4. If the corporate tax is not borne by shareholders, the distributional results would be quite different, however.

Estate and Gift Tax Reductions

The 1981 law also included substantial reductions in the estate and gift taxes. The most important provisions in terms of revenue loss were an increase in the unified credit phased-in from 1982 through 1987, a four-year phased-in reduction in the maximum rates of tax, an unlimited marital deduction, and an increased permissible reduction in valuation due to current use. The total revenue loss due to all of the estate and gift tax provisions is \$2 billion in 1982, increasing to \$6.6 billion in 1985.

The estate and gift tax cuts clearly benefit persons with relatively large amounts of wealth, simply because under prior law these taxes only touched the 1 percent of all households with the greatest wealth. Attribution of the tax cuts in this analysis would likely be misleading, however, because the association between wealth and income is not perfect even though it is strong; and because these tax cuts are received mostly on the occasion of death, when financial affairs are so disrupted that any ranking by current income would be difficult to interpret.

CHANGES IN BENEFIT PAYMENTS FOR INDIVIDUALS

Substantial reductions were enacted in 1981 in most of the federal programs that provide benefit payments for individuals. Reductions were particularly large for means-tested programs, for which total outlays will generally be about 10 to 15 percent lower over the next 4 years than they would have been under prior law. Nonetheless, the savings generated by these reductions will be much smaller than the revenue losses resulting from the tax cuts. Reductions in outlays for benefit payments will total about $17 billion in calendar year 1983, for example, compared to a total reduction in personal income tax liabilities in 1983 of about $82 billion.[3] Reductions in benefit payments for individuals in 1983 account for about 40 percent of the total outlay reductions and reductions in other grants to state and local governments account for another 30 percent. (The remaining 30 percent largely consists of reductions in subsidies for businesses and in government operating costs.)

There are two major types of programs which provide benefits for individuals: cash benefit programs and programs that supply benefits that can only be used to subsidize the consumption of particular goods and services.

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3. The estimates of outlay savings presented here are the differences attributable to legislative changes made during the first session of the 97th Congress relative to the level of spending that would otherwise have occurred. The "baseline" from which the savings are measured assumes that program authorizations would be extended into the future and that, in the case of entitlement programs (encompassing most benefits for individuals) spending would otherwise have risen consistent with current CBO economic assumptions and with anticipated demographic changes. In the case of appropriated accounts (such as the nonindividual-assistance grants to state and local governments discussed in the second part of this memorandum), the baseline assumes that, except where capped by legislation, appropriations would otherwise have risen at the rate necessary to provide the base year's level of services for each year thereafter.

Social Security (Old Age Survivors and Disability Insurance) and Aid to Families with Dependent Children (AFDC) are examples of the first type of program, and the Medicare and housing subsidy programs are examples of the second type. The allocation of programs to each of these two categories is discussed in the Appendix.

Almost two-thirds of the total outlay savings from reductions in benefit payments come from reductions in just four program areas, as Table 6 shows. The cuts in three of these programs--unemployment insurance, food stamps, and child nutrition--result in relatively large reductions in total outlays for those programs; over 20 percent in some years in the first two cases, and up to a third in the last. The Social Security cuts, however, although large in dollar terms, represent less than 2 percent of total outlays for the program. Other programs in which the cuts represent a large proportion of benefits include AFDC, Low Income Energy Assistance, Guaranteed Student Loans (GSLs), and Pell Grants.

Distribution of Federal Outlay Savings from Reductions in Benefit Payments for Individuals

Reductions in Cash Benefits. Reductions in cash benefit programs account for 60 to 70 percent of total outlay savings from cuts in benefits for individuals. These reductions affect some recipients in all income categories, but about two-thirds of the savings come from reductions affecting households with incomes below $20,000, as Table 7 shows. About 40 percent of the total savings in these programs come from reductions in benefits received by households with incomes below $10,000, with the proportion of savings coming from this income category rising slightly over time. Most of

TABLE 6. PERCENTAGE DISTRIBUTION OF REDUCTIONS IN OUTLAYS FOR BENEFIT PAYMENTS FOR INDIVIDUALS, BY PROGRAM: CALENDAR YEARS 1982-1985

Programs	1982	1983	1984	1985
Total Reduction in Benefits (in millions of dollars)	12,990	17,510	17,940	17,410
Reductions in Benefits as a Percentage of Total	100	100	100	100
Cash Benefit Programs	70	68	64	61
Social Security Retirement and Survivors' Benefits and Railroad Retirement Benefits	15	15	19	21
Civil Service and Military Retirement Benefits	5	5	4	4
Social Security Disability and Black Lung Benefits	2	3	3	4
Unemployment Insurance	20	26	16	8
Trade Adjustment Assistance	4	2	2	2
Food Stamps	16	12	13	14
Aid to Families with Dependent Children	6	6	6	6
Supplemental Security Income	a	a	a	a
Low Income Energy Assistance	1	2	3	3
In-Kind Benefit Programs	30	32	36	39
Medicaid	4	6	6	3
Medicare	6	6	7	8
Guaranteed Student Loans	4	6	7	8
Pell Grants	2	3	7	3
Child Nutrition Programs	11	9	10	10
Housing Assistance Programs	1	2	4	6
Veterans' Health and Education Programs	a	a	a	a

NOTE: Totals may not add due to rounding. Estimates may differ from other CBO estimates because of changes in technical estimating procedures and economic assumptions and because these estimates are for calendar rather than fiscal years.

a. Less than 0.5 percent.

TABLE 7. TOTAL REDUCTIONS IN OUTLAYS FOR BENEFIT PAYMENTS FOR INDIVIDUALS, BY INCOME CATEGORY OF BENEFICIARIES, CALENDAR YEARS 1982-1985 (in millions of current dollars)

		Household Income (in 1982 Dollars)				
Calendar Year	Total Savings	Less than $10,000	$10,000- $20,000	$20,000- $40,000	$40,000- $80,000	$80,000- and over
Cash Benefits						
1982	9,040	3,960	2,140	1,980	840	110
1983	11,950	5,190	2,960	2,740	990	80
1984	11,460	5,670	2,780	2,180	760	70
1985	10,580	5,850	2,500	1,620	560	60
Benefits In Kind						
1982	3,950	1,140	1,250	1,040	480	40
1983	5,560	1,680	1,610	1,430	790	50
1984	6,480	1,980	1,890	1,620	950	60
1985	6,840	2,020	2,040	1,760	970	50
Total Benefits						
1982	12,990	5,100	3,400	3,020	1,320	150
1983	17,510	6,860	4,570	4,180	1,780	130
1984	17,940	7,650	4,670	3,800	1,710	130
1985	17,410	7,870	4,540	3,380	1,520	100
Percentage Distribution of Total Benefit Reductions						
1982	100.0	39.2	26.1	23.3	10.2	1.2
1983	100.0	39.2	26.1	23.8	10.2	0.7
1984	100.0	42.7	25.9	21.2	9.5	0.7
1985	100.0	45.2	26.1	19.4	8.7	0.6

SOURCE: Congressional Budget Office.

the remaining savings occur in cuts affecting the next two income groups, with less than 11 percent coming from the top two income groups.[4]

The major cuts in cash benefits affecting households in the bottom income category are those in the Food Stamp, AFDC, and Social Security programs. The largest single reduction is that in food stamps, which results from several changes in the program. These include new eligibility restrictions, a lower deduction for earned income, a delay in the cost of living adjustment (COLA), and the prorating of the first month's benefits based on the date of application. The AFDC cuts are smaller on average than those in food stamps, but will affect many of the same households. These cuts will be particularly large for low-income households with earnings. The major Social Security cut affecting those with incomes below $10,000 is the elimination of benefits for students.

The Social Security cuts also account for a fairly large proportion of the savings coming from households with incomes between $10,000 and $40,000, but the largest reductions for these households are in Unemployment Insurance. Reductions in unemployment benefits for persons who are unemployed longer than 26 weeks account for most of the savings in this program. Cash benefit cuts affecting households with incomes above $40,000 come almost entirely from the Social Security, Military Retirement, and Unemployment Insurance programs.

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4. An exception occurs in 1982, when 11.4 percent of total cash benefit savings come from the top two groups, as a result of changes in the treatment of the Social Security earnings test.

<u>Reductions in Benefits In Kind</u>. Cuts in programs providing subsidies for goods and services rather than cash account for 30 to 40 percent of the total savings arising from reductions in benefit payments.[5] These reductions are fairly evenly distributed across the first three income categories, with 25 to 30 percent of the total savings coming from each. For households with incomes below $10,000, the largest reductions are those in Medicaid and Medicare, although reductions in Pell Grants also produce substantial savings. Households with incomes between $10,000 and $40,000 are particularly affected by reductions in the school lunch program, although Medicare, Medicaid, and Guaranteed Student Loans (GSLs) also account for substantial savings. Cuts in school lunches and in GSLs are the major reductions which affect households with incomes over $40,000.

<u>Total Benefit Reductions</u>. In summary, as the bottom part of Table 7 shows, about 40 percent of the total savings from benefit reductions come from benefits received by the lowest income category, and more than two-thirds of the savings stem from reductions in benefits received by those with incomes less than $20,000. The proportion of the total cuts affecting each income category declines as income rises, with only about 10 percent of total savings coming from benefits received by the highest two groups.

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5. Reductions in benefits in kind are valued at the reduction in the federal government's cost of providing these benefits, which may not equal the reduction in the value of these benefits for their recipients. In addition, some states may institute programs to replace some of the lost benefits. In Medicaid, the cuts were in grants to the states. This analysis assumes that states reduce eligibility and benefits to avoid increasing their own funding of Medicaid.

Distribution of Reductions in Federal Outlays Per Household

The number of households in each income category varies, so that average reductions in benefits for different income groups cannot be inferred from Table 7. As Table 8 shows, however, average reductions in outlays follow much the same pattern as do the total reductions. The average reduction in cash benefits is about twice as large for households with incomes below $10,000 as for those in any other category, and the size of the average cut generally declines with income. The one major exception to this rule is the relatively large decline in average cash benefits experienced by the $80,000 and over category in 1982. This decline largely results from the postponement until 1983 of the elimination of the Social Security earnings test for those aged 70 and 71. This liberalization in benefits for older workers had been scheduled to take place in 1982. When cash and in-kind benefit cuts are combined, the same pattern remains—those in the lowest income group lose about three-fourths more than those in any other category, and average losses decline as income increases.

Table 8 should be interpreted with some caution. In particular these figures represent the average reduction in federal outlays per household, which is not necessarily equivalent to the average reduction in the value of the benefits received. Further, these figures are averages over entire income categories, and include many households that receive no benefits—and therefore no reductions. Average reductions for households that receive benefits would generally be much larger. Unfortunately, however, such averages cannot be computed because of the lack of data on the extent to which the households participate in more than one of the affected programs.

TABLE 8. AVERAGE REDUCTIONS PER HOUSEHOLD IN OUTLAYS FOR BENEFIT PAYMENTS BY INCOME CATEGORY OF RECIPIENTS: CALENDAR YEARS 1981-1985 (in current dollars)

		Household Income (in 1982 Dollars)				
	All Households	Less than $10,000	$10,000-20,000	$20,000-40,000	$40,000-80,000	$80,000-and over
Cash Benefits						
1982	110	210	100	70	60	110
1983	140	270	140	90	70	70
1984	130	290	130	70	50	70
1985	120	290	110	50	40	50
Benefits In Kind						
1982	50	60	60	40	40	40
1983	60	90	80	50	60	50
1984	70	100	90	50	70	50
1985	80	100	90	60	70	40
Total Benefits						
1982	160	270	160	110	100	150
1983	200	360	220	140	130	120
1984	200	390	220	120	120	120
1985	200	390	200	110	110	90

SOURCE: Congressional Budget Office.

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

Three other cautionary points should also be mentioned here. First, changes in benefits in any given program that result from reductions in other benefit programs are not included in these estimates. Such secondary effects may either increase or decrease total benefits received. The net effect of their exclusion, however, is probably some overstatement of total benefit reductions, particularly for the bottom income category.

Second, these savings estimates incorporate assumptions concerning the work disincentive effects of some of the cuts affecting low-income households. In particular, it has been assumed that those in households whose incomes would be approximately the same whether or not they were employed are relatively unlikely to work. This assumption probably results in an accurate estimate of the federal savings arising from these cuts, but it understates the income lost by these households. If their members do not work, they receive higher benefits, but their total income declines relative to what would have been received before the cuts. It is difficult to estimate the total decline in incomes experienced by such low-income households, but it may approximately offset the uncounted increases in supplementary benefits mentioned above. The actual households affected would not necessarily be the same, however.

Third, the reductions in in-kind benefits may have greater or smaller subjective value to the recipients than the amount of the federal budget savings. For example, the loss to students unable to obtain loans to replace GSLs or to persons unable to obtain basic medical care without Medicaid may seem larger than the reductions in the federal payments. On the other hand, those who can relatively easily finance their educations without guaranteed loans, or persons who may have received nonessential medical care, might see their loss as less than the federal cost savings.

Benefit Reductions as a Proportion of Total Income

The impact of reductions in benefit payments on total income is greatest for those in the lowest income category. As Table 9 shows, however, the average percentage decline in income as a result of these cuts

is small even for that class. (Only cash benefit reductions are shown in Table 9, since benefits in kind are not included in income as it has been defined in this study.) The percentage reductions in income experienced by households who receive benefits, however, will be larger than the average reductions shown in the table, since even in the lowest category some households receive no benefits from these programs.

TABLE 9. CASH BENEFIT REDUCTIONS AS A PERCENTAGE OF INCOME, BY INCOME CATEGORY, CALENDAR YEARS 1982-1985

		Household Income (in 1982 Dollars)				
	All Households	Less than $10,000	$10,000-20,000	$20,000-40,000	$40,000-80,000	$80,000-and over
Cash Benefits						
1982	0.4	2.7	0.5	0.2	0.2	0.1
1983	0.5	3.0	0.6	0.3	0.2	a
1984	0.4	2.9	0.5	0.2	0.1	a
1985	0.4	2.6	0.4	0.2	0.1	a

SOURCE: Congressional Budget Office.

a. Less than 0.05 percent.

Certain types of households will be particularly affected by the benefit reductions. In the low-income category, for example, households that receive AFDC benefits and food stamps will lose about 5 to 10 percent of their total incomes on average if they have no earnings and up to 20 percent of their incomes if they are employed. Such households are also likely to experience reductions in benefits from programs such as Medicaid, Low Income Energy Assistance, and the housing subsidy programs if they participate in them. Other households likely to experience large benefit reductions include those with a member who is unemployed for more than 26

weeks, those with a member who would have been eligible under prior law for either Social Security student benefits or the Social Security minimum benefit, and those households that include a student who would have been eligible for either a Pell Grant or a Guaranteed Student Loan.

COMBINED EFFECTS OF THE TAX AND BENEFIT REDUCTIONS

The combined impact of the cuts in taxes and benefits is a net loss in income for those with incomes below $10,000, and an increase for those with incomes over $10,000. Table 10, which shows the dollar amount of government outlay savings and tax reductions by income category, shows that those in the lowest income category lose more in cash benefits than they gain from the tax cut in every year. Inclusion of the in-kind benefit reductions further increases the net loss suffered by this group. For the income categories above the $10,000 income level, the total tax cut exceeds the total benefit reductions by a growing amount each year; in the three highest income categories, the margin between the tax cuts and benefit reductions is large.

The average combined tax and benefit reductions per household follow a similar pattern, as Table 11 shows. Households in the lowest income category lose, on average, in excess of $200 in cash in each of the first three years, but less in the fourth year; if in-kind benefit cuts are included, the losses are greater. The $10,000 to $20,000 income category gains about $100 in 1982, and the margin rises in subsequent years. The net gains are much larger as incomes increase, and they grow substantially over time.

TABLE 10. TOTAL NET CHANGE IN BENEFITS AND TAXES BY INCOME CATEGORY: CALENDAR YEARS 1982-1985 (in millions of current dollars)

		Household Income (in 1982 Dollars)				
	All Households	Less Than $10,000	$10,000-20,000	$20,000-40,000	$40,000-80,000	$80,000 and over
1982						
Cash benefits	-9,040	-3,960	-2,140	-1,980	-840	-110
Taxes	38,080	1,240	4,500	13,460	10,250	8,630
Net	29,040	-2,720	2,360	11,480	9,410	8,520
In-kind benefits	-3,950	-1,140	-1,250	-1,040	-480	-40
Net, including in-kind benefits	25,090	-3,860	1,110	10,440	8,930	8,480
1983						
Cash benefits	-11,950	-5,190	-2,960	-2,740	-990	-80
Taxes	82,130	2,340	9,290	28,720	25,780	16,000
Net	70,180	-2,850	6,330	25,980	24,790	15,920
In-kind benefits	-5,560	-1,680	-1,610	-1,430	-790	-50
Net, including in-kind benefits	64,620	-4,530	4,720	24,550	24,000	15,870
1984						
Cash benefits	-11,460	-5,670	-2,780	-2,180	-760	-70
Taxes	112,980	3,320	12,950	39,650	36,260	20,800
Net	101,520	-2,350	10,170	37,470	35,500	20,730
In-kind benefits	-6,480	-1,980	-1,890	-1,620	-950	-60
Net, including in-kind benefits	95,040	-4,330	8,280	35,850	34,550	20,670
1985						
Cash benefits	-10,580	-5,850	-2,500	-1,620	-560	-60
Taxes	144,120	5,000	17,060	52,340	45,620	24,100
Net	133,540	-850	14,560	50,720	45,060	24,040
In-kind benefits	-6,840	-2,020	-2,040	-1,760	-970	-50
Net, including in-kind benefits	126,700	-2,870	12,520	48,960	44,090	23,990

SOURCE: Congressional Budget Office.

TABLE 11. NET CHANGE IN TAXES AND BENEFITS PER HOUSEHOLD BY INCOME CATEGORY: CALENDAR YEARS 1982-1985 (in current dollars)

		Household Income (in 1982 Dollars)				
	All Households	Less Than $10,000	$10,000-20,000	$20,000-40,000	$40,000-80,000	$80,000 and over
1982						
Cash benefits	-110	-210	-100	-70	-60	-110
Taxes	450	70	220	450	750	8,430
Net	340	-140	120	380	690	8,320
In-kind benefits	-50	-60	-60	-40	-40	-40
Net, including in-kind benefits	290	-200	60	340	650	8,280
1983						
Cash benefits	-140	-270	-140	-90	-70	-70
Taxes	940	120	440	950	1,830	15,250
Net	800	-150	300	860	1,760	15,180
In-kind benefit	-60	-90	-80	-50	-60	-50
Net, including in-kind benefits	740	-240	220	810	1,700	15,130
1984						
Cash benefits	-130	-290	-130	-70	-50	-70
Taxes	1,280	170	590	1,280	2,520	19,350
Net	1,150	-120	460	1,210	2,470	19,280
In-kind benefits	-70	-100	-90	-50	-70	-50
Net, including in-kind benefits	1,080	-220	370	1,160	2,400	19,230
1985						
Cash benefits	-120	-290	-110	-50	-40	-50
Taxes	1,600	250	760	1,650	3,100	21,950
Net	1,480	-40	650	1,600	3,060	21,900
In-kind benefits	-80	-100	-90	-60	-70	-40
Net, including in-kind benefits	1,400	-140	560	1,540	2,990	21,860

SOURCE: Congressional Budget Office.

The cash benefit reductions are a small percentage of income on average in all income categories, averaging 3 percent or less even for the lowest group (see Table 12). For all but the bottom category they are outweighed by the tax cuts, which grow as a percentage of income as income increases. The largest net changes relative to income occur for those in the highest income group, and they increase over time. (In-kind benefit reductions are not shown as a percentage of income because the benefits themselves are not included in the income base.)

TABLE 12. NET CHANGE IN TAXES AND BENEFITS AS A PERCENTAGE OF INCOME BY INCOME CATEGORY: CALENDAR YEARS 1982-1985

	All Households	Household Income (in 1982 Dollars) Less Than $10,000	$10,000-20,000	$20,000-40,000	$40,000-80,000	$80,000 and over
1982						
Cash benefits	-0.4	-2.7	-0.5	-0.2	-0.2	-0.1
Taxes	1.9	0.8	1.0	1.7	2.5	4.6
Net	1.5	-1.9	0.5	1.5	2.3	4.5
1983						
Cash benefits	-0.5	-3.0	-0.6	-0.3	-0.2	a
Taxes	3.5	1.3	1.9	3.2	4.6	6.7
Net	3.0	-1.7	1.3	2.9	4.4	6.7
1984						
Cash benefits	-0.4	-2.9	-0.5	-0.2	-0.1	a
Taxes	4.3	1.7	2.4	4.0	5.7	7.9
Net	3.9	-1.2	1.9	3.8	5.6	7.9
1985						
Cash benefits	-0.4	-2.6	-0.4	-0.2	-0.1	a
Taxes	5.2	2.3	3.0	4.9	6.7	8.4
Net	4.8	-0.3	2.6	4.7	6.6	8.4

SOURCE: Congressional Budget Office.

a. Less than 0.05

The net changes in benefits and taxes as a percentage of income must be interpreted with caution for two reasons. First, in any given income group, the persons receiving the largest tax cuts are often not the persons experiencing the largest benefit reductions. Therefore, any particular household's net change of income may differ substantially from the average. This is particularly true in the lowest income group, where most losers of benefits have incomes low enough to have no tax liability and therefore receive no tax cut. In contrast, since almost all households in the upper-income groups receive tax cuts, benefit losses are almost always offset to some extent.

Second, as was mentioned above, the tables include only direct federal outlay savings; reductions in grants to state and local governments that may in the end lead to reduced benefits are not included. Thus, for households at all income levels more of the tax cut would be offset by reductions in benefits than would appear from these tables. The analysis in the next section indicates that most of the reduction in grants falls on programs that are targeted toward the low-income population. Therefore, inclusion of these additional reductions might result in a net loss (rather than the gain shown) for households with incomes between $10,000 and $20,000, and would certainly increase the net loss for the lowest income group.

EFFECTS OF FEDERAL EXPENDITURE AND TAX CHANGES ON STATE AND LOCAL GOVERNMENTS

Policy changes enacted in the first session affect state and local governments in two ways. First, some changes will have automatic or nearly automatic effects on state and local revenues and expenditures. For

example, reductions in eligibility for individual-benefit programs that entail state matching payments will reduce state outlays. On the tax side, reduction of federal taxes that are linked to state taxes by provisions in state tax codes will reduce state revenues. A second group of changes will affect state and local governments in an indeterminate way, since their effects depend on how these governments choose to respond. Most cuts in grants-in-aid fall into this category, in that they give state and local governments the choice of cutting back the affected services or raising taxes to maintain their current levels.

The "automatic" effects of expenditure and tax changes on state and local governments are discussed next. Cuts in grants-in-aid, and possible state and local responses to them, are discussed in the subsequent section.

Automatic Effects of Changes in Federal Expenditures and Taxes for State and Local Governments

The costs of two individual assistance programs, AFDC and Medicaid, are shared by the federal government and the states, with the federal government paying approximately 55 percent. Changes in federal expenditures in these programs therefore have implications for state outlays. The AFDC cuts passed in 1981 restricted eligibility for the program and reduced benefits for some recipients. Savings to state governments from these changes will be about $730 million in fiscal year 1983.

The effects on state governments of the changes enacted in the Medicaid program are somewhat more difficult to estimate. Approximately 40 percent of the total federal savings of about $1 billion in 1983 comes from reductions in benefits and in payments to health care providers. These

reductions will produce approximately equivalent savings for state governments. The remainder of the savings, however, comes from a provision that reduces payments to states if their spending exceeds a given target level. All of these federal savings, therefore, will appear as net costs to state governments, since states will be required to bear the entire costs of any benefits over specified target levels themselves, rather than sharing them with the federal government. This provision will presumably encourage state governments to cut back their own expenditures on benefit payments. In addition, there is some evidence that state governments have already been cutting back Medicaid expenditures, in response to fiscal pressures at the state level.

The most widely perceived automatic effect of the Economic Recovery Tax Act is the reduction in state income tax revenues due to ACRS. At least twenty-nine states use the federal definition of corporate taxable income or depreciation in some way, and had their tax revenues reduced by the passage of ACRS.

These states could respond in at least two ways if they wished to maintain their business tax revenues without introducing their own depreciation systems. One way would be to raise their corporate tax rate to apply to the new, smaller tax base. Another would be to adjust depreciation for state tax purposes to be some fraction of ACRS depreciation. Because these relatively simple options are available, it is likely that the balance of state business taxation relative to individual taxation will be at least approximately maintained in those states that choose to recoup the lost revenue.

In a smaller number of states, individual income tax liability is calculated as a fraction of federal liability. These provisions can also be altered relatively simply if the tax yield is to be maintained.

Discretionary Effects of Reductions in Grants-in-Aid

In 1981, the Congress enacted cuts in grants-in-aid totaling between $24 billion and $26 billion for fiscal years 1982 through 1984.[5] Of these reductions, from $10.9 to $11.7 billion (depending on the year) were in programs that are also classified as grants for individuals; these are excluded from this section and are included, where possible, in the sections above. Throughout this section, "grants-in-aid" refers only to grants that are not classified as grants for individuals.

5. The estimates of reductions in grants discussed here are all in budget authority, rather than outlays. This is necessary because the rate at which budget authority is spent out and the rate at which changes in funding are manifested at the state and local level is complex, varies greatly from program to program, and depends in part on state and local discretion. In addition, the estimates of reductions are subject to some error because of the way they were calculated. The estimates are the difference between two projections of expenditures: a "baseline" projection that reflects the status of the programs before the actions of the first session took effect, and a current projection that incorporates those actions. Both projections assume increases to compensate for inflation except when funding would be capped by authorization ceilings. Between the Spring of 1981, however, when one baseline was calculated, and February 1982, when the current projection was developed, the CBO's economic assumptions changed. The effects of the changes in assumptions cannot be separated from the effects of the policy changes enacted in the first session. Although the effects of the changes in assumptions cannot be estimated precisely, it is likely that they bias the estimates of cuts upwards for 1982 and 1983 (there would be no effect in 1984), by biasing upward the projections of baseline expenditures by a maximum of 1.2 or 1.3 percent. The magnitude of the bias in the estimate of the reductions would vary depending on authorization ceilings but, in general, the larger the percent reduction in a program, the smaller the bias in the estimate.

Principal Reductions in Grants-in-Aid. Reductions in 14 programs or budget accounts make up for 90 to 97 percent (depending on the year) of the total $13.2 to $14.5 billion in reductions in nonindividual-assistance grants. Because the remaining 3 to 10 percent of the reductions comprises a large number of changes, many of which are quite small, the following discussion considers only the largest 14 reductions.

These 14 largest reductions were classified in terms of the degree to which the affected programs or budget accounts are targeted on low-income individuals or recipients of public assistance.[6] If all or most of the funds in the account are targeted at one or both of those groups, the program was classified as "highly targeted." "Moderately targeted" programs are those in which an appreciable portion, but less than half, of the funds are targeted on those groups. "Largely untargeted" programs are those in which none, or only a negligible proportion, of the funds are targeted toward those groups.

To the extent feasible, only the intended beneficiaries, and not incidental beneficiaries, were considered in classifying programs. Thus, for example, Urban Mass Transit grants for operating assistance were

6. The characteristics of current beneficiaries can only be described in general terms, for several reasons. The services provided under many of the affected programs, and the ways in which services are targeted, vary considerably among jurisdictions. Moreover, the federal requirements only provide a rough index of how programs are targeted, since the federal standards often leave room for substantial state or local discretion. (For example, prior to the past session, federal law restricted most social services provided under the Title XX program to families with incomes below 115 percent of the state median, but several states in practice applied a more stringent standard, excluding families above 80 percent of the state median.) Finally, data describing which services are provided to which people are often nonexistent or of poor quality.

classified as largely untargeted, because criteria such as income are not considered in allocating its funding; no attempt was made to assess the income distribution of the transit users who benefit from the services subsidized by the grants. Conversely, Title I (Chapter I) compensatory education grants were classified as highly targeted, because almost all of the funding is allocated on the basis of counts of low-income children and children in households receiving public assistance. The income distribution of the teachers and teacher aides whose salaries constitute the bulk of Title I expenditures was not considered.

Almost 60 percent ($7.2 billion) of the reductions in grants in 1982 were in highly targeted programs or accounts (see Table 13). This includes $5.3 billion in reductions of employment programs that are targeted on unemployed individuals who have low incomes or receive public assistance. Outside of employment programs, the largest reduction in the highly targeted category is a $1.1 billion cut in compensatory education (primarily the Chapter I or Title I program). The remaining $858 million in reductions of highly targeted programs are in two programs: the Community Services Block Grant and the Human Services Block Grant (formerly the Title XX program).

About 12 percent ($1.5 billion) of the largest reductions in 1982 fall into the "moderately targeted" category. About half of these reductions were in community development programs (Community Development Block Grants and Urban Development Action Grants). The remainder is in Vocational and Adult Education, portions of which are targeted at the educationally or economically disadvantaged; Energy Conservation Grants, a portion of which

TABLE 13. FOURTEEN LARGEST REDUCTIONS IN GRANTS (EXCLUDING GRANTS FOR INDIVIDUALS), BY DEGREE OF TARGETING ON LOW-INCOME INDIVIDUALS OR PUBLIC ASSISTANCE RECIPIENTS (Fiscal Years, Budget Authority in millions of dollars)[a]

Budget Account of Program	Amount of Reduction 1982	1983	1984	Principal Beneficiaries
TOTAL, 14 PROGRAMS OR BUDGET ACCOUNTS	**12,118**	**12,578**	**13,834**	
(Percent)	**(100.00)**	**(100.0)**	**(100.0)**	
Highly Targeted[b]				
Employment and Training Assistance	4,150	3,941	4,194	Primarily low-income or public assistance
Temporary Employment Assistance (CETA Title VI PSE)[c]	1,129[d]	1,218[d]	1,317[d]	On public assistance or unemployed and low-income
Compensatory Education (Chapter I/Title I)[e]	1,061	1,241	1,469	Low-income children; local districts with many such children; educationally disadvantaged children
Community Services Block Grants	507	569	603	Low-income individuals
Human Services Block Grant	351[f]	379	422	Was primarily low- and moderate income, with set-asides for public assistance recipients
Subtotal, Highly Targeted	**7,198**	**7,348**	**8,005**	
(Percent of Total 14)	**(59.4)**	**(58.4)**	**(57.9)**	

(Continued)

TABLE 13. (Continued)

Account or Program	Amount of Reduction 1982	1983	1984	Principal Beneficiaries
Moderately Targeted[g]				
Community Development Block Grants	504	641	674	Census tracts with high concentrations of residents with incomes below area median
Vocational and Adult Education	279	304	348	Portions of programs targeted at educationally or economically disadvantaged, handicapped, others
Energy Conservation Grants	261	276	291	One of four programs targeted at low-income, particularly elderly and handicapped
Employment Services Admintration (Unemployment Insurance Trust Fund Training)	228	251	280	Employers and unemployed individuals
Urban Development Action Grants	235	251	261	Jurisdictions exhibiting economic and social distress. Benefits to low-income and unemployed persons are generally indirect.
Subtotal, Moderately Targeted	**1,507**	**1,723**	**1,854**	
(Percent of Total 14)	**(12.4)**	**(13.7)**	**(13.4)**	

(Continued)

TABLE 13. (Continued)

Account or Program	Amount of Reduction 1982	1983	1984	Principal Beneficiaries
Largely Untargeted				
Urban Mass Transit Grants	1,559	1,462	1,567	
EPA Construction Grants	1,200	1,320	1,600	
Grants-in-Aid for Airports	339	383	413	
Impact Aid (School Assistance to Federally Affected Areas)	315	342	395	
Subtotal, Largely Untargeted	3,413	3,507	3,975	
(Percent of Total 14)	(28.2)	(27.9)	(28.7)	

a. These 14 accounts correspond to 90 to 97 percent of the total net cut in grants-in-aid, excluding grants for individuals.

b. Most or all of the funds are targeted by income or receipt of public assistance.

c. Title VI (Public Service Employment) of the Comprehensive Employment and Training Act.

d. Program eliminated.

e. Title I of the Elementary and Secondary Education Act, as modified by Chapter I of the Education Consolidation and Improvement Act.

Classification of this program is not straightforward, because of the complexity of the system for allocating its funding. Prior to the first session, allocation to school districts, and to schools within districts, was based primarily on counts of children in poverty or receiving public assistance. Accordingly, on the jurisdictional level, this program has been very highly targeted. Within schools, however, students are selected for services on the basis of educational disadvantage. On the level of students, therefore, the program would be classified as moderately or highly targeted, depending on the income criterion used. About 42 percent of Title I students fall below the poverty standard used in allocating Title I funds, and about 61 percent have family incomes in the bottom 40 percent of the national distribution.

(continued)

TABLE 13 (Continued)

Footnotes.

(e, continued) The Education Consolidation and Improvement Act (part of the Omnibus Budget Reconciliation Act of 1981) increased local discretion in the use of Title I funds, but the practical effects of those changes are not yet known.

f. Reduction was coupled with termination of federal requirements for income targeting and set-aside for public assistance recipients.

g. Less than half of the funds are targeted by income or receipt of public assistance.

are targeted at low-income individuals, particularly the elderly and handicapped; and Employment Services Administration, which is targeted at all unemployed (and employers), regardless of income.

The remaining 28 percent ($3.4 billion) of reductions in 1982 are in the "largely untargeted" category. (It is important to note that "largely untargeted" in this context means only that the criteria of income and receipt of public assistance are not used in allocating funds; programs in this category can nonetheless be highly targeted by other criteria related to their purposes.) About 80 percent of the reductions in this category were accounted for by cuts in Urban Mass Transit grants (primarily capital assistance) and Environmental Protection Agency Construction Grants.

Assessing the Distributional Effects of Cuts in Grants. The distributional effects of these cuts in grants depend on the responses of state and local governments. On the one hand, jurisdictions could respond by reducing services, in which case some or all of the current recipients would bear the burden. Alternatively, states and localities could respond by raising taxes in order to maintain current levels of services; in this case, the distributional effects would be determined by the mix of taxes that was levied.

—Possible Reductions in Services. It is likely that many jurisdictions will respond—at least in part—by reducing services. In some cases (for example, the Employment Service), such reductions have already occurred. Several factors suggest that reductions are likely—for example, the poor fiscal condition of many states and localities, the reduction in

state revenues caused by federal tax changes, and the presence in several states and localities of tax limitation measures. It is not presently possible, however, to estimate how extensive the reductions will be or in which jurisdictions or program areas they will be largest.

Moreover, even in cases where jurisdictions respond by reducing services, the distributional effects cannot be estimated precisely, and descriptions of current beneficiaries provide only a rough measure of who is likely to bear the burden. This stems from the often considerable leeway jurisdictions have in determining which recipients of a given service would lose benefits, or which of several services would be reduced or terminated. For example, states have several options in reducing services under the Human Services Block Grant (Title XX). They could cut services across the board; cut certain services while retaining others; lower the current income ceiling for beneficiaries to further target the remaining funds on the most needy; or couple an across-the-board or selective cutback of services with total elimination of income-based targeting (an option made possible by the Reconciliation Act of 1981). It is likely that states will vary in the mix of these options they choose.

—Possible Tax Changes in Response to Cuts in Grants. State and local reactions on the tax side to reductions in grants-in-aid are far less predictable than their responses to the automatic tax cuts. Should the states or localities decide to raise more revenue in order to make up for grant reductions, they will have several existing tax instruments at hand and other new taxes available. Debate will likely be sparked over the

fundamental aspects of the tax systems, and the tax systems that emerge may or may not resemble those that existed in 1981.

At the state level, the chief existing tax instruments are generally income and sales taxes. State income taxes vary from proportional flat-rate taxes to progressive taxes that resemble the federal model. For taxpayers who itemize their federal deductions, the deductibility of the state income tax reduces its progressivity. Sales taxes are generally held to be regressive, because persons with lower incomes tend to consume a greater proportion of their incomes; however, some economists claim that sales taxes are progressive, because some transfer payments are indexed for sales tax-induced increases in the price level. Some state sales taxes are levied on specific products such as gasoline, cigarettes, or alcoholic beverages, and these taxes bear on consumers of these specific goods.

A significant share of state revenues also comes from user fees, particularly for higher education and hospital services. Expansion of these fees is possible, and their distributional consequences would likely be difficult to determine.

A final state option would be increased severance taxes, for those states that are rich in natural resources. States that can tax the extraction of coal, oil, or natural gas may expect that those taxes would be passed on to consumers and owners of the resources elsewhere, rather than concentrated on their own citizens. Resource-poor states would thus bear some of the brunt of resource-rich states' loss of grants.

For the localities, the most prominent revenue raising option is the property tax. The actual incidence of the property tax (at least on improvements) is controversial, with some claiming that the tax is borne by owners of houses or of capital in general and others arguing that it is passed on to renters of housing units. In addition, increased property taxes in a period of high interest rates might lead to delinquencies and defaults as well as higher revenues. Other local options include the raising or the introduction of wage taxes, sales or excise taxes, or user fees (again largely applying to education and hospitals, as well as airports and other local facilities).

APPENDIX

REDUCTIONS IN CASH AND IN-KIND BENEFIT PAYMENTS FOR INDIVIDUALS

This appendix covers three topics—the specific cuts in benefit payments to individuals that are included in the analysis, the allocation of benefit programs to the cash or in-kind categories, and the impact of an alternative categorization for food stamps. Appendix Table 1 lists the programs included in the analysis and describes the major cuts in each.

In this analysis, programs have been included in the cash benefits category if the government's expenditures on benefit payments would in all cases equal the value of benefits received by the beneficiaries. In general, this rule will hold only for benefits actually paid in cash. If the benefit payments take the form of subsidies for the consumption of particular goods and services, such subsidies will distort the set of consumption possibilities open to recipients, and they will generally consume more of the subsidized goods than they would have if given an equivalent amount of cash. Thus, their perceived well-being will not have been increased commensurately with the amount of the government's expenditure. In addition, large subsidies may increase the prices of some goods and services, if they encourage much higher levels of consumption than would otherwise have occurred.

Under the above definition, food stamps may logically be included in either cash or in-kind benefits. On the one hand, they do represent a subsidy for the consumption of a particular category of goods. On the other hand, they do not increase food consumption for most recipients, but simply substitute for cash income when recipients pay for food, with the cash income then being used for other purposes. Appendix Tables 2, 3, and 4 are

comparable to text Tables 7, 8, and 9 except that food stamps is reclassified as an in-kind benefit. The conclusions stated in the text are not sensitive to this change, except that, for the lowest income category, reductions in cash benefits and reductions in in-kind benefits would be roughly the same size, rather than the cut in cash benefits being substantially larger than the cut in in-kind benefits.

APPENDIX TABLE 1. REDUCTIONS IN PROGRAMS PROVIDING BENEFIT PAYMENTS FOR INDIVIDUALS

Program	Major Reductions
Cash Benefit Programs	
Social Security Retirement and Survivors' Benefits	Phase-out of student's benefits; elimination of minimum benefit for new retirees; partial elimination of lump-sum death benefits; postponement of earnings test elimination for workers aged 70 and 71.
Railroad Retirement Benefits	Limitation of windfall benefits to appropriation; elimination of pre-retirement indexing for windfall benefits.
Civil Service Retirement and Military Retirement Benefits	Change from semi-annual cost-of-living adjustments (March and September) to annual adjustment in March.
Social Security Disability Benefits	Reduction in Disability Insurance benefits if total benefits from specific disability programs exceed a measure of predisability earnings; elimination of reimbursement for vocational rehabilitation in most cases; phase-out of students' benefits.
Black Lung Benefits	Restriction of eligibility for new benefit awards; reductions in expected interest payments on general revenue borrowing due to increased coal tax.
Unemployment Insurance	Elimination of national trigger for extended benefits; increase in state trigger levels; restricted benefit eligibility for former military personnel.
Trade Adjustment Assistance	Limitation of benefits to level received under unemployment insurance.

(Continued)

APPENDIX TABLE 1 (Continued)

Program	Major Reductions
Food Stamps	Gross income eligibility restrictions; drop in earned income deduction from 20 percent to 18 percent; delays in the COLAs for both benefits and deductions; prorating of benefits to date of application.
Aid to Families with Dependent Children	Limitation of earnings disregards and elimination after 4 months; counting income of stepparents; counting EITC income; elimination of payments to children 18 and over if not in high school; other smaller changes and various administrative savings.
Supplemental Security Income	Introduction of retrospective accounting and other minor administrative changes.
Low Income Energy Assistance	Conversion to a block grant with reduced funding.
In-Kind Benefit Programs	
Medicaid	Reductions in payments to states if outlays exceed target levels; increased flexibility for states in setting reimbursement rates for health care providers.
Medicare	Increases in the deductible paid by patients for both Hospital Insurance (HI) and Supplementary Medical Insurance (SMI); reductions in reimbursement rates for health care providers.
Guaranteed Student Loans	Requirement that those with incomes over $30,000 prove need; introduction of a 5 percent loan origination fee.
Pell Grants	Reduction in all awards of $80.

(Continued)

APPENDIX TABLE 1 (Continued)

Program	Major Reductions
Housing Assistance Programs	Phase-in of rent increases from 25 percent of adjusted income to 30 percent by 1986.
Child Nutrition Programs	Reductions in school breakfast and lunch subsidies; eligibility restrictions for free and reduced price meals; reductions in special milk and summer feeding programs.
Veterans' Health and Education Programs	Reductions in dental health coverage; reduction in period of coverage; elimination of burial payments for some veterans; elimination of tuition assistance payments for some types of courses.

APPENDIX TABLE 2. TOTAL REDUCTIONS IN OUTLAYS FOR BENEFIT PAYMENTS FOR INDIVIUALS, BY INCOME CATEGORY OF BENEFICIARIES, CALENDAR YEARS 1982-1985 (in millions of current dollars)

		Household Income (in 1982 dollars)				
Calendar Year	Total Savings	Less than $10,000	$10,000-20,000	$20,000-40,000	$40,000-80,000	$80,000 and over
Cash Benefits (Excluding Food Stamps)						
1982	6,990	2,240	1,880	1,920	840	110
1983	9,880	3,440	2,690	2,680	990	80
1984	9,200	3,770	2,490	2,110	760	70
1985	8,230	3,870	2,200	1,550	560	60
Benefits In Kind (Including Food Stamps)						
1982	6,000	2,860	1,520	1,110	480	40
1983	7,640	3,420	1,880	1,490	790	50
1984	8,740	3,880	2,180	1,690	950	60
1985	9,190	4,000	2,350	1,830	970	50
Total Benefits						
1982	12,990	5,100	3,400	3,020	1,320	150
1983	17,510	6,860	4,570	4,180	1,780	130
1984	17,940	7,650	4,670	3,800	1,710	130
1985	17,410	7,870	4,540	3,380	1,520	100

SOURCE: Congressional Budget Office.

NOTE: Totals may not add due to rounding.

APPENDIX TABLE 3. AVERAGE REDUCTIONS PER HOUSEHOLD IN OUTLAYS FOR BENEFIT PAYMENTS BY INCOME CATEGORY OF RECIPIENTS, CALENDAR YEARS 1982-1985 (in current dollars)

Calendar Years	All Households	Household Income (in 1982 dollars) Less than $10,000	$10,000-20,000	$20,000-40,000	$40,000-80,000	$80,000 and over
Cash Benefits (Excluding Food Stamps)						
1982	80	120	90	60	60	110
1983	110	180	130	90	70	70
1984	100	190	110	70	50	70
1985	90	190	100	50	40	50
Benefits In Kind (Including Food Stamps)						
1982	70	150	70	40	40	40
1983	90	180	90	50	60	50
1984	100	200	100	50	70	50
1985	100	200	110	60	70	40
Total Benefits						
1982	160	270	160	110	100	150
1983	200	360	220	140	130	120
1984	200	390	220	120	120	120
1985	200	390	200	100	110	90

SOURCE: Congressional Budget Office.

NOTE: Totals may not add due to rounding.

APPENDIX TABLE 4. CASH BENEFIT REDUCTIONS AS A PERCENTAGE OF INCOME, BY INCOME CATEGORY, CALENDAR YEARS 1982-1985

	All Households	Household Income (in 1982 dollars): Less than $10,000	$10,000-20,000	$20,000-40,000	$40,000-80,000	$80,000 and over
Cash Benefits (Excluding Food Stamps)						
1982	0.3	1.5	0.4	0.2	0.2	0.1
1983	0.4	2.0	0.6	0.3	0.2	a
1984	0.4	1.9	0.5	0.2	0.1	a
1985	0.3	1.7	0.4	0.1	0.1	a

SOURCE: Congressional Budget Office.

a. Less than 0.05 percent.