CENTER ON BUDGET AND POLICY PRIORITIES

October 20, 1994

Dear friend,

I have enclosed our new analyses of the Census Bureau's 1993 poverty and income data, as well as an analysis of the "Contract with America" recently proposed by a group including some House Republican Members of Congress.

The first analysis of the 1993 poverty data examines the drop in median income and the failure of poverty rates to decline despite an improved economy and lower unemployment. The number of poor people last year was the largest since 1962, and the income gap between the wealthy and other Americans reached its widest point in more than a quarter century.

The second piece, *Trends in Health Insurance Coverage 1987-1993*, is based in part on the same Census Bureau 1993 data. Our report shows that the number of Americans without health insurance climbed for the sixth year in a row, largely because of deteriorating employer-related health coverage.

Finally, we've just revised and expanded our preliminary analysis of the federal tax and budget changes in the "Contract with America". Our report focuses on four central issues of the Contract:

- The revenue loss under the plan would rise dramatically after five years.
- The revenue proposals would likely cause either a worsening of the deficit or unusually large reductions in major benefit programs.
- Future Medicaid benefit reductions or tax increases would be impaired.
- High-income households would be the only clear winners.

I hope this information is useful. Please call me if you have any questions.

Sincerely,

Ellen

Ellen Nissenbaum
Legislative Director

Enclosures

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Iris J. Lav and Isaac Shapiro, Acting Co-Directors

CENTER ON BUDGET
AND POLICY PRIORITIES

October 1994

DESPITE ECONOMIC RECOVERY, POVERTY AND INCOME TRENDS ARE DISAPPOINTING IN 1993

Even though the economic recovery shifted into a higher gear in 1993 and the unemployment rate fell, the annual poverty and income data released by the Census Bureau on October 6 were discouraging. In 1993, the poverty rate remained exceptionally high, and the number of poor people continued to rise. The income of the typical middle-income household dropped, and income disparities between the wealthy and other Americans reached their widest point in more than a quarter century.

The 1993 poverty rate of 15.1 percent compares with a rate of 14.8 percent in 1992.[1] While this change in the poverty rate was not statistically significant, the increase in the number of poor people — from 38 million in 1992 to 39.3 million in 1993 — was significant. Some 6.9 million more people are now poor than in 1989, the peak of the last economic recovery.[2]

The 15.1 percent poverty rate for 1993 was essentially the same as the levels in 1982 and 1983, when the unemployment rate hovered close to 10 percent and the economy was in its deepest slump since the Depression.

In addition, the income of the typical household edged down in 1993, falling more than $300, or one percent, after adjusting for inflation. While those in the bottom and middle of the income spectrum lost ground in 1993, the incomes of the wealthy rose.

The high poverty rates and widening income disparities both reflect long-term trends. A comparison of the years 1993 and 1977 illustrates the long-term poverty trend. These two years had similar unemployment rates and came at similar points in the economic cycle. The 1993 poverty rate of 15.1 percent, however, is sharply higher

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[1] The Census Bureau also revised its poverty and income data for 1992 and 1989. The revisions yielded slightly higher poverty rates and slightly lower incomes than the figures published initially. All comparisons between 1989, 1992 and 1993 in this paper use the revised poverty and income data. The revisions do not affect comparisons to years prior to 1989.

[2] The poverty line varies by family size and is adjusted each year to reflect inflation. In 1993, the poverty line for a family of three was $11,522; for a family of four, it was $14,763.

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than the 1977 rate of 11.6 percent. If the poverty rate in 1993 had been the same as in 1977, some nine million fewer people would have been poor in 1993.

Income inequality has been growing steadily since the early 1970s. In 1993, the Census data show that the share of national income going to the richest fifth of households — 48.2 percent — was the highest ever recorded, while the shares of income going to the broad middle class and to the poorest fifth of households dropped to the lowest levels on record.

Several factors have contributed to the persistence of high poverty levels and rising income inequality. These include wage erosion, cutbacks in government benefit programs for low-income families and individuals, and increases in the number of female-headed families.

The Census data provide fresh evidence of the role of declining wages. The earnings of the typical year-round full-time male worker fell $700 between 1992 and 1993, after adjusting for inflation. The earnings of the typical full-time year-round female worker declined about $250.

In short, the new income and poverty figures indicate that in this decade, as in the 1980s, the gains of economic growth are not being broadly shared and are going mainly to the affluent. If anything, the data indicate that the economic forces which have been leading to falling wages and widening income disparities may be growing even stronger.

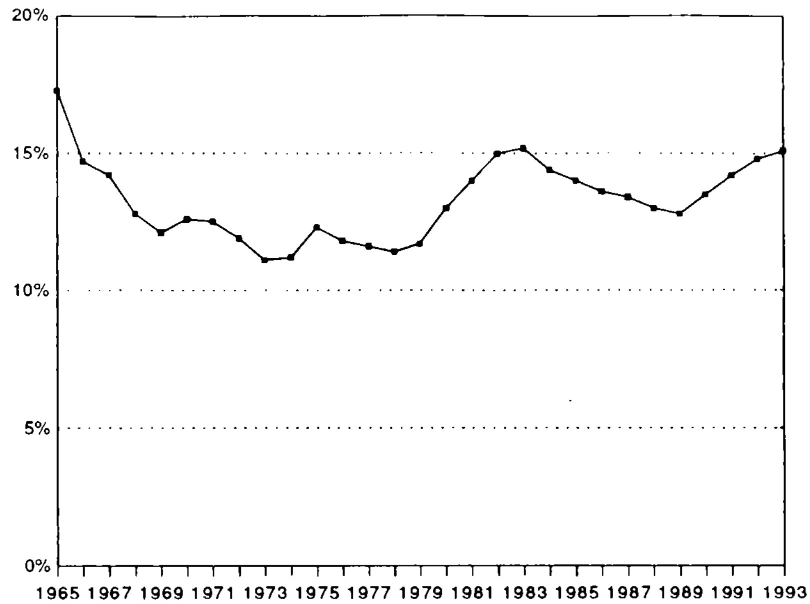
Along with the new poverty and income data, the Census Bureau also released new information on health insurance coverage. Here, too, the developments were discouraging. The number of Americans without health insurance climbed for the sixth consecutive year in 1993, to nearly 40 million people. While the poor are more likely to be uninsured than other Americans, about 28.2 million of the 39.7 million people without coverage are not poor. Continued erosion in the proportion of Americans receiving health insurance through their jobs is the main factor behind the continuing drop in coverage. Some 57.2 percent of Americans were covered by employment-related health plans in 1993, a substantial drop from the 1988 level of 62 percent.

Poverty Less Responsive to Improvements in Unemployment

The recession officially ended in 1991 and the economy grew in 1992. But other indicators fared less well that year. The unemployment rate rose to 7.4 percent in 1992 from its 1991 level of 6.7 percent.

In 1993, the recovery picked up steam. The overall economic growth rate increased to 3.0 percent, and the unemployment rate dropped back down to 6.8

Figure 1
Poverty Rate in the United States



Center on Budget and Policy Priorities
Source: U.S. Census Bureau
*This chart reflects Census revision of 1989 and 1992 data. Census has not yet revised 1990 and 1991 data.

percent. The average monthly number of unemployed people fell 650,000 between 1992 and 1993.

But these positive trends did not improve the poverty picture. The early signs from this recovery suggest the pattern of the last economic cycle may repeat itself.

After the back-to-back recessions of the early 1980s, the economy recovered and unemployment fell, but progress on poverty was muted and income disparities widened. The absence of improvement in poverty in 1993 suggests that during this recovery, too, poverty may not be very responsive to falling unemployment. The long-term upward trend in the poverty rate is continuing.

The degree of the upward drift in poverty in recent decades can be seen by comparing the current poverty rate to that for 1977. Both 1993 and 1977 were the second years of economic recoveries, and the 6.8 percent unemployment rate in 1993 was slightly lower than the 1977 unemployment rate of 7.1 percent. Nevertheless, the poverty rate in 1993 was 3.5 percentage points higher than the rate in 1977.

The upward drift in poverty rates has affected virtually all groups. (See Table I.) Working families, whites and minorities, and female-headed and married-couple families have all experienced significant increases in their poverty rates. For example, the poverty rate among non-Hispanic whites rose from about 8.0 percent in 1977 to 9.9 percent in 1993.

The major exception is the elderly — the one group for whom government assistance programs have generally been strengthened. The elderly poverty rate fell from 14.1 percent in 1977 to 12.2 percent in 1993. Children, by contrast, experienced a particularly dramatic jump in their poverty rates, increasing from 16.2 percent in 1977 to 22.7 percent in 1993. While the 1993 child poverty rate was not statistically different from the 22.3 percent rate for 1992 and 1983, it exceeded the rate for all other years since 1964. Some 15.7 million children were poor in 1993.

Most Continue to Face Falling Incomes

After adjusting for inflation, the income of the typical or median household fell from its 1992 level of $31,553 to its 1993 level of $31,241. Low-income households, too, experienced a decline. The inflation-adjusted or "real" average income of the poorest fifth of households fell by 1.3 percent in 1993, from $7,506 to $7,411.

Only relatively wealthy households experienced income gains in 1993. The gains were concentrated among the richest one-fifth of households.

- For one part of this group — those whose incomes were higher than 80 percent of all households but lower than the richest five percent of households — average incomes increased by 2.1 percent in 1993. Their average real income rose by $1,600 — from $75,475 in 1992 to $77,043.

- The Census data suggest that the wealthiest five percent of households gained the most. Their average real incomes rose from $148,946 in 1992 to $163,228 in 1993, an increase of more than $14,000, or 9.6 percent. In 1993, however, the Census Bureau changed the way it collects certain income information. This change yielded fuller and more accurate information about the incomes of the wealthiest five percent of households. As a result, some — but almost certainly not all — of the increase between 1992 to 1993 in the incomes of this group is likely to be overstated.[3]

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[3] In 1992, under the old approach, the incomes of the wealthiest households were likely understated. So although the 1993 figures for the richest five percent of households represents a truer estimate than previous estimates, the increase in income from 1992 to 1993 is somewhat overstated. The Census Bureau cannot precisely measure this overstatement, but it is very likely that if this measurement difference could

(continued...)

Table I
Poverty Rates: 1977, 1992* , and 1993

	1977	1992	1993
Unemployment Rate	7.1%	7.4%	6.8%
Poverty Rate (persons)			
All Persons	11.6%	14.8%	15.1%
Non-Hispanic White	8.0**	9.6	9.9
Black	31.3	33.4	33.1
Hispanic	22.4	29.6	30.6
Child Poverty Rate (persons)			
All Children	16.2%	22.3%	22.7%
Non-Hispanic White	9.9**	13.2**	13.6**
Black	41.8	46.6	46.1
Hispanic	28.3	40.0	40.9
Poverty rate among families with children where householder works	7.7%	NA	11.3%
Elderly Poverty Rate (persons)	14.1%	12.9%	12.2%
Family Type (families)			
Married-couple families	5.3%	6.4%	6.5%
Female-headed families	31.7	35.4	35.6
Persons in Poverty	24,720,000	38,014,000	39,265,000
Children in Poverty	10,288,000	15,294,000	15,727,000

Center on Budget and Policy Priorities
Source: U.S. Census Bureau

*Poverty rates for 1992 reflect revisions by the Census Bureau.
**Figures are Center calculations based on Census data.

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[3] (...continued)
be adjusted for, there would still be a significant increase in the average incomes of the upper five percent of households from 1992 to 1993.

It also bears noting that the Census data still significantly understate the incomes of wealthy households because they do not include income from capital gains. The average household at the top of the income scale has substantial capital gains income.

Income Gaps Reach Record Levels

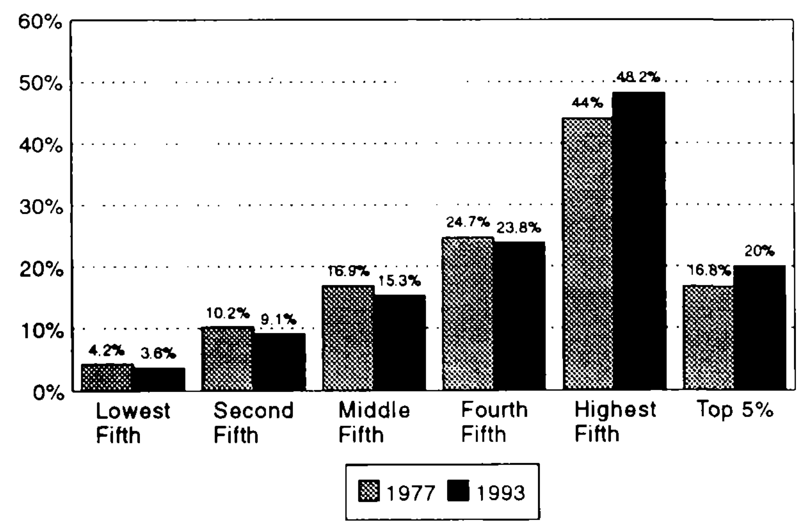
The unevenness of income gains and losses in 1993 continues a long-term trend. The net result of this trend is that the income gaps between wealthy and poor Americans, as well as the gaps between the wealthy and the middle-class, are at record levels. The Census data show that the household income gaps in 1993 were the widest ever recorded since the Census Bureau began collecting such data in 1967. (See Figure 2.)

- The share of national income going to the top fifth of households — 48.2 percent — was the highest proportion ever recorded. The richest fifth of households had nearly as much income in 1993 as the other four-fifths of households combined. The share of income received by the top five percent of households — 20.0 percent — also reached its highest level on record.

- The share going to the middle three-fifths of households — the broad middle class — fell to 48.2 percent, the lowest ever recorded.

- The share of income going to the bottom fifth of households also dropped to its lowest level on record — 3.6 percent.

Figure 2
Shares of National Income Held by
Various Groups of Households



Center on Budget and Policy Priorities
Source: U.S. Census Bureau
*The changes in income shares are likely to be somewhat exaggerated because of improved data collection techniques that yielded more accurate -- but likely somewhat higher -- incomes for the very wealthiest households in 1993. The direction of the changes, however, are indisputable.

The income data cited above are for all *households*, including households composed of single individuals or unrelated individuals. If only the incomes of *families* are examined, however, the picture is the same. In 1993, low and middle-income families lost ground while upper-income families gained ground. Family income disparities were at their widest levels ever recorded (these data are available back to 1947).

Factors Behind Long-Term Increases in Poverty and Income Gaps

Wage trends constitute a major factor underlying rising poverty and growing income inequality. Labor Department data show that the average hourly wage for non-supervisory jobs continued to slide in 1993, falling to its lowest level since 1964, after adjusting for inflation.

Wage erosion among low- and middle-income workers has made it more difficult for working parents to lift their families out of poverty. In 1979, some 12.1 percent of full-time year-round workers earned too little to lift a family of four out of poverty. In 1993, some 16.2 percent of full-time year-round workers had earnings this low. And, as noted earlier, the earnings of the typical full-time worker fell in 1993.

When combined with favorable wage trends at the top of the income spectrum, all these wage developments go a long way toward explaining the record income gaps between the wealthy and other Americans.

When the rise in poverty is examined, a second underlying factor emerges: the rise in single-parent families. Female-headed families are more than five times as likely to be poor as married-couple families, and the number of female-headed families has been growing fairly rapidly for several decades. Female-headed families were both a larger proportion of all families and of poor families in 1993 than in 1977. The poverty rate in 1993 would have been somewhat lower than its 15.1 percent level if not for this growth.

At the same time, however, the effect of the growing number of female-headed families on poverty trends in the past 20 years is sometimes exaggerated. During this period, the average size of female-headed families became smaller and poverty also increased among two-parent families. As a result of these and other trends, the proportion of poor people living in female-headed families has remained fairly steady since the late 1970s. Census data show that 37.2 percent of all poor people lived in female-headed families in 1977. In 1993, some 37.3 percent did.

A weaker safety net also has contributed to the rise in poverty.[4] In 1993, fewer than one in every seven children who were poor before receipt of government benefits were lifted from poverty by these benefits.[5] In 1979, nearly one in five children who were poor before receipt of benefits were lifted from poverty by them. (These data are not available for 1977.)

The Aid to Families with Dependent Children program, the primary cash assistance program for poor families with children, has been cut especially dramatically. Between 1970 and 1994, the AFDC benefit for a family of three without other income fell 47 percent in the typical state, after adjusting for inflation. AFDC benefits for the working poor have also eroded.

Another part of the safety net that has been hit hard in recent years is general assistance. General assistance programs can serve groups of low-income people not covered by AFDC or the Supplemental Security Income program for the elderly and the disabled. In recent years, several states reduced benefits or entirely eliminated general assistance programs.

The cutbacks in AFDC and general assistance have contributed to a rise in the size of the group that might be called "the poorest of the poor." In 1993, more than four of every 10 poor people had income below *half* the poverty line, or $7,382 for a family of four. In 1977, three of every 10 poor people had incomes this low.

Further Erosion in Health Insurance Coverage

The number of people without health insurance coverage for the entire year rose in 1993 to 39.7 million people, an increase of 1.1 million from the previous year. Some 15.3 percent of the population was uninsured in 1993. More than 70 percent of those without insurance were not poor.

Both the number of people and the proportion of the population lacking health insurance has increased steadily since 1987, the first year for which comparable data

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[4] Since the official definition of poverty is based on a household's income before taxes, it does not account for the assistance low-income households receive from the Earned Income Tax Credit, a program that has been expanded substantially in recent years. Counting EITC benefits would not, however, have improved the 1993 poverty picture. This is true for two reasons. First, counting the EITC would necessitate moving to an after-tax income measure, and experimental Census definitions of poverty show that the poverty rate after-taxes (including the EITC) would have been *higher* in 1993 than the before-tax measure. More people would have fallen into poverty because of payroll and income taxes than would have been lifted out of poverty by the EITC. Second, recent EITC expansions will not be fully phased in until 1996.

[5] This decline in the proportion of children raised from poverty by government benefits is likely to reflect the combined effect of benefit reductions and wage erosion. Declining wages left many working families with children further below the poverty line, thus reducing the chances that the combination of wages and government benefits would lift them to the poverty line.

are available. According to the Census Bureau data, 8.7 million fewer people were insured in 1993 than in 1987.

It is likely that millions of other people lacked coverage for some part of 1993. While 35.4 million people were uninsured for all of 1991, a Census report published earlier this year found that some 60 million people — about one quarter of the U.S. population — lacked health insurance coverage for at least one month during a 32-month period beginning February 1990.

The decline in health care coverage reflects a decrease in employment-related health insurance. Some 57 percent of Americans were covered by employment-related health plans in 1993, down from 62 percent in 1988 (the latest years for which data are available). If the same proportion of Americans had job-related health coverage in 1993 as in 1988, another 12.5 million individuals would have had such coverage last year.

One factor that has tempered the rise in the total number of uninsured people is increased enrollment in the Medicaid program. In the period between 1987 and 1993, Medicaid rolls increased by 11.3 million people. In 1993, some 12.2 percent of the population was covered under Medicaid, up from 8.4 percent in 1987. Much of the growth in the Medicaid program in the last year was among the near-poor population, who benefited from recent expansions in Medicaid eligibility rules. Medicaid continues to cover less than half of the poor.

(The Center on Budget and Policy Priorities has released a separate, more detailed analysis of the new health insurance data and how it compares to information from previous years. See "Trends in Health Insurance Coverage, 1987 to 1993".)

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beginning in February 1990. This represents about one-quarter of the entire U.S. population.[5]

Decline in Employment-Related Coverage

The decline in health care coverage reflects a decrease in employment-related health insurance. The share of the population receiving health insurance through a job has declined every year since 1988 (the first year for which such data are available). The net drop during this period has been dramatic.

- In 1988, some 62 percent of Americans were covered by employment-related health plans. By 1993, the figure had fallen to 57.2 percent.

- If the same proportion of Americans had job-related health coverage in 1993 as in 1988, another 12.5 million individuals would have had such coverage last year.

Table 2
Proportion of People with Employer-Related Coverage

	All	Non-Poor	Poor
1993	57.2%	65.4%	11.2%
1988	62.0%	69.3%	12.8%

During years when unemployment is on the rise, one might expect a large number of people to lose their job-related coverage. From 1990 to 1992, some part of the erosion in employer-related coverage can be attributed to the rising unemployment; many workers lost their health insurance when they lost their jobs.

But employment-related coverage has weakened during recovery years as well. In 1993, for example, the general employment picture brightened, but employment-related health coverage deteriorated.

- In 1993, the unemployment rate dropped from its 1992 level of 7.4 percent to 6.8 percent. The number of unemployed people fell by 650,000, while the number of employed people rose by 1.7 million people.

- Nevertheless, half a million fewer people had employer-related coverage in 1993 than in 1992. The share of the population with employer-related

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[5] Bureau of the Census, *Health Insurance Coverage — Who Had a Lapse Between 1990 and 1992?*, Statistical Brief, March 1994.

income status of the uninsured is available, the number of people who are not poor but who lack health insurance has jumped by 5.3 million. Some 74 percent of the overall growth in the number of uninsured during this five-year period occurred among the non-poor.

- The proportion of non-poor people without health insurance rose from 10.8 percent to 12.8 percent during this period.

Health insurance trends among the poor have been mixed. The *number* of poor people without health insurance coverage has increased since 1988, rising by 600,000 just between 1992 to 1993. But in many of these years, the increase in the number of poor people without insurance related to an overall rise in the size of the poverty population. From 1988 to 1992, the *proportion* of the poverty population lacking health insurance coverage decreased from 30.3 percent to 28.7 percent. As discussed later, an expansion in Medicaid coverage helps explain this decrease.

The increase in 1993 in the number of poor people lacking coverage does not, however, appear to be due entirely to the increase in the size of the poverty population. While 28.8 percent of the poor lacked health insurance coverage in 1992, some 29.3 percent of the poor were without coverage in 1993.[4] In 1993, ongoing expansions in Medicaid coverage appear to have been offset by other trends. Among the offsetting factors could be a growth in the number of working poor, many of whom lack health insurance through their jobs.

Data Understate the Problem

These figures understate the dimensions of the health insurance problem because they represent only people who reported they lacked health insurance for the *entire* year examined — for example, for *all* of 1993. People who had health insurance for as little as one month in 1993 would not be counted as uninsured. It is likely that millions of other people lacked coverage for *some* part of 1993.

A Census report from earlier this year documents this point. While 35.4 million people were uninsured for all of 1991, a much larger number — 60 million people — lacked health insurance coverage for at least one month during a 32-month period

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[4] The difference was not statistically significant.

- Every year from 1987 to 1993, both the number and the proportion of the population without health insurance increased. (In some years, though, the increases were not large enough to be "statistically significant."[2])

- From 1992 to 1993, the number of people without coverage rose significantly, by 1.1 million. Some 15 percent of the population lacked coverage in 1992, compared to the 15.3 percent without coverage in 1993 (this change was not statistically significant).

The Large Majority of the Uninsured Are Not Poor

As would be expected, a larger proportion of the poor than of the non-poor lack health insurance. Among those who were poor, 29.3 percent had no health insurance in 1993. Some 12.8 percent of the non-poor lacked insurance.

The large majority of people without coverage, however, are not poor. Of those without insurance last year, some 28.2 million — 71 percent — had incomes above the poverty line.

Table 1
People with no Health Insurance
(in millions)

	All	Non-poor	Poor
1993	39.7	28.2	11.5
1988	32.6	22.9	9.7
1987	31.0	N/A	N/A
1988-1993 Increase			
Number	7.1	5.3	1.8
Percent	100%	74%	26%

Similarly, from 1988 to 1993, the lion's share of the growth in the health insurance gap occurred among people who are not poor.[3] Both the number and the proportion of those living above the poverty line but lacking health insurance grew during this period.

- Since 1988, the first year for which information on the

[2] The Census Bureau data are based on surveys of the U.S. population. Accordingly, the data are not absolutely precise reflections of the population's characteristics. "Statistical significance" tests are performed to determine if the difference between surveys conducted in different years are due to the imprecision of the surveys or to actual changes over time. Changes are usually considered statistically significant if the mathematical test suggests there is at least 90 percent certainty that the direction of the change noted is correct.

[3] The year-to-year patterns do vary somewhat. For example, from 1992 to 1993, just 45 percent of the increase in the number of people lacking health insurance coverage occurred among the nonpoor. By contrast, from 1991 to 1992, some 78 percent of the increase occurred among the nonpoor. The one-year changes reflect, in part, statistical variation, so the long-term picture is more telling.

CENTER ON BUDGET AND POLICY PRIORITIES

File Center on Budget and Policy

October 19, 1994

TRENDS IN HEALTH INSURANCE COVERAGE, 1987 TO 1993

by Laura Summer and Isaac Shapiro

In early October, new health insurance coverage data for 1993 were issued by the Census Bureau as part of its annual report on poverty and income trends and other economic indicators. More detailed, unpublished data on health insurance coverage from the Census Bureau also became available. This analysis examines this new information for 1993 and compares it to data from earlier years. (Some comparisons are available back to 1987 while others are available back to 1988.)

Coverage Deteriorates Rapidly

The basic trend in health insurance coverage is unmistakable. Both the number of people and the proportion of the population that lack health insurance for the entire year have increased steadily since 1987.[1] The problem has grown worse during both recessionary and recovery periods.

- According to the Census data, the number of people without health insurance for the entire year rose from 31 million in 1987 to 39.7 million in 1993, an increase of nearly nine million people in a relatively short time span.

- During this same period, the proportion of the population without insurance increased from 12.9 percent to 15.3 percent.

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[1] When the Census Bureau released the 1993 poverty, income, and health insurance data, the Bureau also revised its 1992 data to reflect population counts from the 1990 Decennial Census. The revision yielded higher numbers and rates of people lacking health insurance coverage than the 1992 figures published initially. The comparisons between 1992 and 1993 in this paper use the revised 1992 health insurance data. The revisions do not affect comparisons between 1987 or 1988 and 1993.

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health insurance coverage fell from 58 percent in 1992 to its 57.2 percent level in 1993. It appears that the loss of employment-related coverage in 1993 occurred primarily because some employers ceased offering coverage.

With a steadily smaller share of the population receiving health insurance coverage through work, it is not surprising that the proportion of non-poor people lacking health insurance has risen substantially.[6]

Medicaid Coverage Grows

From 1988 to 1993, the proportion of the population with *private* health insurance declined significantly, primarily because of the decline in employer-based coverage.[7] At the same time, the proportion of the population with *government*-provided health insurance increased. The decline in private coverage would have led to an even sharper drop in overall coverage if government coverage had not expanded.

In particular, increased enrollment in the Medicaid program tempered the rise in the total number of uninsured people. In the period between 1987 and 1993, Medicaid rolls increased by 11.3 million people. In 1993, some 12.2 percent of the population was covered under Medicaid, up from 8.4 percent in 1987.

A large part of the growth in the Medicaid program stemmed from expansions in Medicaid eligibility for pregnant women and young children. Almost one quarter of *all* children under 18 years of age — some 23.8 percent — were covered by Medicaid in 1993, a sizeable jump from the 15.5 percent covered in 1988.

Much of the growth in the Medicaid program has occurred among the near-poor population. Recent Medicaid expansions have made significant numbers of pregnant women and children from near-poor families eligible for Medicaid coverage (see box).

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[6] Employment-related coverage decreased among both the poor and the non-poor. The proportion of poor people with employment-related coverage fell from 12.8 percent in 1988 to 11.2 percent in 1993. Nevertheless, the share of the poverty population with health care coverage increased during this time, largely because the expansion in Medicaid coverage more than offset the decline in employer-related coverage.

[7] Most private health insurance is obtained through employers, so it follows that the decline in the proportion of people covered by employment-related coverage is mirrored by a decline in the proportion of the population that has private health insurance. Some 74.7 percent of the population had private health insurance coverage in 1988; this proportion declined to 70.3 percent in 1993.

Recent Medicaid Expansions

In recent years, the Medicaid program has been expanded in several ways. Beginning in 1987, states had the option to extend Medicaid coverage to young children whose families have incomes above their state's AFDC income limit but below the poverty line. Starting in April 1990, states were required to extend Medicaid coverage to all children under age six from families with incomes below 133 percent of the poverty line. States are also required to cover all poor children born after September 30, 1983. This will result in virtually all poor children through age 18 being covered by 2002.

Eligibility for pregnant women has also been expanded. States must cover all pregnant women with family incomes below 133 percent of the poverty line. States may set income limits for pregnant women and infants as high as 185 percent of the poverty line.

- In 1993, about 40 percent of Medicaid beneficiaries had incomes above the poverty line, up from 36 percent in 1988.

- More than one third of the children covered by Medicaid in 1993 — some 36 percent — were not poor. This is a substantial increase from 1988,

  when 28 percent of the children enrolled in Medicaid had incomes above the poverty line.

- A portion of the increases in Medicaid enrollment likely stemmed from the decrease in employer-based coverage, as some families that lost coverage at work signed up for Medicaid.

Even with expansions in the program, Medicaid still covers fewer than half of all poor people. Some 48 percent of the poor were enrolled in Medicaid in 1993. Among poor children, 67 percent had Medicaid coverage in 1993.

One fifth of all poor children — 20.1 percent, or 3.2 million children — had no health insurance at all in 1993. Many of the children in this group either were eligible for Medicaid but had not enrolled in the program or will become eligible for Medicaid sometime in the next decade as a result of Medicaid eligibility expansions enacted in the past few years. These data suggest that greater efforts are needed to inform poor parents of their children's potentially eligibility for Medicaid.

The extent of Medicaid coverage varies among racial and ethnic groups. Some 61.5 percent of poor blacks had Medicaid coverage in 1993, compared with 47.6 percent of poor Hispanics and 40.1 percent of poor non-Hispanic whites.[8]

The Uninsured

Some groups were more likely to be uninsured than others. Hispanics were most likely to be uninsured. Nearly one in three Hispanics — 31.6 percent — lacked coverage in 1993. An even larger proportion of *poor* Hispanics — 40.8 percent — lacked health care coverage. The concentration of Hispanic workers in low-wage jobs that provide few benefits may contribute to the low insurance rates for Hispanics.

Some 20.5 percent of all blacks — and 23.5 percent of poor blacks — had no coverage. Among all non-Hispanic whites, 12.1 percent had no insurance. But more than one quarter of poor whites — 27.7 percent — were uninsured.

Members of female-headed families were more likely to lack coverage than members of married-couple families. Some 18.8 percent of the people in female-headed families lacked health care coverage last year, compared with 12.4 percent of the people in married-couple families.

Among poor families, however, the opposite was true. Some 18 percent of the people in poor female-headed families had no health insurance while 34.8 percent of people in poor married-couple families lacked insurance. This is a reflection of the close link between Medicaid and the AFDC program. AFDC recipients, most of whom are members of female-headed families, are automatically eligible for Medicaid coverage. The difference in coverage rates also reflects the fact that more married-couple families than female-headed families are working poor families who do not receive health insurance through their jobs and who do not qualify for Medicaid.

Differences Among States

The Census Bureau also released state-by-state data on health insurance coverage (see Table 3). There is a wide range in the proportion of state populations lacking coverage.

- In five states — Arizona, Louisiana, New Mexico, Oklahoma, and Texas — as well as the District of Columbia, more than one-fifth of the

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[8] The data on non-Hispanic whites in this paper are authors' calculations based on Census data.

population had no health care coverage in 1993. In general, people living in Southern and Southwestern states were most likely to lack health insurance coverage.

In California, the nation's largest state, nearly one in five residents lacked health insurance.

- By contrast, in several states relatively few people lack coverage. In at least two states — Iowa and Wisconsin — less than one-tenth of the population did not have health insurance coverage in 1993.[9]

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[9] The Census data indicate that 11.1 percent of Hawaii's residents lack health insurance, but this figure does not adequately reflect Hawaii's state-specific health insurance plan that is designed to provide universal coverage. The Census questionnaire does not fully account for people who receive state-specific health insurance, but the Bureau says it is likely that this only has a significant impact on coverage numbers in Hawaii, the state with the most extensive state-specific coverage by far.

Table 3
Percent of Population Not Covered by Health Insurance, by State, 1993

Alabama	17.2
Alaska	13.3
Arizona	20.2
Arkansas	19.7
California	19.7
Colorado	12.6
Connecticut	10.0
Delaware	13.4
District of Columbia	20.7
Florida	19.6
Georgia	18.4
Hawaii	11.1
Idaho	14.8
Illinois	12.6
Indiana	11.9
Iowa	9.2
Kansas	12.7
Kentucky	12.5
Louisiana	23.9
Maine	11.1
Maryland	13.5
Massachusetts	11.7
Miami	11.2
Minnesota	10.1
Mississippi	17.8
Missouri	12.2
Montana	15.3
New England	11.9
Nevada	18.1
New Hampshire	12.5
New Jersey	13.7
New Mexico	22.0
New York	13.9
North Carolina	14.0
North Dakota	13.4
Ohio	11.1
Oklahoma	23.6
Oregon	14.7
Pennsylvania	10.8
Rhode Island	10.3
South Carolina	16.9
South Dakota	13.0
Tennessee	13.2
Texas	21.8
Utah	11.3
Vermont	11.9
Virginia	13.0
Washington	12.6
West Virginia	18.3
Wisconsin	8.7
Wyoming	15.0

Source: U. S. Census Bureau

CENTER ON BUDGET
AND POLICY PRIORITIES

THE *CONTRACT WITH AMERICA* PROPOSAL: ASSESSING THE LONG-TERM IMPACT

By Iris Lav, Cindy Mann, and Pauline Abernathy

Overview

On September 27, 1994, a number of federal tax and budget changes were proposed in a *Contract with America* released by a group including House Republican Members of Congress. Among other proposals, the Contract calls for changes that would reduce revenues by approximately $190 billion over the next five years.[1] The revenue proposals include a new tax credit for children, a new type of Individual Retirement Account, reductions in the rate of taxation of capital gains income for individuals and corporations, a reduction in taxes for businesses that invest in buildings, machinery, and equipment, and a reduction in the extent to which Social Security income is taxable for higher-income taxpayers. In addition, the proposal calls for a constitutional amendment requiring a balanced budget by the year 2002.

There are four key issues with respect to the long-term impact of the Contract.

- **The revenue loss under the plan would rise dramatically after five years**. The plan is presented as losing $190 billion in revenue over the next five years, itself a substantial amount. But the IRA, capital gains, and business depreciation provisions are designed so they lose smaller amounts or even *raise* revenue over the next five years — and then lose much larger amounts of revenue after the five-year budget period ends.

    - The IRA proposal is said to raise $5 billion over the next five years, but past analyses show it could eventually lose $50 billion over subsequent five-year periods.

    - The Contract puts the cost of the capital gains proposal at $56 billion over its first five years. But the Joint Committee on Taxation has estimated that the cost in the second 5-year period after enactment could exceed $160 billion.

[1] House Budget Committee minority staff cost estimates for the Contract with America, September 22, 1994. No further estimates were released with the Contract. The staff estimate showed a total cost of $147.9 billion, which is comprised of $192.9 billion in net revenue reductions offset by $45 billion in spending cuts in welfare, nutrition, and crime bill programs.

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- The Contract lists the depreciation proposal as raising $20 billion over the first five years. Past analysis of similar proposals suggests that the cost in subsequent five-year periods could reach $58 billion.

Just these three proposals in the Contract, which are said to have a net cost of $31 billion in their first five years, could have a combined cost in subsequent five-year periods of more than $260 billion. Thus, the overall eventual revenue loss from the Contract for subsequent five-year periods greatly exceeds $190 billion.

- **The revenue proposals would likely cause either a worsening of the deficit or unusually large reductions in major benefit programs**. The deficit has been halved as a share of the Gross Domestic Product since 1992, but the proposals in the Contract would put further progress in question. Over the next five years, large potential budget savings would have to be devoted to paying for tax cuts rather than continuing to make progress on deficit reduction. After five years, when the revenue losses would escalate, much larger cuts would be needed to keep the deficit from growing. If, in addition, the budget had to be balanced — as the Contract calls for — cuts of unusual depth would likely have to be made in many big-ticket items in the budget. This suggests that major benefit programs such as Medicare, Medicaid, veterans programs, and Social Security could be subject to substantial reductions.

- **Future Medicare benefit reductions or tax increases would be required.** The Medicare hospital insurance trust fund is out of long-term balance. The Medicare actuaries project that without changes to reduce Medicare costs or increase the revenues flowing into the trust fund, the Medicare hospital insurance trust fund will be insolvent by 2001. Yet the Contract would lower the taxes that are now deposited in the Medicare trust fund. The Contract proposes to cut the taxes of higher-income Social Security beneficiaries through lowering the proportion of their Social Security benefits that are subject to taxation; under a 1993 law, these taxes go to the Medicare trust fund. By withdrawing these revenues from the trust fund, the Contract would push Medicare further out of balance and require larger Medicare reductions or tax increases to avert insolvency.

Since 1984, the Center on Budget and Policy Priorities has been analyzing the effects of various tax and budget proposals on low-income families. Over the years, the Center has issued more than 20 analyses of tax plans, including analyses of Clinton, Bush, Gingrich, Bentsen, and Rostenkowski tax proposals. This analysis of the "Contract with America" is the latest in this series.

- **High-income households would be the only clear winners.** Several of the major revenue proposals — including the changes in IRAs, capital gains taxation, and the taxation of Social Security income — would primarily benefit those at higher income levels.

  - Past analyses indicate, for example, that about 95 percent of the benefits from the IRA proposal would accrue to the top fifth of the population.

  - Almost half of the benefits from the capital gains provisions would go to the wealthiest one percent of the population.

  - The reduction in the proportion of Social Security benefits that are subject to taxation would give a tax break to the top 13 percent of beneficiaries.

  Middle income families would benefit significantly from the $500 per child tax credit, but whether middle income families are better off in the long-run would depend on how the costs of the various tax cuts are financed. This is especially true in years after the five-year budget period ends, when the costs of the tax cuts primarily benefitting upper-income households and corporations begin to mushroom. If financing the tax cuts required sharp cuts in programs from which middle income families derive substantial benefits, significant numbers of middle income families might find their disposable incomes reduced as a result of the offsetting actions.

  Low-income households are the clear losers. They would gain little from the tax proposals but bear most of the burden from the budget cuts identified in the Contract. They would likely also be affected by other cuts that would ultimately have to be made.

Escalating Costs in Future Years

In issuing the Contract, its authors have provided estimates of its costs over the next five years. This is the period for which the impact of tax bills are considered under the provisions of the Budget Enforcement Act of 1990. Under that Act, any revenue reduction must be offset within the five-year period through increases in other taxes or reductions in entitlement spending, so that no increase in the deficit occurs. Thus, even when a tax proposal such as the Contract does not include the offsetting measures to achieve deficit neutrality, it is traditional to assess the costs over the five-year period.

In years after the five-year estimation period, however, the costs of the Contract's proposed new Individual Retirement Accounts, capital gains taxation, and business depreciation allowances are likely to increase rapidly. Each of these proposals has been structured to have costs that are relatively small in the initial years after enactment but increase over time.

"American Dream Savings Accounts"

The Contract would establish "American Dream Savings Accounts (ADSAs)," which are a new version of current Individual Retirement Accounts (IRAs). Prior to the Tax Reform Act of 1986, taxpayers at all income levels could deposit up to $2,000 a year in an IRA and deduct that amount in figuring their income taxes. The Tax Reform Act eliminated the IRA deduction for single individuals with incomes exceeding $35,000, and for married couples with incomes above $50,000, who are covered by an employer-sponsored pension plan. This and other tax advantages for people at higher income levels were eliminated in the 1986 act in exchange for sharply lower income tax rates. Nevertheless, more than 70 percent of taxpayers with earnings remain eligible for an up-front deduction for IRA contributions.

Simply restoring the $2,000 IRA deduction for those who lost it in 1986 would cost between $30 billion and $40 billion over five years, based on past Joint Tax Committee estimates of such proposals. The Contract's ADSA proposal, however, has a number of provisions that are more generous than pre-1986 IRAs.

- Like pre-1986 IRAs, the Contract would allow taxpayers at all income levels to contribute to an ADSA. Unlike the pre-1986 law and the current law on IRAs, however, the Contract would index for inflation in future years the $2,000 maximum permitted deposit. Thus, the maximum permitted deposit amount would grow over time.

- In addition, the Contract would allow each spouse to make a contribution up to the limit whether or not both spouses work. Under pre-1986 law and current law on IRAs, non-working spouses may make a maximum deductible contribution of only $250.

Because the ADSA provisions allow higher tax-advantaged contributions than pre-1986 IRAs, the proposal should cost more than simply restoring universal deductibility would cost. Yet the Contract says its IRA expansion *raises almost $5 billion* over five years.

How can a more generous tax break raise revenue? The Contract achieves this feat through the use of several devices to shift the timing of tax payments. These devices increase revenue collections in the short term but lead to large revenue losses outside the five-year budget period.

Timing Devices Mask Exploding Costs

The Contract's ADSA is a version of what is often described as a *backloaded* IRA. Under current law, eligible taxpayers may deposit funds into an IRA and deduct the contribution from their taxable income. Funds deposited in IRA accounts then accumulate interest that is tax free until the funds are withdrawn after retirement. Withdrawals of both principal and interest are taxed as ordinary income at that point. With a *backloaded* IRA, there is no up-front deduction, but all interest earned in the account would be permanently tax free. As long as taxpayers leave the funds in the account for at least a specified number of years (such as the five-year period the Contract specifies for the ADSAs), both the interest and the principal could later be withdrawn without paying tax. Thus, unlike current IRAs, the interest earned is never subject to taxation.

Ultimately, backloaded IRAs cost the federal government about the same as regular IRAs, but the timing of the revenue losses differs. Backloaded IRAs have very little cost initially because the taxpayer receives no up-front tax deduction on the amount put into the IRA. Over time, however, the costs mount. The total amount of funds in backloaded IRAs increases as the years pass, and as a result, the interest earned on a growing share of the personal savings in the United States becomes exempt from taxation. The backloading intentionally shifts the bulk of the revenue loss to a period not covered by the budget rules requiring deficit neutrality to be maintained over the next five years.

In addition to being backloaded, the Contract's ADSA proposal also has another key feature, known as a rollover provision. This provision also helps turn the proposal from a revenue-loser to a revenue-gainer over the first five years. Under the rollover option, a taxpayer who currently holds a regular IRA would be allowed — for the two years after the ADSA provisions are enacted — to withdraw funds in current IRA accounts free of penalty, pay taxes on the withdrawn funds (the tax payments would be spread over the subsequent four years), and deposit the withdrawn funds into a new, backloaded ADSA. The funds transferred to the ADSA would be tax-free in perpetuity so long as the deposit remained in the account for at least five years.

The rollover provision is expressly designed to induce taxpayers with existing IRAs to roll them over and pay tax now rather than paying tax after they retire. The taxes collected now as a result of this provision are then used to offset the revenue losses from the ADSA proposal over the next five years and to help turn the proposal from a revenue-loser to revenue-gainer during the five-year budget period. After the five-year budget period ends, however, so does the one-time infusion of revenues from the rollover provision.

Moreover, the rollover provision causes revenue collections to be substantially lower after the five-year period ends than otherwise would be the case. The rollover device does not raise any new revenue; the revenue it brings in during the next five years is revenue that would have been collected in subsequent years when IRA account-holders retired. The rollover simply shifts the timing of the revenue collection.

The rollover provision is likely to be attractive to taxpayers who hold existing IRAs, because the new ADSAs provide a vehicle for tax-advantaged savings for a variety of purposes. Under current law, funds in an IRA must remain on deposit until the taxpayer reaches age 59½. A taxpayer younger than age 59½ who withdraws funds from an IRA must pay a penalty in addition to the taxes due on the withdrawn amounts. By contrast, once funds have remained in an ADSA for five years, they may be withdrawn without penalty for a variety of qualifying purposes. The qualifying purposes include first-time home purchases; higher education expenses for the taxpayer or the taxpayer's spouse, children or grandchildren; and a variety of medical expenses, including the purchase of insurance for long-term care. Given the choice, some taxpayers will want to rollover their accounts, thereby gaining the option to use their tax-advantaged savings before retirement.

The combined effect of the backloading and rollover provisions is simultaneously to push most of the revenue losses caused by the ADSAs outside the five-year budget window, while accelerating into the five-year budget period billions of dollars in revenue collections that normally would occur later. This is what allows proponents to claim that an expensive tax cut raises almost $5 billion during the five-year budget period.

The timing of revenue gains and loses is not accidental, nor was the concept of backloaded IRAs and the rollover device invented by the authors of the Contract. These devices were developed by both Democratic and Republican members of Congress in the early 1990s for one purpose only — to circumvent the pay-as-you-go requirements of the 1990 Budget Enforcement Act by artificially making most of the costs of the IRA expansion disappear during the five-year budget period.

Thus, the ADSA provision portrayed by the Contract authors as a revenue-raiser is actually a large revenue loser after the five-year budget period ends. Past analyses have found the long-run annual costs of similar IRA proposals to be five times as large as their costs in their fifth year. That suggests this provision could add $50 billion to the federal deficit over subsequent five-year periods.[2]

While IRA type proposals are extremely costly, there is little or no evidence that such provisions benefit the economy through increasing the rate of savings. For example, a 1991 report of the Republican staff of the House Committee on the Budget found that "most evidence suggests that savings is unresponsive to any tax incentives designed to increase it....Even the most optimistic estimates of the responsiveness of savings to taxes are too low to support the argument that such incentives significantly boost savings and growth.[3] Because IRAs are likely to swell the long-term budget deficit by an amount that would be greater than any likely increase in savings, another report concluded that IRAs are likely to slow long-term economic growth.[4] (See box on pages 12-13.) In other words, if the ballooning revenue loss of the contract ADSA proposal outside of the five-year budget period were not offset by increases in other taxes or cuts in spending, economic growth could be impeded.

Taxation of Capital Gains

The Contract also includes proposals to cut the capital gains tax, which is the income tax paid on profits from the sale of assets such as stocks, bonds, art, and rare coins. The Contract proposals affecting the capital gains tax paid by individuals would allow investors to lower the tax paid on profits in two ways. First, taxpayers could exclude from taxation the portion of profits that is attributable to inflation. In addition, half of the inflation-adjusted profits would be excluded from taxation. The combination of these two provisions would sharply lower the effective rate at which most capital gains, or profits, are taxed. Although very high-income taxpayers pay a marginal tax rate of 39.6 percent on other types of income, these taxpayers would face a maximum rate of 19.8 percent on capital gains income — and lesser rates after adjustment for inflation. At no time since 1954, has the maximum marginal tax rate that high-income taxpayers pay on capital gains been this low. (See box on page 10.)

By combining a 50 percent exclusion with an adjustment for inflation, the Contract goes beyond the major capital gains proposals advanced over the past several years. The capital gains cuts offered by President Bush in 1991 and 1992, for example,

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[2] Jane G. Gravelle, Congressional Research Service, *Statement before the Committee on the Budget*, U.S. House of Representatives, February 11, 1992.

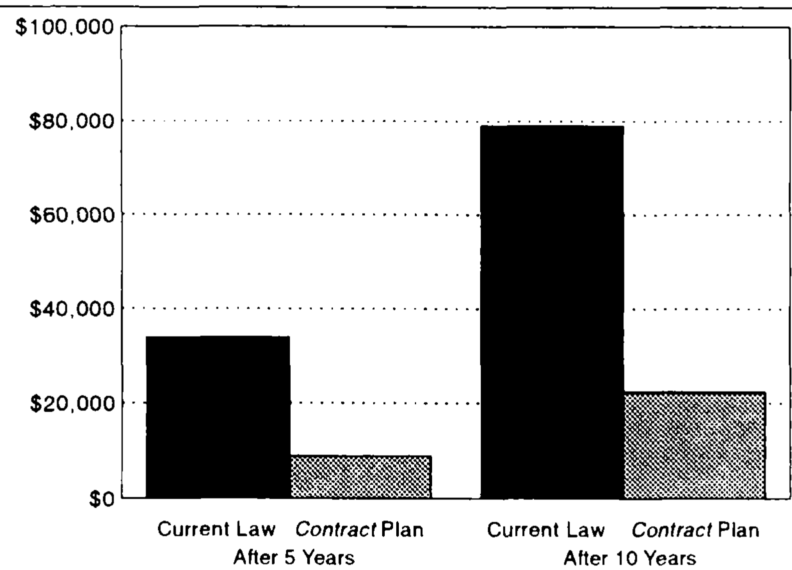
[3] House Committee on the Budget, Republican Staff Report, *Tax Incentives, Growth and Deficit Reduction, Budget and Economic Analysis*, Volume I, Number 3, November 6, 1991.

[4] House Committee on the Budget, Republican Staff Report, *The Truth About IRAs*, Volume 1, Number 4, November 22, 1991.

called for exclusions that varied based on the length of time an asset was held. The maximum exclusion proposed by President Bush was 45 percent, and his proposals did *not* couple the exclusion with an adjustment for inflation. Other bills have included inflation indexing (i.e., adjusting for inflation), but not coupled with an across-the-board exclusion as high as 50 percent. Through the combination of an exclusion and inflation indexing, the Contract would allow a substantial majority of capital gains income to escape any taxation.[5] This would provide a generous tax break to high income individuals who, as explained below, receive the bulk of capital gains income.

Figure 1

Amount of Capital Gain Subject to Tax: Current Law Compared to *Contract* Plan



Center on Budget and Policy Priorities calculations
Assumes $100,000 purchase price, 3% inflation and 3% real growth in the asset's value

Consider, for example, an investor who purchases $100,000 worth of stock. Figure 1 shows that the portion of the gain that is subject to taxation would be reduced sharply. Assuming an average of three percent inflation and three percent real growth in the value of the stock, the figure shows that if the stock were sold after five years the investor would pay tax on a $33,820 capital gain under current law. Under the Contract proposal, the taxpayer would pay tax on only $8,950. The amount of gain

[5] The Contract plan proposes additional capital gains tax benefits as well, including reductions in the capital gains tax for businesses and reductions for individuals who sustain a loss from the sale or exchange of a principle residence.

which escapes taxation grows if the stock is held 10 years and then sold. Under current law, the investor would pay tax at that point on a $79,085 gain. Under the Contract, only $22,350 of the gain would be subject to taxation.

This translates into very substantial tax cuts. Assuming again a $100,000 stock purchase, average annual inflation of three percent, and real annual growth of three percent in the stock's value, an investor in the top income tax bracket who sold the stock after five years would pay $6,000 less in income tax under the Contract than under current law.

After 10 years, the investor would realize a tax benefit worth nearly $13,300. By 20 years the benefit of the Contract capital gains tax changes to this investor would jump to about $34,000. If the average inflation rate exceeded three percent, the tax benefits would be even greater.

Table 1
The *Contract* Capital Gains
Tax Benefits Grow Sharply Over Time

	Selling Price	Tax Under Current Law	Tax Under Contract Proposals	Tax Savings
Initial Investment	$100,000			
Year 1	$106,000	$1,680	$590	$1,090
Year 5	$133,800	$9,470	$3,540	$5,930
Year 10	$179,100	$22,140	$8,850	$13,290
Year 15	$239,700	$39,100	$16,600	$22,500
Year 20	$320,700	$61,800	$27,740	$34,060

Center on Budget and Policy Priorities calculations
Assumes three percent annual inflation and three percent annual real growth. Rows may not add due to rounding.

Capital Gains Already Receive Favored Tax Treatment

Capital gains are already granted favored treatment under the tax code. An estimated three-quarters of all capital gains escape taxation altogether because the gain that accrues during the lifetime of an investor is not taxed if the asset is held until death.[6] This provides substantial unearned benefits to heirs of mostly wealthy asset-holders.

In addition, unlike income from interest on savings accounts — which is taxed each year regardless of whether the investor withdraws the interest — capital gains are not taxed until the asset is sold. This deferral of tax favors those who invest in stocks and bonds over those who put their (usually much smaller) capital into savings accounts.

Finally, if the capital gain is taxed, current law already provides the equivalent of a 30 percent exclusion for very-high-income investors. Under current law, capital gains income is subject to a maximum tax rate of 28 percent — which is just over 70 percent of the 39.6 percent top marginal tax rate applied to other income. The nontaxation of capital gains at death and the lower maximum rate under current law will cost the Treasury an estimated $94.2 billion between 1994 and 1998.[7] The Contract proposals would add substantially to that cost.

Proposed Capital Gains Rate Lowest in Four Decades

Although capital gains income has enjoyed preferential tax treatment through much of the past four decades, at no time during that period was the maximum effective marginal tax rate — including reductions in the effective rate that resulted from excluding a portion of capital gains from taxation — as low as it would be under the provisions of the Contract. From 1954 through 1967, capital gains income was subject to a maximum effective rate of 25 percent. Maximum tax rates on gains then rose gradually, and in 1976 and 1977 reached 49.1 percent for some taxpayers and 35 percent for other taxpayers. The maximum rate of taxation then declined to 20 percent by 1982 but was increased to 28 percent in 1987, where it remains today. The Contract proposes lowering the maximum rate to 19.8 percent by allowing half of all gains to be excluded from tax. Moreover, while in the past most capital gains income has been taxed at the maximum rate, the indexing provisions of the Contract would insure that almost all gains are taxed at rates *below* the 19.8 percent maximum rate.

Potential for Investment Bias May be Costly

Despite the fact that various forms of preferential treatment for capital gains have been in place since the 1960s, preferential treatment of capital gains has *not* been shown to stimulate savings or investment. This is largely because most transactions that yield capital gains involve sales of stock between investors. These sales may result in profit for the individual making the sale, but they do not necessarily result in new investment in plant or equipment. In a 1990 study, the Congressional Budget Office found that "cutting taxes on capital gains is not likely to increase saving, investment,

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[6] Henry L. Aaron, *Statement before the Committee on Finance*, U.S. Senate, March 28, 1990.

[7] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1994 - 1998*, April 22, 1993.

and GNP much if at all," a finding supported by a broad range of tax experts (See box on next page.)

While savings and investment are not likely to be stimulated significantly by capital gains tax advantages, capital gains tax cuts are likely to give rise to economic distortions and investment inefficiencies. A reduced tax on capital gains would cause investors to divert capital to projects that yield capital gains income and away from projects that would produce ordinary business income, because ordinary business income is taxed at a much higher corporate or partnership rate. Rather than encouraging productive new investments, capital gains tax relief turns investors' attention to maximizing tax advantages.[8]

The potential for economic distortion would be particularly strong under the capital gains provisions of the Contract plan, since the Contract combines a 50 percent capital gains exclusion with inflation indexing. When profits from asset sales are indexed but borrowing costs are not adjusted for inflation, an imbalance is created. Taxpayers who purchase assets with borrowed funds would receive a much larger tax break than taxpayers who use other types of funds to purchase assets.

It is common for high-income investors to borrow substantial amounts of funds with which to make large investments. Consider such an investor who borrows $100,000 to be repaid over ten years at an eight percent rate of interest and uses those funds to purchase $100,000 worth of stock. Over the lifetime of the loan, the investor's interest payments on the loan will total approximately $45,000. Current law permits the full amount of these interest payments to be taken as deductions from taxable income.[9]

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[8] One analysis finds that after capital gains taxes were cut and other tax write-offs greatly expanded in 1978 and 1981, investment shifted from productive uses like industrial plant and equipment and into a variety of tax shelters, most notably for commercial real estate. From 1981 to 1986, real investment in commercial real estate climbed at an unusually high annual rate of 6.3 percent, while industrial investment *fell* 2.7 percent a year. After the capital gains differential was removed and tax sheltering opportunities severely narrowed in the 1986 Tax Reform Act, the situation reversed; industrial investment rose 6.3 percent a year between 1986 and 1989. See Robert McIntyre, *Republican and Democratic Tax Plans*, Citizens for Tax Justice, Nov. 27, 1991.

[9] Although "consumer interest" (such as interest on car loans) may not be deducted from taxable income, "investment interest" may be deducted so long as it does not exceed the amount of investment income reported in the year. If the investment in the example were the only investment the taxpayer had, then the interest on the loan would not be deductible each year because there would be no reported investment income until the stock was sold. By contrast, if the taxpayer had investment income each year from a large portfolio of investments, he or she likely would have had sufficient investment income against which to deduct the yearly investment interest.

Capital Gains and IRA Tax Relief
Does Little to Promote Savings, Investment or Growth

An impressive array of tax experts has concluded that tax-advantaged IRAs and cuts in the tax on capital gains income are likely to do little to promote savings and investment. In 1991, the Republican staff of the House Committee on the Budget, under the direction of Representative Bill Gradison, then the Committee's ranking Republican, issued a report examining the relationship between tax incentives — including capital gains tax cuts and IRA expansions — and savings and investment. It found that:

> (M)ost evidence suggests that saving is unresponsive to any tax incentives designed to increase it. And capital gains tax cuts and IRAs only affect a small part of saving. Even the most optimistic estimates of the responsiveness of saving to taxes are too low to support the argument that such incentives significantly boost saving and growth.[1]

The House Budget Committee Republican staff also took a close look in 1991 at IRA proposals, including proposals similar to that contained in the Contract. In a report on IRAs, the Republican staff explained that to increase the pool of savings available for investment, an IRA proposal must increase private savings by more than it adds to the federal budget deficit. Otherwise, any additional private savings that are generated will have to be used to soak up the increase in the deficit. But while IRAs are likely to add to the long-term deficit, they cannot be expected to generate a large increase in private savings, the report added; as the Congressional Budget Office has noted, "studies of savings behavior generally have not found that people save significantly more in response to higher after-tax returns. " Thus, the Republican staff report concluded that any increase in savings would likely be smaller than the increase in the long-term deficit and that "IRAs are likely to slow long-term economic growth through their effects on the deficit."[3]

Others have examined proposals to cut capital gains taxes and concluded that here, also, the economic benefits touted by supporters of these proposals are dubious. For example, Herbert Stein, Senior Fellow at the American Enterprise Institute and chair of the Council of Economic Advisors under President Nixon, has written that capital gains tax cuts are not likely to promote savings but will result in inefficiencies and tax-avoidance schemes:

> Unless cutting the capital gains tax increases the rate of saving, it will only divert investments to projects that can be structured to yield capital gains away from projects that cannot. I see no reason to want such a diversion. On the question whether cutting the capital gains tax would increase saving you can get as many different answers as you can find econometricians. My own view is that the effect would be extremely small, and not worth betting on. In any case, if there is a strong desire to try to increase saving and investment by increasing the after-tax return to

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[1] House Committee on the Budget, Republican Staff Report, *Tax Incentives, Growth and Deficit Reduction, Budget and Economic Analysis*, Volume I, Number 3, November 6, 1991.

[2] Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 1992*, March 1991, p. 45.

[3] House Committee on the Budget, Republican Staff Report, *The Truth About IRAs*, Volume 1, Number 4, November 22, 1991.

investment there are, in my opinion, better ways to do that. I think that the only economic consequence we can confidently expect from reducing the capital gains tax is increased activity by lawyers and accountants in converting other income into capital gains.[4]

These views are shared by Henry Aaron, director of economic studies at The Brookings Institution and one of the nation's leading tax experts. Aaron has stated that "tax concessions on capital gains are a remarkably inefficient method of encouraging current real investment."[5] Similarly, Jane Gravelle, a leading tax expert at the Congressional Research Service, observed in testimony in 1992 that capital gains tax cuts cannot be expected to stimulate investment or growth and that their effect on the nation's economic output would likely be negligible.[6]

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[4] *Summary of the Statement of Herbert Stein*, Senior Fellow, American Enterprise Institute, to the House Ways and Means Committee, December 17, 1991.

[5] Henry L. Aaron, *Proposals to Expand a Part of Capital Gains from Taxable Income*, March 28, 1990. See also Henry L. Aaron," *The Capital Gains Tax Cut, Economic Panacea or Just Plan Snakeoil?," The Brookings Review"*, Summer, 1992.

[6] Jane G. Gravelle, Congressional Research Services, *Statement before the Committee on the Budget*, U.S. House of Representatives, February 11, 1992.

The interest payments, however, may be viewed as having two components — a component that compensates the lender for inflation over the period of the loan and a component that represents the amount paid for the privilege of borrowing funds. Only that portion of the interest payment that exceeds the inflation rate represents the real cost of borrowing. In this case, assuming a three percent inflation rate, approximately $17,000 of the total interest paid represents the inflation component; only $28,000 represents the real cost of the loan to this investor. Nevertheless, the investor will have taken $45,000 in tax deductions for interest payments over the life of the loan — deducting $17,000 beyond the real cost of the loan.

Under current law, the ability of the investor to deduct the full amount of interest paid is balanced by the way in which tax is assessed when the assets that were purchased with the borrowed funds are sold. When the investor sells the stock, current law requires that a tax is paid on the full capital gain and not just on the amount of the gain that exceeds inflation. If, as in the example given above, the investor sells the stock for approximately $79,000 more than the price paid ten years earlier (assuming a three percent inflation rate and three percent real growth), capital gains tax will be due on the entire $79,000 — with no downward adjustment to take inflation into account.

Under the Contract proposal, however, the symmetry disappears. In determining how much capital gains tax is due, this investor will be able to adjust the $79,000 profit downward by approximately $34,300 to account for inflation. The tax on capital gains will be lowered substantially even though the investor will have deducted the *full* amount of interest paid over the life of the loan — with no adjustment downward to reflect the inflation component of the interest payments.

In addition to applying the inflation adjustment to the capital gain, the investor will be able to exclude 50 percent of the inflation-adjusted gain. As a result, only about $22,350 of the $79,000 would be subject to tax as a capital gain. But an amount exceeding that $22,350 has already been taken by the investor as interest deductions during the period the stock was held. Since the $45,000 of interest the investor deducted over the life of the loan far exceeds the $22,350 capital gain subject to tax, the investor has a negative rate of tax on this investment.

Under the Contract, it is likely that there would be no net taxes on the profits from the investment made with borrowed funds. In addition, since the interest deductions often would exceed the amount of capital gain subject to tax, those deductions could offset taxes on profits from other investments made with non-borrowed funds.

The unequal treatment of the inflation component of interest payments and the inflation component of investment profits would create a considerable windfall for investors. It also would encourage excessive borrowing and distort investment decisions by allowing investors to realize higher rates of returns on otherwise less attractive investments — as long as the investment is accomplished with borrowed funds. Since, by and large, moderate income investors invest savings rather than borrowed funds and only wealthy individuals have access to substantial amounts of borrowed funds, the windfall created by the Contract's indexing proposal predominantly benefits upper-income investors.

Cost of Capital Gains Proposals Grow Over Time

The Contract capital gains proposals would substantially increase the cost of capital gains preferences. Contract sponsors estimate the cost of the capital gains proposals to be $56 billion over five years. But this estimate likely understates long-term costs.

For a short period of time, a capital gains tax cut can have a modest cost — or can even increase federal revenues — as investors decide to sell assets sooner than they otherwise might have to take advantage of a new provision, such as the proposal to exclude 50 percent of capital gains profits from taxation. Under a 50 percent exclusion, the maximum 19.8 percent tax rate would be the lowest rate of taxation on such income in the past 40 years. As a consequence, investors are likely to assume the rate might be raised again in the future and be anxious to avail themselves now of the tax break.

The surge in revenues that would result from these transactions, however, will be short-lived. Once the sale of assets stabilizes, the cost of the lower rate of tax on capital gains profits will increase rapidly — both because some of the sales that would have produced future revenues will have already occurred and because the tax per transaction will be cut by more than half as a result of the 50 percent exclusion and indexing.

When the Joint Committee on Taxation analyzed President Bush's more modest 1992 proposal for a maximum 45 percent capital gains exclusion, it found the proposal would lose $27 billion over a six-year period, or an average of almost $4.5 billion per year. But the year-by-year trend in revenue gains or losses also told another story — the Joint Committee found an accelerating revenue loss. Revenues would increase by $3.2 billion during the first two years and then decrease by $30.3 billion over the following four years. By the sixth year, the annual revenue loss would have been more than twice the average annual loss for the six-year period as a whole. This pattern demonstrates that the revenue losses from capital gains tax cut proposals like those included in the Contract are likely to accelerate sharply over subsequent periods.

Inflation indexing makes the potential for high revenue losses in later years even greater because it removes an ever-increasing amount of capital gains from the tax base. The Joint Committee on Taxation reviewed an indexing proposal by Representative Gingrich in 1991 and found it had a relatively small cost — a total of $700 million — in the first three years of implementation, but a much larger cost — $2.6 billion — in the fifth year. Taking this estimate a step further, a recent study by Jane Gravelle of the Congressional Research Service suggests that the cost of capital gains

State Revenues Would Also Be Reduced

The capital gains and IRA proposals would in many cases reduce *state* as well as federal taxes on individuals with higher incomes. This is because 36 states and the District of Columbia incorporate the federal definition of adjusted gross income (AGI) in their tax codes.

For instance, if a percentage of capital gains were excluded from the definition of AGI, the excluded gains would not be considered income in many states. Similarly, if expanded eligibility for the new type of IRA accounts sheltered interest income from federal taxation, taxable income also would decline in most states.

In addition, the tax codes of 14 states conform to the federal treatment of Social Security benefits. These states' revenues would drop as a result of the Contract's proposal to reduce the proportion of Social Security benefits subject to taxation.

If these Contract provisions were adopted, states could lose billions of dollars in revenue in coming years and could face the same problem the federal government is likely to experience of exploding revenue losses after the year 2000. To offset this revenue loss, states would likely be forced to cut programs, raise taxes, or do both. State spending cuts typically affect low- and moderate-income families the most, while tax increases in most states also are likely to affect low- and middle-income taxpayers disproportionately. Those benefiting the least from the new state tax cuts that would result from federal approval of the Contract proposals likely would be those most adversely affected by the actions states would take to offset the impact on state budgets.

indexing in the fifth year represents about 30 percent of the annual cost that can be expected when losses stabilize.[10] Applying Gravelle's calculations to the Joint Committee estimate of the 1991 Gingrich indexing proposal suggests the eventual cost of indexing could be at least $40 billion over five years.

Moreover, the Contract proposal will be more costly than the 1991 Gingrich proposal because the earlier Gingrich indexing proposal applied only to assets purchased after the effective date of the legislation. By contrast, the Contract would allow indexing of *all assets* sold after the last day of 1994, including those purchased years ago.[11] This would greatly expand the universe of assets subject to indexing.

Consistent with these earlier analyses, preliminary estimates by the Joint Committee on Taxation of the revenue effects of the Contract capital gains proposals project very large long-term revenue losses. The Joint Committee estimates the 10-year cost of the Contract's proposals for reducing the taxation of capital gains for individuals and corporations at $208 billion.

Like the estimates of prior, more modest capital gains tax cut proposals, the new JCT estimates of the Contract proposals demonstrate the accelerating nature of the revenue loss. The 50 percent capital gains tax exclusion for individuals is projected by the Joint Committee on Taxation to cost $26.3 billion over the initial five-year period, mushrooming to a $79.1 billion loss in the following five years. Indexing would cost $7.7 billion in the first five years, and the cost would grow to $40 billion in the second five years.[12] The average annual revenue loss from the 50 percent exclusion would be three times greater in the second five-year period than in the first five-year period. The growth in the average annual loss from indexing is even more pronounced; in the second five years, the average annual cost of indexing would be more than five times as much as the average yearly cost in the first five-year period. (See Figure 2.)

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[10] Jane G. Gravelle, "*Estimating Long-Run Revenue Effects of Tax Law Changes*," *Eastern Economic Journal*, Vol. 19, No. 4, Fall 1993. Gravelle's analysis uses the historic average of five percent inflation and three percent real growth and calculates that the losses grow over time and then stabilize after 18 years.

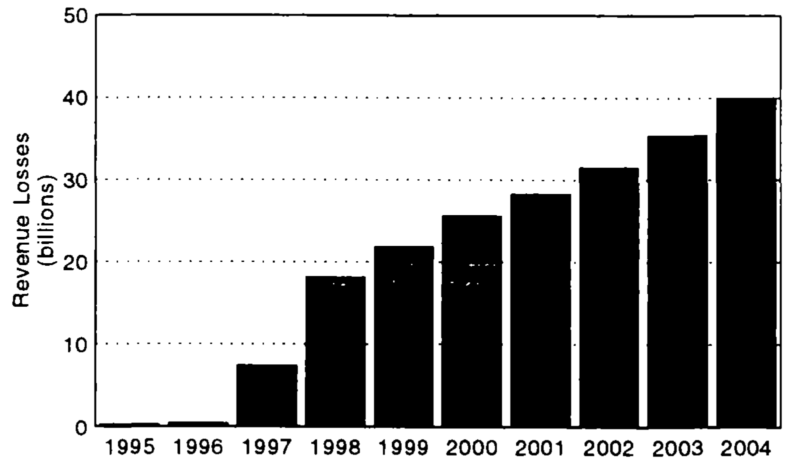
[11] For assets purchased before the end of 1994, the inflation adjustment would be calculated beginning with the calendar quarter ending December 31, 1994.

[12] These are estimates of the revenue losses attributable to the capital gains cuts proposed for individuals. Additional 10-year revenue losses of $14.8 billion would result from extending the 50 percent exclusion to corporations and a $21.3 billion loss would result from applying the indexing proposal to assets held by corporations. The losses resulting from the individual and corporate tax cuts do not sum to the total because the JCT includes an "interaction effect." The Joint Committee estimates the total cost of the Contract capital gains proposal at $47.4 billion in the first five years and $160.7 billion in the second five years. Joint Committee on Taxation, *Estimated Revenue Effects of Capital Gains Tax Reduction*, October 6, 1994. The Joint Committee on Taxation characterizes these estimates as "very preliminary."

Figure 2

The Cost of the *Contract* Capital Gains Proposals Grows Sharply Over Time

(Fiscal Years 1995-2004)



Source: Joint Committee on Taxation, *Estimated Revenue Effects of Capital Gains Tax Reduction*, October 6, 1994. The JCT estimate considers revenue changes that would result from the individual and the corporate capital gains tax changes proposed by the Contract.

The "Neutral Cost Recovery System"

The Contract also proposes some complex changes in depreciation allowances. Depreciation is the way that businesses account for the use of capital investments such as buildings, machinery and equipment in the production of business income. The proposed changes would increase the amount that businesses can deduct over the useful life of an investment.

In determining their taxable income, businesses are permitted to deduct the cost of capital investments such as buildings, machinery, and equipment. Since these items typically have a useful life of a number of years, their cost is deducted as the asset *depreciates* or wears out. For financial accounting purposes, the cost of machinery and equipment is deducted in equal amounts each year of its expected life. Current tax law, by contrast, allows businesses to deduct the cost of capital investments faster than it wears out, using a system known as "accelerated depreciation." Accelerated depreciation permits some acceleration of deductions into the early years of ownership, with smaller deductions in subsequent years. Total deductions for depreciation, however, are limited to the value of the initial investment. Compared to depreciation of assets in equal increments over their useful life, current-law accelerated depreciation is estimated to save businesses more than $100 billion over the next five years.[13]

The "neutral cost recovery system" (NCRS) proposed in the Contract would provide more generous depreciation deductions than current law. NCRS would both allow businesses to continue to use a form of accelerated depreciation *and* allow businesses to adjust the amount of their depreciation deduction upward each year by a percentage that exceeds the rate of inflation. Total deductions would *not* be limited to the initial investment and would exceed the amount of the original investment by a substantial amount in most cases.

Consider the case of equipment purchased for $10,000 and expected to last for 10 years. Under a straight-line depreciation schedule used for normal accounting purposes, the business could deduct $1,000 a year for 10 years. Under current-law accelerated depreciation provisions, more than half of the value of the asset may be deducted in the first four years, but lesser amounts are deducted in subsequent years, so total depreciation deductions over the 10 years also equal $10,000. If the NCRS tax break were in effect, however, the business could inflate the purchase price each year by the rate of inflation plus another 3.5 percent. (The 3.5 percent bonus over the rate of inflation is a number specified in the proposed law. It would not vary with the rate of inflation or economic circumstances.)[14] If the inflation rate were a modest three percent, the business could deduct $13,500 over the 10-year period — 35 percent more than under current law as a result of the NCRS adjustments. If the inflation rate were five percent, the business would be able to deduct 50 percent more over the life of the asset.

For buildings or equipment expected to last longer than 10 years, the difference between current law deductions and the NCRS system would grow dramatically as a result of the compounding of inflation plus 3.5 percent. Assuming a modest three percent rate of inflation, a business that purchased a $100,000 building or piece of equipment expected to last 20 years could deduct $196,000 over 20 years, while a $100,000 purchase expected to last 30 years would yield $290,000 in tax deductions. As noted above, at present no more than $100,000 could be deducted. (See Figure 3.)

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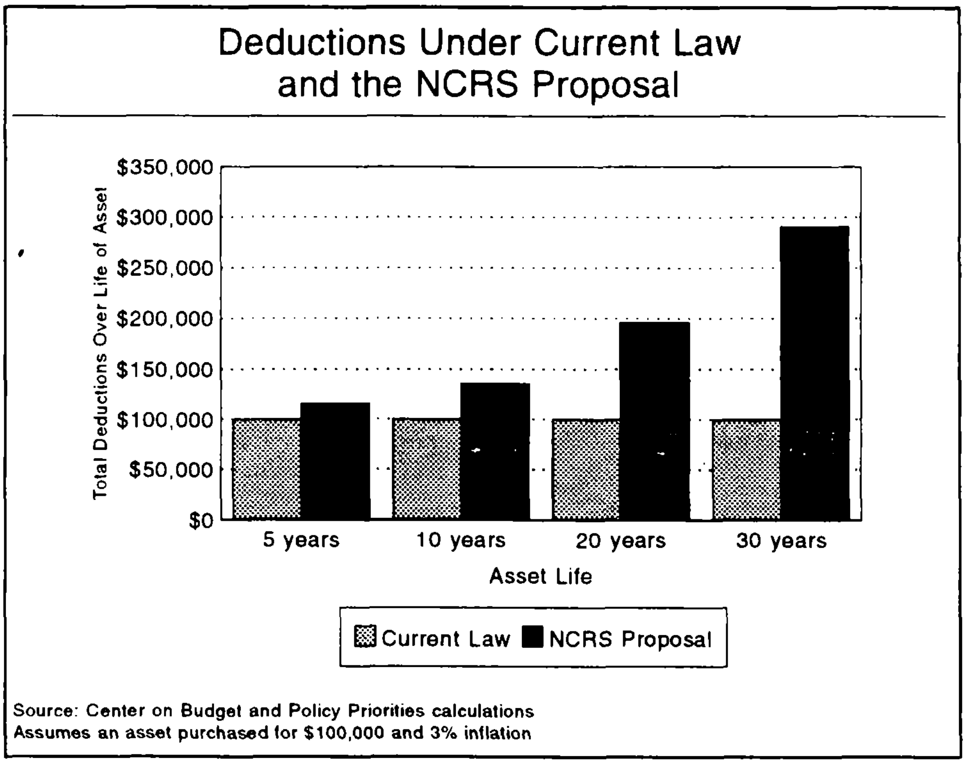
[13] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1994-1998*, April 1993.

[14] The 3.5 percent factor is intended to make the depreciation deductions over the life of the asset equivalent to deducting the entire cost of the asset in the year it is purchased. The inflation plus 3.5 percent adjustment in effect pays interest to the business for delaying depreciation deductions beyond the year of purchase.

Figure 3



Despite the large increase in permitted deductions, the Contract lists the proposed depreciation changes as *raising* $20 billion over the next five years. This large tax cut can raise revenue in the near term because the proposal changes the timing of deductions for shorter-lived assets. For assets that may be depreciated over 10 or fewer years, the degree of permitted acceleration of deductions would be reduced from what is known as the "200-percent declining balance" method to a "150-percent declining balance" method. The 150-percent method currently is used for longer-lived assets. Therefore, while the total amount of allowed depreciation deductions would be greater under NCRS than under current law, for shorter-lived assets the amount of deductions permitted in the first few years would be less than under current law. Since only new assets would be eligible for NCRS, and since shorter-lived assets such as vehicles and computers wear out and are replaced more frequently than longer-lived assets, these short-lived assets will make up the bulk of assets eligible for NCRS in the first few years after implementation.

As longer-lived assets are slowly replaced and depreciated under the compound growth path of NCRS, however, overall depreciation deductions would rise sharply. The cost of NCRS would rise steadily beyond the five-year period. An analysis by the Congressional Research Service of an earlier, identical NCRS proposal found that the proposal could increase the taxable income of business by $87 billion in the first five calendar years, but in the long run, after all assets came under the new system, the proposal would reduce taxable income by $984 billion over a five-year period — an amount in the opposite direction that is 11 times as large. The report notes that with effects this large, it is very difficult to predict changes in tax liability or revenues, since for some firms the depreciation deductions would exceed the taxable income that could be offset by the deductions. But there is little question the long-term revenue loss would be quite substantial.[15]

A Joint Committee on Taxation estimate of a 1991 depreciation proposal gives some indication of the revenue impact beyond the five-year budget period. The proposal that was analyzed included the adjustment of deductions for inflation plus 3.5 percent, but did not include the change in the accelerated depreciation for short-lived assets — so the immediate cost of the proposal was not masked. The Joint Committee on Taxation estimated that proposal to cost $58 billion over its first five years.[16] The contract proposal is likely to cost at least that much in subsequent five-year periods.

Impact on Deficit Reduction

The revenue reductions in the Contract are estimated by its sponsors to cost more than $190 billion over the first five years. As discussed above, the cost in subsequent years is likely to be much greater. The cost of the IRA, capital gains, and depreciation proposals in the Contract, which are said to have a net cost of $31 billion in their first five years, could have combined cost in subsequent five-year periods of more than $260 billion — $50 billion for the new-style IRAs, $160 billion for the reduction in capital gains taxation, and $58 billion for the more generous depreciation allowances. If the costs of all other tax provisions in the Contract remained constant at $159 billion, the cost in subsequent five-year periods could exceed $400 billion.

The sponsors do not indicate how the majority of these cuts will be financed. Nevertheless, they call for a constitutional amendment requiring a balanced budget by the year 2002. According to the Congressional Budget Office, balancing the budget gradually over a five-year period would require spending cuts or tax increases totalling approximately $750 billion. Balancing the budget gradually over a seven-year period would require spending cuts or tax increases totalling approximately $1,200 billion. These spending cuts or tax increases would be in addition to those needed to pay for the revenue reductions proposed by the Contract.

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[15] Jane G. Gravelle, *Background Information on the Neutral Cost Recovery Proposal*, Congressional Research Service, March 8, 1994.

[16] Joint Committee on Taxation analysis of Kasten-Weber Tax Incentive Plan, 1991.

Substantial progress has been made in recent years in reducing the federal budget deficit, but that progress has required difficult tax increases and painful budget cuts. In its most recent analysis, the Congressional Budget Office projected that the 1995 deficit will be a smaller share of GDP — 2.3 percent — than in any year since 1979. As a result of the 1990 and 1993 budget reconciliation laws and recent economic growth, the deficit as a share of GDP will have been more than halved since 1992, when it stood at 4.9 percent. And despite the Clinton Administration's proposals to increase funding for various domestic programs identified as investment initiatives, total spending for domestic non-entitlement programs will — by fiscal year 1998 — constitute a *lower percentage of GDP than in any year since 1962.*[17]

Under current forecasts, just maintaining the progress that has been achieved will be difficult. In the absence of health care reform, further deficit reduction action will be required to keep health care costs from driving the deficit higher by the end of the decade. Maintaining or improving the progress on deficit reduction is important. Most economists believe the nation is now better prepared to tackle the challenges posed by a global economy and better able to invest in the future of our workers and businesses as a result of the lower deficit.

The Contract puts further progress in question. Over the next five years, potential budget savings would be devoted to paying for tax cuts, rather than continuing progress on deficit reduction. And outside the five-year budget window, the deficit likely would increase sharply unless massive cuts in domestic spending programs were made.

As noted above, the Contract does not specify how the bulk of the tax cuts would be offset with spending cuts or other tax revenues, either within the five-year budget horizon or beyond that period. The sponsors suggest, however, that the financing could include budget cuts along the lines of earlier proposals with which some of the sponsors have been associated. In particular, some sponsors have pointed to a budget plan developed in Spring 1994 by Representative John Kasich that contained substantial budget cuts.

But many of the budget cuts in that plan would prove extremely difficult to achieve as they would fall heavily on the middle class. Elderly Medicare beneficiaries with incomes above $11,000 a year for individuals and $15,000 a year for couples would pay significantly more for certain health care costs, large numbers of middle-income

[17] The 1990 and 1993 budget reconciliation acts set strict caps on discretionary (non-entitlement) spending though fiscal year 1998. To comply with these caps, the Clinton Administration's fiscal year 1995 budget eliminated or reduced spending for various programs considered to be low priorities in order to increase spending for the Administration's high-priority programs, such as crime control, infrastructure, Head Start, and national service.

students would have to make significantly higher payments for student loans, and support for school lunches for middle-income students would be eliminated. (These proposals are discussed in more detail in the next section.) Proposals similar to these have faced overwhelming bipartisan opposition in the past.

Moreover, cuts such as these would be only the tip of the iceberg. They would be tiny compared to the cuts that would be required to pay for the new tax cuts and balance the budget in years after 2000. If the budget gaps that would result had to be closed without raising taxes, cutting defense, or touching Social Security, areas that many Contract proponents have said should be immune from deficit reduction measures — the reductions in the rest of the budget and especially in entitlement programs that principally benefit the middle class would have to be massive. The benefits provided to millions of primarily middle-class Americans under programs such as Medicare, veterans programs benefits, student loans, and programs providing retirement benefit for civilian and military employees would face reductions of unprecedented severity. Otherwise, the numbers would not add up.

Impact on the Medicare Trust Fund

The Contract includes a provision that would lower the taxes of the highest-income 13 percent of Social Security beneficiaries, reversing changes made in the 1993 budget reconciliation act. In 1993, Congress increased the percentage of Social Security benefits subject to taxation from 50 percent to 85 percent for single taxpayers with annual incomes above $34,000 and for married couples with annual incomes above $44,000. This step was taken to improve the financial condition of the Medicare Trust Fund, reduce the deficit, and control the growth in entitlement costs.

The Contract proposes repealing these changes at a cost of $17 billion over five years. The repeal would be phased in gradually over the five-year period, so here, also, the cost in subsequent five-year periods would be somewhat higher — approximately $25 billion.[18]

Funds from the taxes collected as a result of the 1993 law are deposited directly in the Hospital Insurance (Medicare) Trust Fund. Repeal of the law thus would weaken the trust fund's financial condition.

The most recent report of the Social Security actuaries finds that the Medicare Trust Fund is out of long-term balance. Without changes to reduce Medicare costs or

[18] The 1993 law change was estimated by the Joint Committee on Taxation to raise $25 billion over five years.

increase the revenue flowing into the trust fund, the Medicare Trust Fund will be insolvent by 2001. This loss of tax revenue would push Medicare further out of balance. Offsetting actions, such as reductions in Medicare benefits or increases in taxes deposited in the trust fund, would be required as part of future efforts to avert insolvency.

Distribution of Costs and Benefits

Low- and middle-income households will receive little benefit from the expensive changes in IRA provisions and capital gains taxation proposed in the Contract. Middle-income taxpayers would stand to benefit from the child tax credit included in the Contract. At the same time, however, it is likely that a number of federal programs primarily benefitting middle-income households would ultimately have to be cut to compensate for the cost of the tax cuts, particularly beyond the five-year budget period. Overall, high-income taxpayers would reap large gains, while low-income households would lose ground. The effects on middle-income households are unclear. Middle-income households could face a loss in disposable income if benefits they receive are reduced by more than their taxes are cut.

Higher-Income Taxpayers

While proposals to expand IRAs are often described as middle-class tax cuts, they are, in fact, primarily tax breaks for the affluent. A Joint Tax Committee analysis of earlier IRA proposals found that the benefits from restoring universal full-IRA deductibility would accrue overwhelmingly to higher-income people, not to the middle class.[19]

- The top one-fifth of taxpayers would receive approximately 95 percent of the tax benefits from restoring universal eligibility for IRAs.

- The wealthiest five percent of taxpayers — those with incomes of at least $100,000 — would collect nearly one-third of the tax benefits.

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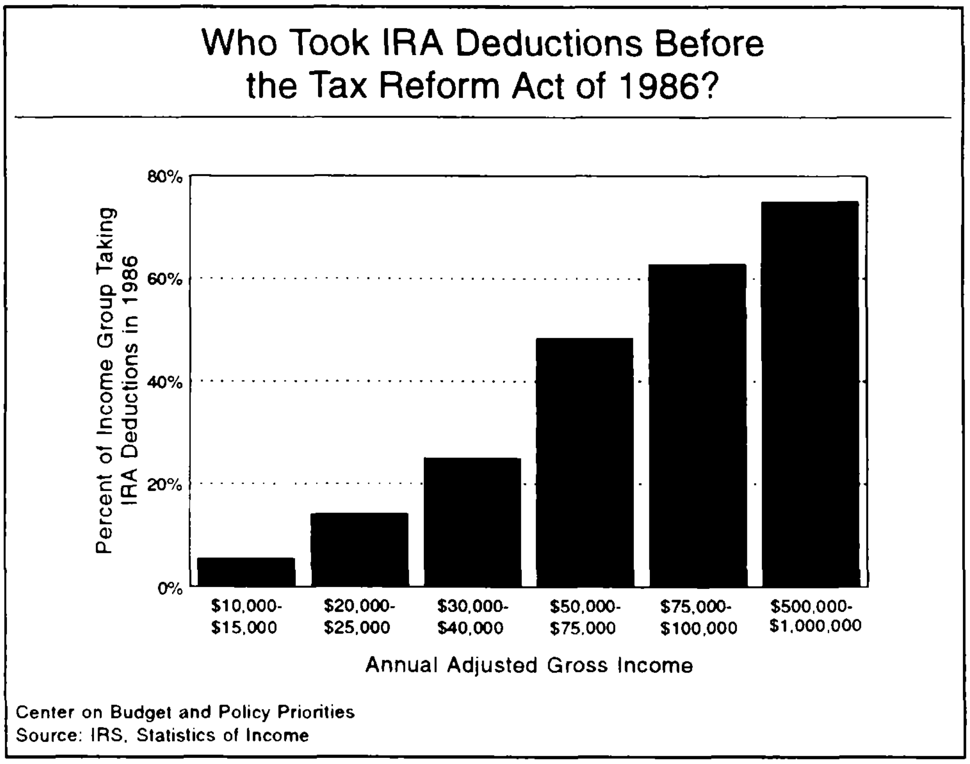
[19] These data are based on Joint Committee on Taxation estimates from 1989. The Joint Committee has not provided similar data since then. The data are based on 1990 income levels and tax laws and on a proposal to make IRA's only 50 percent deductible for taxpayers who lost deductibility under the Tax Reform Act of 1986. These estimates are likely to *understate* the share of benefits received by high-income taxpayers, because the 1993 budget reconciliation act raised the marginal tax rates on the highest-income Americans and therefore increased the tax benefits of IRA contributions for this group.

Several factors explain why the tax benefits of IRA expansion proposals are so skewed in this manner. First, most middle- and lower-income taxpayers are already eligible for IRA tax deductions. In 1995, more than 70 percent of taxpayers with earnings will be eligible for an up-front tax deduction for IRA contributions. Second, the higher a taxpayer's income level, the more likely the taxpayer is to have money to save and thus to use for IRA deductions. In 1986, the last year that IRA deductions were available to all taxpayers, 66 percent of the tax filers in the top four percent of the income scale made IRA contributions, but only 13 percent of those in the middle third of the income scale did. (See Figure 4.) Finally, the higher an individual's tax bracket, the greater the tax benefit derived from an IRA deduction. An IRA deduction is worth more than twice as much to high-income people in the 36 percent or 39.6 percent tax brackets — taxpayers with incomes over $115,000 — as it is to middle-income people in the 15 percent tax bracket.

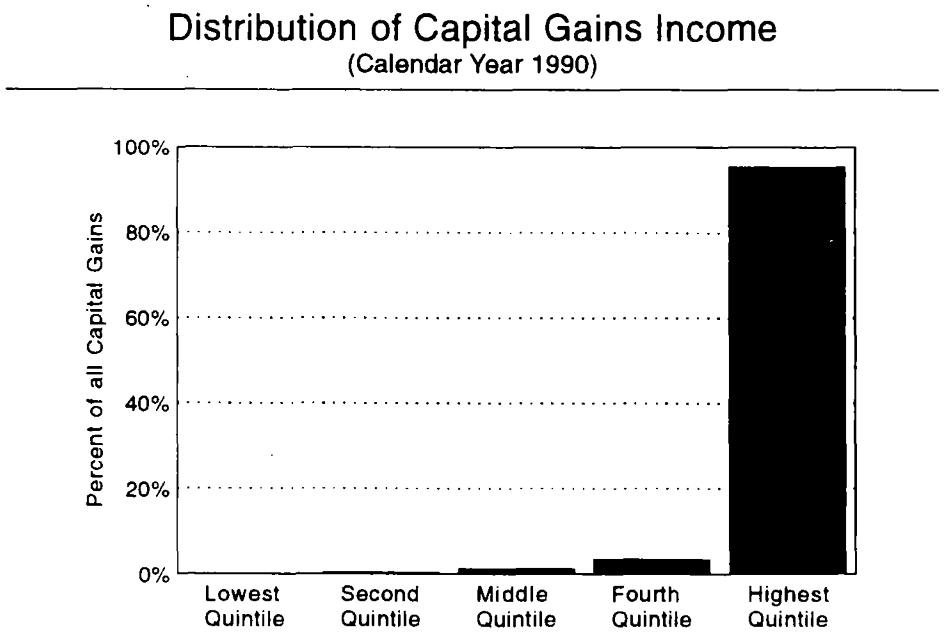
Figure 4



Capital gains tax relief is likely to accrue to an even smaller portion of taxpayers than would the benefits from expanded IRAs. Proposals to cut capital gains taxes benefit primarily the wealthiest Americans because the distribution of capital gains income is so highly skewed; higher-income households are far more likely to have investment income that can yield capital gains income than other households.

Moreover, among those who have capital gains income, the average amount of capital gains income received by high-income investors is much greater than the average amount realized by middle-income investors. (See Figure 5.)

Figure 5



Center on Budget and Policy Priorities
Source: Based on data prepared by CBO, Committee on Ways and Means, U.S. House of Representatives, *Overview of the Federal Tax System*, June 14, 1993, Part X, Table 14.

The Joint Committee on Taxation considered the distribution of the tax benefits that would have resulted from President Bush's 1992 capital gains proposal to allow a 45 percent exclusion of the gain realized on certain assets.[20] The Committee's data show the following distribution:

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[20] Joint Committee on Taxation estimates of the *Distributional Effects of the Administration's Capital Gains Proposal*, February 3, 1992. The proposal that was examined would have provided for a 45 percent exclusion from income of the gain realized on certain qualified assets. In placing households into various income categories, household income included adjusted gross income plus tax-exempt interest, employer contributions for health plans, inside buildup on life insurance, workers compensation, nontaxable social security benefits, deductible contributions to IRAs, minimum tax preferences, and net losses in excess of minimum tax preferences from passive business activities. Households include filers and nonfilers. Since the tax reduction reported assumes no change in taxpayer behavior, the Joint Committee's estimates understates the tax benefit received by certain taxpayers who alter behavior to maximize their gains.

- Less than four percent of households with incomes between $20,000 and $30,000 would receive any benefit from the tax cut, and their average benefit would be $180. Some seven percent of households with incomes between $30,000 and $40,000 would benefit from the tax cut, receiving an average benefit of about $300. Hardly any tax benefits would go to those with incomes under $20,000.

- By contrast, close to one-third of households with incomes between $100,000 and $200,000 would receive an average tax cut worth $1,250. And the 44 percent of households with incomes of $200,000 or more that report capital gains profits would receive an average benefit of $8,478.

- Looked at another way, 70 percent of the total benefit from the tax cut would go to households with incomes of $100,000 or more, who constituted the top five percent of households.

- And the top one percent of taxpayers — those with incomes of at least $200,000 — would capture more than half of the total tax benefits from the capital gains exclusion.

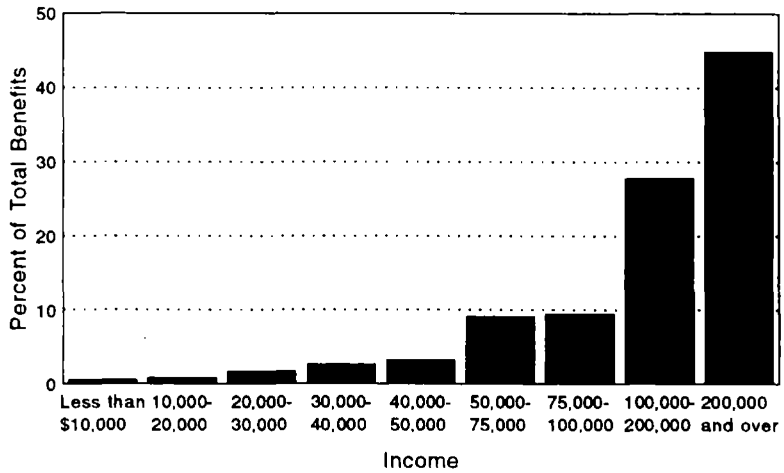
The distribution of tax benefits resulting from proposals to index capital gains for inflation is also tilted in favor of the wealthy. When the Joint Tax Committee analyzed an indexing proposal in 1992, it found that a little more than half the benefits would accrue to the wealthiest one percent of taxpayers — those with incomes $200,000 or more.[21]

The lopsided distribution of benefits is also apparent in the analysis the Joint Committee on Taxation recently conducted of the combined effect of the Contract's capital gains exclusion and indexing proposal. The Committee's data show that less than six percent of the total tax benefit would accrue to households with income under $40,000, while nearly 45 percent of the benefit would go to households with incomes over $200,000. Almost three-fourths of all the benefits would go to those with incomes of $100,000 or more. (See Figure 6.)

[21] Joint Committee on Taxation, *Distributional Effect of Indexing the Cost Basis of Certain Capital Assets*, February 18, 1992. The analysis assumes indexing is fully phased in, with annual inflation equal to the average rate assumed by the Congressional Budget Office for the 1992 - 1997 budget period. Income is adjusted gross income, plus the items noted in footnote 20.

Figure 6

Distribution of Benefits of *Contract* Capital Gains Proposals
(Calendar Year 1999)



Source: Joint Committee on Taxation, *Distribution of the Change in Federal Tax Liability Resulting From a Fifty Percent Exclusion and Indexation of Cost Basis*, October 6, 1994.

In short, wealthy individuals and families would be large winners under the Contract. If government benefit programs were reduced to help pay for the tax cuts, it would not be possible to recapture from those at high-income levels more than a small fraction of the value of the tax cuts they would obtain. The wealthiest households do not receive a large enough proportion of entitlement benefits for that to be done. Moreover, upper income households secure a smaller percentage of their income from government benefits than average families at middle- and lower-income levels do, and so would be affected the least by benefit reductions.

Middle-Income Families

In addition to the large tax reductions for upper-income households and corporations, the Contract proposes a children's tax credit. Under this proposal, a $500 tax credit would be allowed for each child in families with adjusted gross income up to $200,000 a year. The credit would gradually phase out for families with incomes between $200,000 and $250,000; families with incomes exceeding $250,000 would be ineligible for the credit.

The children's credit would immediately benefit many middle-income families. For families with federal income tax liability, the credit would result in a reduction in taxes. And in limited circumstances, the credit would be refundable for some moderate-income families with insufficient tax liability to utilize the entire credit as an offset to taxes owed.[22]

Whether middle-income families are better off under the Contract in the long-term, however, would depend on how the costs of the tax cuts are financed, especially in future years when the costs of the tax cuts that primarily benefit upper-income households and corporations would grow rapidly.

If the budget gaps that resulted from the need to pay for the new tax cuts and balance the budget in years after 2002 had to be closed without raising taxes, cutting defense, or cutting Social Security, the reductions in the rest of the budget would have to be extremely large. As noted above, the benefits provided to middle-class Americans under programs such as Medicare, veterans benefits, farm programs, student loans, and retirement benefits for current civilian and military employees would likely face reductions of unprecedented depth. If financing the tax cuts ultimately requires sharp reductions in programs from which middle-income families benefit, significant numbers of middle-income families might find their incomes reduced or their expenses increased as a result of such offsetting actions. (See box on next page.)

Lower-Income Families

Low-income households are the clear losers under the Contract. They would gain little from the tax proposals and bear a disproportionate share of the burden of the

[22] Many moderate-income families whose income taxes are reduced or eliminated by the earned income credit would not have sufficient tax liability to utilize the entire child credit to which they otherwise would be entitled. The credit is refundable only to the extent that a household's income tax liability plus its employee and employer FICA (Social Security and Medicare) contributions exceed its earned income credit. Had the proposed children's credit been in effect for 1994, families of four with two qualifying children and incomes between $15,640 and $22,817 would have received some benefit from the credit being partially refundable. For example, a family of four with earnings of $20,000 would have 1994 income tax liability of $578 before application of its EIC. The combined employer and employee FICA taxes on the $20,000 of earnings would total $3,060, bringing total income and FICA taxes, before the EITC, to $3,638. Since the EIC of $1,475 to which the family was entitled was $2,163 less than this, the family would have been entitled to receive the portion of its children's credit that exceeded its income tax as a refund. (Families of four with incomes above $22,817 will have income tax liability exceeding $1,000 in 1994, and so would receive their entire children's credit as an offset their income tax income tax. Families of four with incomes below $17,730 would receive some but not all of the credit through a combination of a tax offset and a partial refund, while families of four with incomes below $15,640 would receive no benefit from the children's credit.)

The Kasich Budget Cuts and Middle-Class Households

Some leading supporters of the Contract have pointed to the budget plans drawn up in the past two years by Representative John Kasich as examples of ways in which the budget could be cut. Many of the reductions in the Kasich plan would affect the middle class. A few examples follow.

- Under the Kasich plan, the middle-class elderly would pay more for health care. For example, the plan would make all elderly and disabled Medicare beneficiaries with incomes above about $11,000 a year for individuals and $15,000 for couples pay 20 percent of the costs of clinical laboratory fees as well as 20 percent of the costs of home health care. Over the next five years, that would require Medicare recipients to pay $21 billion more, with most of these payments coming from middle-class elderly and disabled people. Those who have illnesses or health conditions requiring substantial attention and only modest incomes could be significantly affected.

- Middle-income students with student loans would be charged interest on the loans while they are in college. Currently, interest charges begin to accrue after a student leaves school. Under the Kasich proposal, the payment on these additional interest charges would be deferred until the student left school, but middle-class students would owe substantially more to the government than at present once they are out of school.

- All federal support would cease for school lunches provided to children with family incomes above 185 percent of the poverty line — or above $22,800 for a family of three and $27,400 for a family of four. The price of school lunch for these children would rise at least 30 cents a day. A middle-class family with two children would pay over $100 more per year for school lunches.

- Substantial cuts in federal support for mass transit could result in fewer transit routes, higher fares, or higher state or local taxes. People using public recreation areas such as national parks also would pay more.

- Retirement benefits would be reduced substantially for all people entering federal employment after October 1, 1994. The federal contributions to their pensions would be reduced. In addition, no retirement benefits would be paid before age 65. For those entering the military after October 1, 1994, no cost-of-living adjustments would be paid before age 62.

resulting cuts in federal programs. The principal spending cuts specified in the Contract are $40 billion over five years from reductions in AFDC, Supplemental Security Income, public housing, and nutrition programs for the poor.

The proposals in the Contract thus would likely exacerbate recent trends in income disparities. From 1977 to 1990, the average after-tax income of the richest one percent of American households doubled, after adjusting for inflation, while the income of the average American household in the middle fifth of the income distribution rose a scant three percent, and the income of the lowest-income fifth of American households dropped 12 percent.[23] The benefits of key tax proposals in the Contract, such as the new IRA and the capital gains taxation changes, would accrue to the groups that have fared the best in income growth over the past decade and a half.

While tax policies have not caused the widening gap in before-tax incomes, they have contributed to the disparities in after-tax incomes. Between 1977 and 1990, the richest Americans received large tax reductions, while middle-income Americans did not. A study by the Congressional Budget Office shows that for most households — the bottom four-fifths of the income distribution — the percentage of income paid in federal taxes was about the same in 1990 as in 1977. Among the wealthiest one percent of the population, however, the percentage of income paid in federal taxes fell one-fourth.

Since 1990, most of the lost progressivity in the federal income tax has been restored. The largest tax increases in both the 1990 and 1993 budget packages were targeted on those with the highest incomes. In addition, both packages reduced the taxes of low- and moderate-income working families by expanding the earned income credit. Even so, the wealthiest one percent of Americans will still pay a modestly smaller share of their income in federal taxes in 1995 than in 1977. The Contract, with its restoration of IRA tax breaks for higher-income taxpayers, dramatic reduction of taxes on capital gains income, and substantially more generous depreciation deductions, would exacerbate the growing income gap and reverse much of the progress in restoring fairness in the tax code.

Conclusion

The rapidly escalating revenue losses under the Contract for tax cuts primarily benefitting upper-income households would risk increasing the federal budget deficit substantially in future years. If the deficit were allowed to rise substantially, long-term economic growth and competitiveness likely would be affected. If offsetting actions were taken to prevent the deficit from rising — and, in fact, also to balance the budget as the Contract proposes — the magnitude of the budget reductions required would be unprecedented. Budget reductions this deep could not be achieved without very substantial cuts in an array of programs on which middle-income and poor households rely.

October 20, 1994

[23] Congressional Budget Office data, Committee on Ways and Means, *1993 Green Book*, p. 1500.

File Center on Budget and Policy Priorities

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NUMBER OF PAGES: (including cover)	5	

Comments:

Our analysis of the Census Bureau's 1995 poverty data.

NEWS RELEASE

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FOR IMMEDIATE RELEASE:
September 26, 1996

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Improvements In Poverty and Income in 1995 Are Substantial But Tempered by Disturbing Long-term Trends Affecting Hispanics, Wages, Income Inequality, and Health Care

The Census Bureau issued data today showing that poverty declined and median income rose in 1995 as the economic recovery continued. The data also show that the poverty rate for African-Americans and the elderly reached the lowest levels on record last year, although at 29.3 percent the African-American poverty rate remains high. The Census data reflect a year in which economic growth was not only strong but broad-based, reaching the bottom end of the population and the middle class.

This good news is tempered, however, by four elements of disturbing news in the Census data, according to an analysis of the new data by the Center on Budget and Policy Priorities. The disturbing elements reflect a continuation of long-term economic trends.

- The Hispanic poverty rate failed to show any statistically significant improvement in 1995, remained near its all-time high, and surpassed the African-American poverty rate for the first time. In addition, the median income of Hispanic households fell 5.1 percent in 1995 and has declined 14.6 percent since 1989. The Center said the Hispanic poverty rate is virtually certain to climb and reach record highs in coming years as the provisions of the new welfare bill, which contains severe cuts in basic assistance for legal immigrants, take effect.

- While income grew for lower- and middle-income households and income inequality lessened slightly in 1995, only the wealthiest fifth of the U.S. population has seen its average income return to pre-recession levels. The average income of each of the bottom four-fifths of the population remains below 1989 levels. By contrast, the average income of the wealthiest five percent of the population was $19,000 higher in 1995 than in 1989, although a portion of this $19,000 is due to changes in Census methodology and not to true income gains.

— more —

- One reason the poverty rate fell was that a larger proportion of the population was working in 1995, certainly good news. But while employment rose, median wages for full-time, year-round workers did not. The median wage earned by women working full time throughout the year fell $337 to $22,497. The median wage of men working full time throughout the year showed no statistically significant change.[1]

- Despite the increase in employment, there was no improvement in health care coverage. The number of Americans lacking health insurance throughout the year changed from 39.7 million in 1994 to 40.6 million in 1995, although this change was not statistically significant.

  The number of people without health insurance has risen steadily since 1987, the first year for which comparable data are available. The number of uninsured rose by nine million from 1987 to 1995 while the proportion of the population without coverage increased from 12.9 percent to 15.4 percent.

Black and Hispanic Poverty Rates

At 29.3 percent, the black poverty rate was lower in 1995 than in any year since the Census Bureau began collecting such data in 1966. The Hispanic poverty rate, on the other hand, failed to show any statistically significant improvement last year and surpassed the black poverty rate for the first time.

In 1994, the black and Hispanic poverty rates were statistically the same — 30.6 percent for blacks and 30.7 percent for Hispanics. The Hispanic poverty rate edged down to 30.3 percent in 1995, but this did not represent a statistically significant change from the 1994 level.

The Hispanic poverty rate for 1995 is high compared with the rates in earlier years. The rate never surpassed 30 percent until 1993, hitting all-time highs in 1993 and 1994. The Hispanic poverty rate has been pushed up in recent years by the erosion of wages of low-paid work — a very large share of poor Hispanics live in working families — and probably by immigration as well.

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[1] One factor contributing to the disappointing trend in wages may have been that employment may have expanded most rapidly among lower-skilled workers who receive below-average wages. That would make the median wages appear smaller.

— more —

"The failure of the Hispanic poverty rate to show significant improvement in 1995 despite the robust performance of the economy is disturbing," said Robert Greenstein, the Center's director. Greenstein noted that "the severe cuts in basic assistance for *legal* immigrants included in the recently enacted welfare bill are virtually certain to drive the Hispanic poverty rate to record levels in the years ahead."

Passage of the pending immigration bill, which includes still deeper cuts and additional restrictions on the receipt of such assistance as child care by legal immigrants, would further aggravate this problem, he said.

Trends in Income Gains by Income Groups

Between 1994 and 1995, the average income of households of all income levels rose, although some of the changes were not statistically significant. In addition, income inequality declined, with the share of national income going to middle and low-income households edging upward; some of these changes are statistically significant, while others are not.

When longer-term trends are examined, however, the Census data show that only the most affluent fifth of U.S. households — and possibly only the top five percent — have average income above their level in 1989, the last year before the recession of the early 1990s. The average incomes of all other income groups remains below their 1989 levels.

Since the early 1970s, there has been a marked long-term trend in the U.S. economy toward widening income disparities between the wealthy and other Americans. While changes between 1994 and 1995 moved in the opposite direction and lessened inequality, the change is small and is heavily outweighed by the long-term trend. The following table shows the average income of different income groups for several years: for 1995; for 1994; for 1989, the peak year of the economic recovery of the 1980s; and for 1979, the peak year of the recovery of the late 1970s.

Changes in the early 1990s in Census methodology account for a fraction of the income increase shown in the table for the top fifth and top five percent of households between 1995 and earlier years. On the other hand, these Census data do *not* include capital gains income, which accrues primarily to the very affluent. The top income groups would be shown to have received much larger average income gains in 1995 if capital gains income were included.

— more —

Average Income by Household Income Group (in constant 1995 dollars)						
Year	**Bottom Fifth**	**Next-to-Bottom Fifth**	**Middle Fifth**	**Next-to-Top Fifth**	**Top Fifth**	**Top 5%**
1995	$8,350	$20,397	$34,106	$52,429	$109,411	$188,828
1994	7,982	19,769	33,303	51,823	108,947	188,231
1989	8,629	21,386	35,550	53,774	105,118	169,834
1979	8,473	20,638	33,971	49,824	88,536	132,211
% change 94-95	+4.6%	+3.2%	+2.4%	+1.2%	+0.4%	+0.3%
% change 89-95	-3.2%	-4.6%	-4.1%	-2.5%	+4.1%	+11.2%

Note: Figures in table do not include capital gains income, the earned income tax credit, or non-cash benefits.

The Center on Budget and Policy Priorities is a nonpartisan research organization and policy institute that conducts research and analysis on a range of government policies and programs, and specializes in issues related to fiscal policy. It is supported primarily by foundation grants.

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File Center on Budget & Policy

CENTER ON BUDGET
AND POLICY PRIORITIES

MEMO

To: Interested Parties
From: Ellen Nissenbaum, Legislative Director
Re: New Medicaid and Budget Analyses
Date: July 9, 1996

Enclosed are two analyses prepared by the Center on Budget and Policy Priorities.

The Senate Finance Committee Medicaid Bill: Still No Guarantee is a new analysis of the Medicaid bill reported out by the Senate Finance Committee. The analysis shows most of the changes are not significant with respect to questions of guaranteed coverage under Medicaid. We also have an analysis of the House Commerce Committee bill. Please give me a call if you are interested in receiving a copy.

The analysis, ***A Kinder, Gentler Budget?***, uses figures from the recent House/Senate agreement on the 1997 budget resolution — the congressional plan to balance the budget by 2002. It updates a previous analysis of the separate House and Senate plans.

The analysis finds that in four key areas — non-defense discretionary expenditures, Medicare, Medicaid, and welfare — the new budget plan proposes spending reductions as deep as, or deeper than, those the Republican leadership offered during negotiations with the President in January 1996.

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CENTER ON BUDGET
AND POLICY PRIORITIES

July 8, 1996

THE SENATE FINANCE COMMITTEE MEDICAID BILL: STILL NO GUARANTEE

by Cindy Mann and Richard Kogan

The Senate Finance Committee made a number of revisions to the Medicaid bill as originally filed. On the surface, these revisions appear significant. For example, the bill now requires states to phase in coverage of poor children aged 13 through 18 as required under current law, and the bill adds back current law provisions regarding the amount, scope, and duration of benefits provided to certain groups of people enrolled in Medicaid.

These changes, however, leave open many avenues for states to restrict coverage and the scope of benefits if funding falls short of program needs. This potential is aggravated by the fact that the Committee did not alter the provisions of the bill that would enable many states to withdraw large amounts of state Medicaid funding without such action affecting the level of federal funding they receive. Nor did the Committee address the bill's failure to provide added federal funding to a state on an ongoing basis whenever enrollment growth, and therefore ongoing state Medicaid costs, exceeds the original forecast.

As a result, the changes the Committee made are largely cosmetic. The bill continues to fall far short of its stated goal of guaranteeing coverage for vulnerable groups of people.

No Real Guarantee

Consider the newly added "guarantee" of coverage for older children:

- The Committee bill directs states to phase in coverage of poor children over age 12 as required under current law. But the Committee did *not* add any money to cover the costs of serving these children to the federal block grant payments that states would receive under the bill.

- A state might receive federal "umbrella" payments for enrolling children during the phase-in period. These payments, however, would cover a very small fraction of the cost of insuring these children. This is largely

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because umbrella payments only cover the cost of *new* enrollees. Once a new group of children has been added to the program, no additional federal funds would be made available to states to offset any of the *ongoing* cost of covering that group of children.[1]

- Adding to the likely shortfalls in federal funding are provisions in the bill, left unchanged by the Committee, that offer states strong incentives to cut *state* Medicaid funding sharply. Under this bill, total state and federal cuts could be as high as $246 billion over six years. When inflation is taken into account, funding would rise more slowly than expected Medicaid beneficiary growth. In other words, funding per Medicaid beneficiary would actually *decline* from one year to the next in perpetuity.[2]

- These financing provisions bear directly on the issue of whether the bill offers real guarantees of coverage. Under the Committee bill, *the guarantee of coverage lasts only as long as the funding lasts,* and, unlike current law, the bill does not provide that *all* persons in the so-called guaranteed groups must be served.

  If funds prove to be insufficient to meet the cost of providing health care to all eligible persons — perhaps because a state has withdrawn a sizable amount of state funds — a state could narrow eligibility rules, create waiting lists, or otherwise deny or delay health care coverage for older poor children or any other "guaranteed" group, such as pregnant women and young children.

  States would have many opportunities to limit or deny coverage to keep costs within newly constrained funding limits. The bill explicitly allows states to impose additional eligibility requirements even with respect to so-called guaranteed groups, undercutting any notion that this bill assures health care coverage to federally-defined groups of people. For example, a state could impose asset rules that deny coverage to poor

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1 For a full discussion of the design flaws in the umbrella fund proposal, see Kogan, *"Umbrella Payments" Under the Medicaid Restructuring Act of 1996,* Center on Budget and Polity Priorities, June, 1996.

2 This estimate of total state and federal funding reductions assumes that states will spend the full level of state funds required to receive their maximum federal payments under the bill, but not more than that. See, Kogan, *Federal Caps and State Matching Requirements Under the New Republican Medicaid Proposal,* Center on Budget and Policy Priorities, June, 1996. Under the bill, total Medicaid funding per beneficiary, in 1996 dollars, would decline from $4,691 in 1996 to $4,352 in 2002 and to $4,256 in 2006. (In this analysis, the inflation adjustment is based on CBO's projected changes in the Consumer Price Index. If the cost of health care services rises more rapidly than the CPI, as it has done for many years and as it is expected to do in the future, due in part to continuing improvements in medical technology, the purchasing power of Medicaid funding per beneficiary will decline to a greater degree than noted here.)

children if their family owns a home or an automobile, even one that is of little value, or a state could deny poor children Medicaid coverage if their parents do not meet work requirements imposed by the state's welfare program.[3]

The bill also allows states to establish their own rules for determining how income and assets will be counted when the eligibility of poor children or other income groups is evaluated. This gives states the ability to restrict eligibility in any number of ways, for example, by counting income of nonsupporting absent parents, or by counting noncash benefits, such as housing subsidies, which are not available to pay for medical care.

Ingredients of a Real Guarantee

For any federal guarantee of coverage to be meaningful, basic changes would have to be made in the legislation:

- Minimum standards concerning eligibility, benefits, and access to care must be set forth in federal law at least with respect to all members of guaranteed groups, and these rules must be enforceable in federal court by intended beneficiaries.[4] Without federally defined parameters on eligibility and benefits, there is no bottom-line assurance of coverage guaranteed by federal law.

- The financing must assure funding sufficient to cover the cost of providing a minimally adequate benefit package to all members of the guaranteed groups. As long as the bill offers states incentives to withdraw large amounts of state Medicaid funding while simultaneously allowing states to restrict eligibility, coverage is not guaranteed.

- Federal funding must follow enrollment and not be based on arbitrary formulas that ignore actual enrollment levels and fail to respond to the ongoing costs of covering those added to the program. Federal payments to states should respond fully — upward and downward — to changing state enrollment patterns.

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3 The bill allows states to add any eligibility standard relating to age, income, resources, residency, disability status, immigration status, or employment status of individuals. Section 1502(b).

4 The bill, as revised by the Senate Finance Committee, denies access to federal court in all instances. It allows beneficiaries to go to state court, but only to enforce the right to payment for benefits. The bill does not allow any appeal to state or federal court to enforce any right to coverage.

Conclusion

Claims that vulnerable people, including poor children, are guaranteed coverage under the Senate Finance Committee's Medicaid bill are not borne out by a thorough examination of the bill's provisions. Without basic changes in financing and enforceable rules setting minimum standards for eligibility and benefits for all members of a protected group, no one is truly guaranteed health care coverage.

CENTER ON BUDGET AND POLICY PRIORITIES

Revised July 5, 1996

A KINDER, GENTLER BUDGET?

How Deep are the Republican Budget Reductions?

By Richard Kogan, Robert Greenstein, and Lily Hua

Much of the initial discussion of the Republican budget plan for fiscal year 1997, unveiled in May, described it as much more moderate than earlier Republican budget proposals. Careful analysis of the final House and Senate agreement on the 1997 budget resolution shows, however, that the degree of moderation has been overstated. In four main program areas — Medicare, Medicaid, Welfare/ EITC, and non-defense discretionary programs — the cuts in the new plan are somewhat milder than proposed last year but as deep or deeper than offered by the Republicans in their January negotiations with the President.

Using Comparable Figures

In dollar terms, the total amount of reductions in programs such as Medicare, Medicaid, and other low-income benefit programs necessarily appears smaller than under earlier Republican proposals because the *earlier proposals contained seven years of reductions while the new proposal contains six.* Furthermore, for some programs, changes in the Congressional Budget Office (CBO) baseline and "scoring" procedures have made the dollar amount of the reductions appear smaller.

Current Budget Plans Compared With January Budget Offer

Program Area	How the Cuts Compare
Non-Defense Discretionary Programs	Deeper Cut
Welfare/EITC	Slightly Deeper Cut
Medicaid	Same Depth
Medicare	Deeper Cut

But comparing seven years of reductions for the previous budget plans, measured under the old baselines, with six years of cuts for the new plan, measured under the current baseline, is to compare apples and oranges. Such a comparison tells little about whether the cuts have become more moderate and if so, by how much.

To determine whether the new budget proposal is in fact less extreme than earlier proposals — and if so, by what magnitude — one must compare the depth of the cuts in 2002 (that is, how large the reductions are in percentage terms in 2002) under the earlier plans with the depth of the cuts in 2002 under the new plan. Such a comparison shows how deep the proposed budget cuts would be in the year in which the budget is supposed to reach balance.[1]

When this comparison is made, the reductions in non-defense discretionary programs, Medicaid, Medicare, and other basic low-income benefits under the new budget plan are all found to be as deep as, or deeper than, under the final budget offer that Republican leaders made in the budget negotiations in January 1996. In most of these areas, the Republican leadership has taken a step away from the Administration.

Overall non-defense discretionary spending would be cut virtually as deeply by 2002 under the new Republican plan as under the original budget proposal of one year ago. Both the new plan and last year's original budget plan would set total non-defense discretionary expenditures for 2002 at a level 27 percent below their 1995 level, as adjusted for inflation. By contrast, in the Republican January budget offer, the reduction in non-defense discretionary spending would have been 24 percent in 2002.

The new budget plan calls for $53 billion in so-called "welfare" cuts in such programs as food stamps, SSI, AFDC, child nutrition, and other programs. This figure is identical to the $53 billion in reductions that CBO estimates last fall's vetoed welfare bill would have produced. This figure is $9 billion more than the amount CBO estimates would be saved by the governors' welfare proposal even when the reductions in benefits for legal immigrants contained in the vetoed welfare bill are added to it. (The governors took no position on the cuts aimed at legal immigrants.) There is not new budgetary moderation in this area.

In addition, while the EITC cut in the new budget is less severe than in last fall's reconciliation bill, the cut is several billion dollars deeper than in the GOP's January budget offer. Last February, the governors unanimously recommended that the EITC cuts in the January budget offer be made smaller, but the new budget enlarges them instead. As a result of the enlargement of the EITC cuts, the combined welfare and EITC cuts are slightly deeper in the current Republican budget than in the budget proposed by the Republican leadership in January.

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[1] Most proposed cuts are phased in gradually, reaching their full depth only in 2002. Further, the legislation drafted to reach the GOP budget targets sometimes produce cuts that grow deeper each year even *after* 2002; Medicaid, for example, would be cut half again as much in 2006 as in 2002.

In Medicaid, the cuts are about equally deep as those proposed in the January budget offer. The cut in 2002 (relative to existing law) would be 18.0 percent under the new budget plan, compared with 17.9 percent under the January offer. Because the Republican Medicaid proposal enables states to withdraw very large sums of state Medicaid funding without losing any federal funding, however, total federal and state Medicaid reductions over the next six years could equal a quarter-trillion dollars, with total federal and state cuts reaching 25 percent in 2002. This is only about one-seventh less than the 30 percent by which total federal and state Medicaid funding would have been reduced under the budget resolution Congress approved a year ago.

PERCENTAGE REDUCTIONS IN FY 2002

	Reconciliation Bill, Passed Nov. 1995	January 1996 Budget Offer	1997 Budget Resolution
Non-Defense Discretionary	27.0%*	24.3%	26.8%
Welfare/EIT C	12.9%	10.7%	10.9%
Medicaid	26.2%	17.9%	18.0%
Medicare	18.8%	15.9%	17.5%

An analysis of the reductions in the new budgets, as compared with those in earlier budget proposals, follows.

Non-Defense Discretionary Spending

Some news accounts of changes in the level of budget cuts in non-defense discretionary programs may have created misimpressions. They have compared the amount by which last year's budget plan would have reduced discretionary spending below the *1995* appropriations levels for discretionary programs (as those levels stood before last year's rescissions) with the amount the new budget plan would reduce discretionary spending below the recently enacted *1996* appropriations levels. Since the 1996 appropriations levels represent a substantial reduction from the 1995 levels, such a comparison between last year's budget resolution and this year's resolution has little meaning. Comparing seven years of discretionary cuts under last year's resolution to six years of cuts under the new budget resolution aggravates the problem.

If the comparison is done properly — with six years of discretionary cuts under last year's budget compared with six years of cuts under the new budget, and with both sets of cuts measured relative to the same baseline — an interesting story emerges. The non-defense discretionary cuts in the new budget plan turn out to be only one-eighth smaller over the next six years than the cuts in last year's budget resolution. Moreover, by 2001 and 2002, the non-defense discretionary cuts in the new plan are virtually identical to those proposed a year ago. In addition, the cuts in non-defense discretionary programs in the new budget plan are substantially larger in 2001 and 2002 than those in the Republican leadership's January budget offer.

- Last year's budget resolution would have reduced non-defense discretionary programs $382 billion over six years from 1997 through 2002. (These figures reflect the amount by which the expenditure levels proposed under the budget resolution fall below the original 1995 levels adjusted for inflation.)

- The January budget offer reduced these cut to $326 billion.

- The new budget resolution raises the cut back to $337 billion.

- In 2002, the reduction in non-defense discretionary programs would equal 27 percent under the new plan. Expenditures for these programs in 2002 would fall $90 billion below the 1995 levels adjusted for inflation. This is virtually the same dollar and percentage cut as in last year's budget plan.

- Under the January budget offer, these programs would have been reduced 24 percent in 2002, or $81 billion below the 1995 level adjusted for inflation.

Welfare and the Earned Income Tax Credit (EITC)

The new budget fails to moderate the depth of the reductions in non-Medicaid benefits for the poor — benefits such as food stamps, SSI, and AFDC, which have recently been lumped under the general term "welfare." CBO has estimated that under its new baseline, the savings from the welfare bill that Congress passed in late December and President Clinton subsequently vetoed would be $53 billion between 1997 and 2002. This is the precise level of cuts assumed under the new budget.

CBO estimates the governors' welfare proposal (which is silent on the issue of benefits for legal immigrants) would save $22 billion; if the legal immigrant provisions of the vetoed welfare bill were added to the governors' proposal, the reductions would total $43.5 billion. This is $9 billion less than the cuts in the new budget resolution. In short, the new budget rejects the governor's proposals to moderate the depth of the welfare reductions and instead maintains the level of cuts at the full $53 billion in last year's vetoed bill.[2]

The EITC reductions in the Republican budget plan are smaller than under last year's reconciliation bill but larger than under the January budget offer. The reductions also are somewhat larger than was envisioned in the budget resolution a year ago.

Under last year's budget resolution, the EITC cuts were assumed to be $10 billion by the House Budget Committee and $21 billion by the Senate Budget Committee. The reconciliation bill raised the level of EITC cuts to $28 billion. The January budget offer then lowered the EITC cuts to $15 billion, the midpoint of the range called for in last year's budget resolution. The new budget resolution enlarges the EITC cuts to $18.5 billion.[3]

As part of their February welfare proposal, the governors called for limiting EITC cuts to $10 billion. They emphasized the EITC's importance to welfare reform and stated it should not be cut too much. In May, some House Republicans called for expanding the EITC for working families with children as an alternative to raising the minimum wage. Nevertheless, the EITC cuts in the new budget resolution are larger than those the GOP leadership proposed in January, before the governors met and before the current minimum wage debate began.[4]

Medicaid

Last year's budget resolution called for reducing projected federal Medicaid expenditures by $182 billion over seven years. Last fall's reconciliation bill would have

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[2] The $53 billion resolution level is modestly below the level in last fall's reconciliation bill. Very shortly after passage of the reconciliation conference report, the Republican Congressional leadership altered some of its welfare provisions when bringing the welfare conference report to the House and Senate floors as a single bill, separate from the overall budget package. This alteration reduced the seven-year savings by $4 billion.

[3] Since this time last year, the CBO and Joint Tax Committee estimates of EITC costs under current law have dropped more than $25 billion over the next six years, in part due to the success of IRS efforts to reduce EITC error and fraud.

[4] Action by the House Ways and Means Committee and the Senate Finance Committee makes it clear the Republicans intend to achieve their combined welfare and EITC targets by cutting welfare programs about $5 billion less deeply and EITC about $5 billion more deeply than called for in their new budget resolution.

reduced federal Medicaid expenditures by $133 billion over seven years. (The reduction in the reconciliation bill was "scored" as $163 billion under the March 1995 CBO baseline but reestimated at $133 billion under the December 1995 baseline.) The January budget offer would have reduced Medicaid $85 billion over seven years. The new budget resolution would reduce Medicaid $72 billion over *six* years.

In percentage terms, the new budget plan would reduce federal Medicaid costs by 18 percent in FY 2002. This compares with reductions of 18 percent under the January budget offer, 26 percent under the vetoed reconciliation bill, and 30 percent under last year's budget resolution.

At first blush, it thus appears that Medicaid cuts have shrunk by two fifths, from 30 percent to 18 percent. The reality is less dramatic — total federal *and state* Medicaid reductions have shrunk only about one-seventh since last year's budget resolution was adopted in June 1995. This is because the new budget resolution envisions reducing state Medicaid matching rates for most states; it would thereby allow these states to withdraw substantial amounts of state Medicaid funding without that reduction's affecting the amount of federal Medicaid funds they receive. If states expended the full amount needed to secure their federal Medicaid allocations — but no more than that — their total federal *and state* Medicaid funding could be reduced $246 billion over the next six years. This would represent a total federal and state Medicaid reduction of 26 percent in 2002.

While last year's budget resolution assumed much larger *federal* Medicaid cuts, it did not assume a reduction in the state matching contribution. The Senate Budget Committee and Conference Committee reports accompanying last year's budget resolution explicitly stated that the budget committees assumed current matching rates would be retained. Total federal and state Medicaid reductions under last year's budget resolution — assuming states expended the amount needed to secure their federal allocation but no more than that — would have been $313 billion over six years, compared with $246 billion under the new budget resolution. The overall federal and state reduction in 2002 would have been 30 percent under last year's budget resolution, compared with a reduction of 26 percent under the new budget. Relative to the Medicaid reductions in last year's budget resolution, the total reductions reflected in the new resolution are about one-seventh smaller in 2002.

In conclusion, when compared with last year's budget resolution, Medicaid reductions as they would be felt by beneficiaries and medical care providers have moderated less than seems to be the case if one looks only at changes in the level of the federal reduction. At the same time, when compared with the Medicaid changes in last fall's reconciliation bill — which contained both large reductions in federal funding *and* reduced state matching rates — the Medicaid reductions in the new budget resolution are substantially smaller.

Medicare

Last year's reconciliation bill contained $226 billion of Medicare cuts over seven years. (The bill was originally estimated to contain $270 billion in cuts under CBO's March 1995 baseline. Under its December 1995 baseline, however, CBO reestimated the reductions at $226 billion.) The January budget offer then lowered the cuts to $168 billion. The new budget resolution also includes about $168 billion in reductions.[5]

But the January budget offer would have reduced Medicare $168 billion over *seven* years. The new proposal reduces the program $168 billion over *six* years. The new proposal represents a deeper Medicare cut than the January budget offer.

In 2002, Medicare would be cut 18 percent below projected levels under the new proposal. It would be cut 16 percent under the January budget offer. In dollar terms, Medicare would be cut $53 billion in 2002, compared with $48 billion under the January budget offer.

On the other hand, the Medicare reductions in the new budget plan are somewhat smaller than those in last fall's reconciliation bill; that legislation would have cut Medicare 19 percent — or $57 billion — in FY 2002. Even so, a change from a 19 percent reduction to an 18 percent reduction is not nearly as large as is implied when the Medicare reduction is said to have shrunk from $270 billion to $168 billion.

Conclusion

Upon its release in May, the new Republican budget plan was portrayed as being far more moderate than earlier Congressional proposals and a significant step toward the Administration. Closer examination shows the new budget plan contains somewhat less in the way of new moderation than some may have assumed. The reductions in a number of key areas have remained about the same or grown deeper since the January budget offer.

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[5] In most presentations, the Budget Committees show their Medicare reductions as $158 billion, but that figure simply reflects the net effects of Medicare reductions of $168 billion and $10 billion in new graduate medical education payments not related to Medicare services for elderly and disabled Medicare beneficiaries. The funding for graduate medical education was also included in last year's reconciliation bill but was shown there as a separate item, not netted against the Medicare cuts.