TAX FOUNDATION

TAX FEATURES

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President's Fiscal Year 1995 Budget Shows Mandatory Spending, Revenue Rising Steadily

Even without dramatic tax or spending changes, President Clinton's fiscal year 1995 budget shows significant growth in both receipts and outlays over the next five years, according to a Tax Foundation analysis of the plan.

In a new Special Report, Foundation Economist Chris R. Edwards says that federal receipts are projected to grow as tax revenue flows into the Treasury from stronger economic growth and higher tax rates enacted in last year's budget. As Charts 1 and 2 show, per-capita federal taxes will rise from $4,824 in FY'94 to $5,146 in FY'99, in constant 1994 dollars. Per-capita individual income tax revenue, which grew a total of only 4.4 percent over the period FY'80 to FY'93, is projected to grow 9.9 percent over the next five years. Per-capita social insurance taxes, which take the form of payroll deductions and fund Social Security and Medicare, rise 7.1 percent in the five-year budget projections.

(Figures and Tables in the report do not include changes in receipts or outlays that would occur under the president's health care plan.)

In addition, federal outlays will grow as demands on entitlement programs—including Social Security, Medicare, and Medicaid—continue to expand. Mandatory spending is projected to increase 40 percent over the five-year plan, after an increase of 51 percent over the previous five years (see Charts 3 and 4).

Leading the way is Medicaid spending, which grew 149 percent from FY'89 to FY'94 and is expected to grow a further 75 percent under the president's budget. Spending on health care for older Americans under Medicare also exploded, with 70 percent growth in the past five years and a projected 67 percent further growth under the president's budget.

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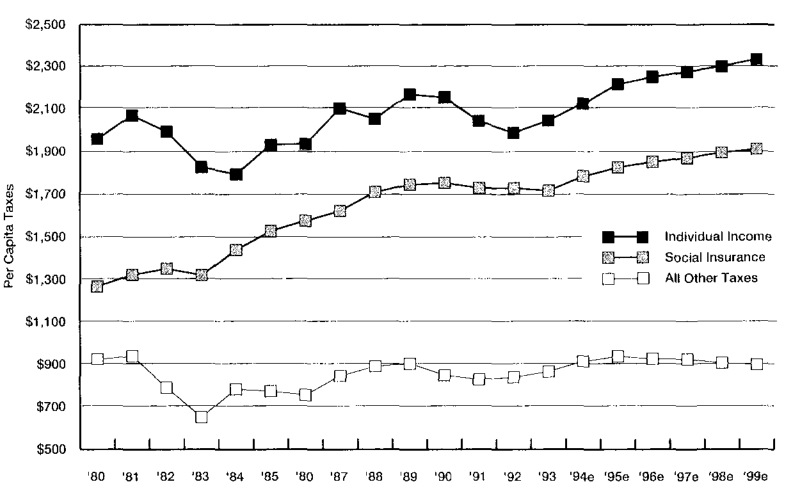
Chart 1: Per Capita Federal Taxes in Constant (1994) Dollars



Source: Tax Foundation.

FRONT & CENTER

Why We Need a Balanced Budget Amendment

Sen. Paul Simon (D-Ill.)

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Outlays for Social Security, now larger than defense, will total $335 billion in FY'95 and will rise 29 percent over the next five years. Outlays for the two main federal programs for the elderly, Social Security and Medicare, together will represent 32 percent of all federal spending in FY'95.

Another huge and rapidly growing "transfer" program operated by the federal government is servicing of the $3.6 trillion (FY'95) federal debt. The program, which transfers dollars from old bondholders to new bondholders, will consume $213 billion in interest expenses in FY'95 representing 14 percent of all federal outlays.

The Deficit

The growing economy has led to substantial improvements in deficit projections compared to just one year ago. On outlays of $1,518 billion and receipts of $1,342 billion in fiscal year 1995, the FY'95 deficit is projected to be $176 billion—as compared to a projection of $207 billion for FY'95 made by the administration last fall.

While the lower deficit projections are good news, they indicate the high sensitivity of budget projections to changing economic assumptions. This provides a warning that the deficit could balloon once again if the economy does not perform as well as assumed.

Mr. Edwards notes that the deficit could be eliminated in only three years if outlays were held to their FY'94 level of $1,484 billion while receipts grew as expected until FY'97. But such a "hard freeze" on outlays does not occur because "mandatory" spending keeps growing.

Discretionary Spending

As entitlement and interest outlays climb, the share of federal spending going to discretionary programs shrinks. Discretionary outlays represented 49 percent of all federal outlays in FY'75, 36 percent of outlays in FY'95, and will fall to just 30 percent of outlays in FY'99. Discretionary spending in FY'95 of $542 billion will actually be less than the FY'94 total of $550, reversing a growth trend that has not been broken since 1969.

The non-defense portion of discretionary spending will rise an average of 1.9 percent annually to FY'99. To make room for new "investment" spending, such as increased funding of homeless aid, job training, and Head Start, President Clinton has reshuffled priorities and proposed modest cuts in some agencies including Agriculture, State, and Energy.

But room for new domestic spending initiatives largely comes from the continuing drop in defense spending. Defense outlays stood at $304 billion in 1989, fell to $281 billion in FY'94, and are projected to fall to $258 billion in FY'99. In constant dollar figures, this is a dramatic 38 percent drop over the10-year period.

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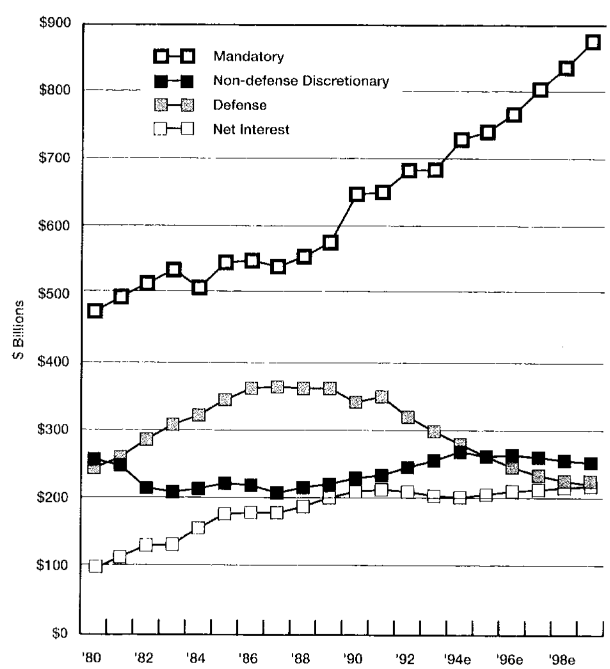
Chart 2: Per Capita Federal Taxes (Constant 1994 Dollars)

Fiscal Year	Individual Income	Social Insurance	All Other	Total
1980	$1,959	$1,268	$923	$4,151
1981	2,069	1,324	940	4,333
1982	1,994	1,352	790	4,135
1983	1,827	1,321	651	3,799
1984	1,795	1,440	783	4,019
1985	1,932	1,528	773	4,233
1986	1,936	1,576	755	4,266
1987	2,103	1,622	846	4,570
1988	2,053	1,710	891	4,653
1989	2,168	1,745	904	4,817
1990	2,154	1,753	849	4,756
1991	2,043	1,729	829	4,601
1992	1,988	1,729	840	4,557
1993	2,045	1,716	866	4,627
1994e	2,124	1,784	915	4,824
1995e	2,216	1,826	939	4,981
1996e	2,250	1,851	927	5,028
1997e	2,274	1,870	925	5,068
1998e	2,299	1,895	908	5,102
1999e	2,334	1,911	900	5,146

Source: Tax Foundation; OMB.

Chart 3: Outlays by Major Category, 1980–1999 (Constant 1994 Dollars)



Source: Office of Management and Budget.

Local Officials Already "Reinventing" Government

While Vice President Gore has focused national attention on the need to "reinvent" federal bureaucracies, local governments across the U.S. are already restructuring to avoid losing out in the competition for business and residents.

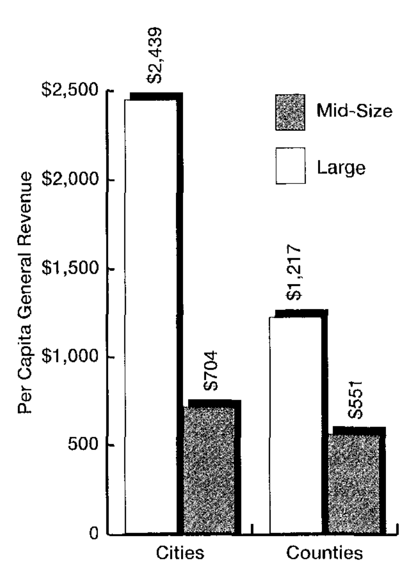
In an upcoming Special Report titled "Local Government Finances," Tax Foundation Economist Chris Edwards highlights the pressures on cities and counties to provide quality services at lower costs. The property tax revenue that flooded into local coffers during the 1980s has slowed, and property tax rate hikes are meeting increasing resistance. At the same time, unfunded "mandates" from federal and state governments are placing extra spending pressures on cities and counties. Recent Price Waterhouse studies estimate that federal mandates cost the nation's cities $5 billion and the counties $7 billion in 1993.

But Mr. Edwards notes that local governments ultimately control their own fiscal destinies. For example, high tax rates are one factor that has caused a steady migration from many large U.S. cities. Census data reveals that cities with over one million residents average $2,439 dollars per capita annual revenue compared to just $1,217 per capita for mid-size cities. Whatever the reasons for this pattern, large, high-cost cities will continue to lose businesses and residents unless they improve service quality and hold the line on taxes.

Some large cities have started taking a more entrepreneurial approach to government. In New York, a committee created by Mayor Giuliani has recommended sweeping privatization and competitive contracting for city services like garbage pickup, street maintenance, and parking meter collections. The committee expects savings of $500 million per year for New York City.

The short-term results of these reforms for local taxpayers remains to be seen, concludes Mr. Edwards. But quality improvements in local services are crucial to the fiscal health of cities in the long-run, given the increasing mobility of industry and taxpaying residents who won't settle for second best. •

Per Capita Revenue in Cities and Counties



Note: "Large" is population over a million; "mid-size" is population between 300,000 and 500,000.
Source: Tax Foundation calculations based on 1991 Bureau of Census data.

1995 Budget

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Health Care Reform

In his report, Mr. Edwards points out that tax and spending projections for the next five fiscal years are subject to change, depending on the financing measures for any health care plan passed by Congress. For example, the president's health care bill—the Health Security Act (HSA)—would radically change current projections. Revenues for the health alliances in the HSA, which would come primarily from employer/employee payroll premiums, would total $558 billion by 1999, according to the Congressional Budget Office. In addition, the CBO estimates that passage of such a plan would increase the federal deficit by $74 billion over five years. •

Chart 4: Outlays by Major Category, 1980 to 1999 ($Billions)

	Current Dollars				Constant 1994 Dollars			
	Mandatory*	Non-Defense Discretionary	Defense	Net Interest	Mandatory*	Non-Defense Discretionary	Defense	Net Interest
1980	$262	$142	$135	$53	$476	$258	$245	$96
1981	301	151	158	69	497	249	261	114
1982	335	140	186	85	517	216	287	131
1983	365	143	210	90	537	210	309	132
1984	361	152	228	111	511	215	323	157
1985	401	163	253	130	548	223	346	178
1986	415	166	274	136	551	220	363	180
1987	420	162	283	139	542	209	365	180
1988	447	174	291	152	557	217	363	189
1989	484	186	304	169	578	222	363	202
1990	567	202	300	184	649	231	343	211
1991	595	215	320	195	652	235	351	214
1992	646	233	303	199	684	247	321	211
1993	667	250	292	199	685	257	300	205
1994e	730	270	281	203	730	270	281	203
1995e	763	271	271	213	741	263	263	207
1996e	815	282	262	225	767	265	247	212
1997e	881	287	257	235	804	262	235	214
1998e	945	291	257	245	836	257	227	217
1999e	1,021	296	258	255	875	254	221	219

*Mandatory includes undistributed offsetting receipts.
Source: Tax Foundation; OMB.

Why We Need a Balanced Budget Amendment

Sen. Paul Simon (D-Ill.)

The Senate is expected to vote on the Balanced Budget Amendment by early March. If the vote takes place as schedule, the next Tax Features will include a list of members who voted for and against the Amendment.

Few question the economic assumption that the United States has a deficit problem of major proportion, a problem that has already caused serious harm to our economy and will continue to cause damage until corrected.

What is at question is whether a constitutional amendment is the proper vehicle for forcing us to deal with the deficit. I believe that the overwhelming body of evidence suggests that without a constitutional amendment, we will not face the difficult political decisions that must be made, and the nation's economic future will be in peril. We need structural budget reform. Those of us who hold public office generally like to get reelected and, faced with the choice of unpopular decisions or simply drifting, we will choose the more popular but infinitely more harmful course of drifting.

Thomas Jefferson . . . said that if he could add one amendment to the Constitution, it would be to prohibit the federal government from borrowing money.

In order to determine whether the nation needs a constitutional amendment, a few questions must be addressed:

What is the purpose of a constitutional amendment?

A constitutional amendment both expresses philosophy and restrains governmental abuse. We could easily pass a statement of philosophy that we should have a balanced budget and not impose our burdens on future generations, but it's the possibility that such a statement will actually be enforced that frightens the abusers.

Thomas Jefferson was not in the United States when our Constitution was written in 1787, but after he returned, he said that if he could add one amendment to the Constitution, it would be to prohibit the federal government from borrowing money: "We should consider ourselves unauthorized to saddle posterity with our debts, and morally bound to pay them ourselves."

Even the lead witness against the amendment in a 1992 hearing, Professor Lawrence Tribe of Harvard, said: "Despite the misgivings I expressed on this score a decade ago, I no longer think that a balanced budget amendment is, at a conceptual level, an ill-suited kind of provision to include in the Constitution. . . . The Jeffersonian notion that today's populace should not be able to burden future generations with excessive debt does seem to be the kind of fundamental value that is worthy of enshrinement in the Constitution. . . ."

Can the deficit problem be handled without a constitutional amendment?

In theory it can. There is nothing to prevent different Congresses and administrations from facing the deficit. To his credit, President Bill Clinton made significant but modest steps in the right direction after assuming the presidency. But that came only with a new president in his "honeymoon period" and a Congress of his own political party—and then this step barely passed.

But that unusual confluence of factors will not often be repeated, certainly not on a regular basis. Attempts to deal with the problem statutorily have met with only limited success. The most dramatic example was the passage of the Gramm-Rudman-Hollings amendment which set specific targets that would have moved us gradually toward a balanced budget. But the problem with a statutory approach is that whenever the problems get a little difficult politically, we simply amend the statutes. The year in which we in theory were to have a balanced budget under Gramm-Rudman-Hollings, 1991, we actually had a deficit of $270 billion. On a subsequent plan, we ended up $357 billion short of the target.

As the total debt mounts each year, the deficit becomes more and more difficult for public officials to deal with. Statutory chances look good on paper, but they will not solve the problem. Public officials faced with the choice of pleasing the public or serving the public too often decide to please the public.

There is an old joke asserting that there were so many heroes at the Alamo because there was no back door. Congress needs a situation where there is no easy way to escape. We need the constraint of a constitutional amendment to force us to do what we know is in the national interest. A constitutional amendment gives office-holders political cover for doing our unpleasant and unpopular duty.

How serious is the deficit problem?

Extremely serious.

First, the deficit is sharply retarding economic growth. A study by the New York Federal Reserve Board shows that the lack of savings in our nation, almost entirely because of the deficit, resulted in a loss of five percent growth in our national income during the decade of the 1980s. The Congressional Budget Office calculates one percent loss means 650,000 jobs. Five percent, then, is roughly three-and-a-quarter million jobs lost, many of them in the highly-paid manufacturing sector. Unless we signal to financial markets that we are serious about the deficit, it is fair to conclude that the loss

The problem with a statutory approach is that whenever the problems get a little difficult politically, we simply amend the statutes.

during the coming decade will be at least as great, if not greater.

Second, the deficit alters fiscal policy in an unreasonable way. Neither conservatives nor liberals would intentionally adopt a policy of spending a larger portion of our tax dollars on interest and a decreasing portion on goods and services. Yet that is the policy that we have stumbled into. In inflation-adjusted dollars, for example, from fiscal years 1981 to 1993, education expenditures dropped one percent while gross interest spending went up 97 percent. The federal government now spends eight times as much on interest as on education, twice as much on interest as all the poverty programs combined.

Third, continuation on the present course will lead to monetizing the debt—that is, printing more money to "solve" our problems. A forecast by the General Accounting Office says that an "economic and fiscal catastrophe" awaits us if our policies are not changed. It does not spell out the catastrophe, but the histories of nations spell it out. Except for strenuous steps taken as a result of a major war, no industrial nation has faced the economic debt burden which we are expected to face without debasing its currency. History suggests that this is not a threat to be taken lightly.

How would the balanced budget amendment to the Constitution work?

Two years after the last of the 38 states required to ratify it acts, or in 1999 (and that may be changed to 2001), whichever is later, income must match outlays by the federal government unless there is a 60 percent vote of both the House and Senate to agree to a deficit. That gives us greater flexibility than Thomas Jefferson wanted, but makes it difficult to have a deficit. To make sure that Congress and an administration do not play games, it also takes a three-fifths majority to authorize an increase in the national debt. That precludes any "off-budget" manipulation.

What are the chances of the passage of the amendment?

The candid answer is that there will be a close vote, one of the most important in the history of the Congress. The last time the Senate voted on a version of this amendment was in 1986, and it lost by one vote. The debt of the nation back then was $2 trillion. "We can solve the problem without a constitutional amendment" was the cry heard over and over. Today the debt stands at $4.4 trillion, and we will hear the same litany from opponents. If we lose, by the time we vote on this again the debt may have doubled again. No one knows how close you can come to the edge of the economic cliff before you fall off. •

The views expressed in Front & Center are not necessarily those of the Tax Foundation.

Who Pays Energy Taxes? Everyone

How pervasive are energy taxes in the United States? A new study by Arthur Hall, Senior Economist at the Tax Foundation, grapples with this question and concludes that they go far beyond the federal and state excise taxes consumers pay at the gasoline pump. In fact, governments at all levels collected $72.4 billion in energy-related taxes in 1993—an average of $756 per American household.

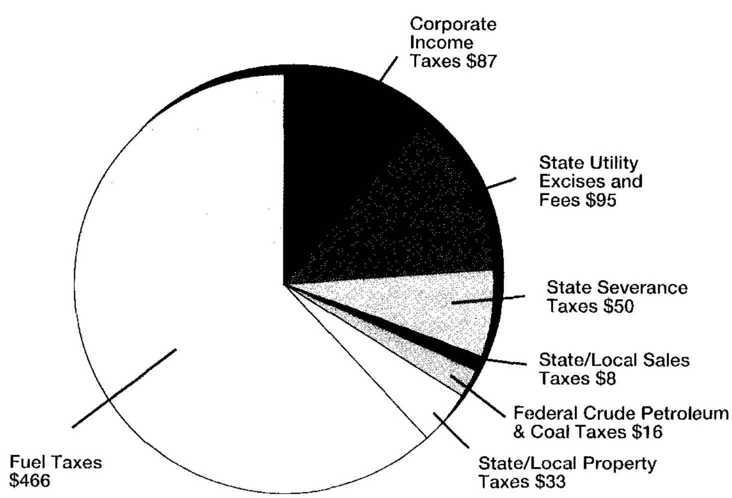
In his *Special Report* titled "The Taxation of Energy in the United States: Who Pays?", Dr. Hall both quantifies and qualifies what these taxes mean to typical Americans. He separates the kinds of energy-related taxes found at the federal, state, and local levels, and provides data on the impact that each has on American households. The report also offers evidence for the regressive nature of energy taxes.

One important premise of the study is that indirect energy taxes—such as corporate income and property taxes—are passed on by energy producers and distributors in the form of higher prices for consumers, lower wages for workers, and lower rates of return for investors. Dr. Hall sets aside a section of the report to explain how such "indirect" taxation gets spread among the population.

Households in energy-producing states have the highest average energy-tax burden. Alaskan households lead the nation, with an annual per-household average of $3,083, followed by Wyoming ($2,382), Texas ($1,114), and Louisiana ($1,099). Oregon households had the lowest average energy-tax burden, with annual average costs of $575. Wisconsin and Arizona were next, with tax burdens of $585 and $595, respectively.

Close to two-thirds of the average annual energy-tax burden for households ($466) stems from federal- and state-level fuel taxes on such energy sources as gasoline, diesel, and aviation fuel. •

Average 1993 Energy-Related Taxes per Household (By Source)



Source: Tax Foundation.

Energy-Related Taxes, 1993 By State and Household Rank

	Total ($Millions)	Per Household	Rank
Alabama	$1,246.79	$799.74	17
Alaska	634.57	3,028.69	1
Arizona	962.42	632.02	45
Arkansas	709.76	775.85	20
California	8,225.26	749.62	25
Colorado	1,144.98	843.83	12
Connecticut	975.60	765.77	22
Delaware	204.91	786.77	19
Dist. of Col.	119.92	483.92	51
Florida	3,423.85	606.63	47
Georgia	1,473.87	580.67	48
Hawaii	306.75	813.59	14
Idaho	297.46	800.57	16
Illinois	3,437.05	808.66	15
Indiana	1,524.60	723.14	28
Iowa	761.46	713.43	30
Kansas	902.61	933.67	9
Kentucky	1,080.34	763.04	23
Louisiana	1,856.30	1,216.34	3
Maine	330.35	676.50	37
Maryland	1,255.85	680.82	35
Massachusetts	1,528.52	660.13	38
Michigan	2,362.00	676.94	36
Minnesota	1,177.17	687.22	33
Mississippi	799.26	852.25	11
Missouri	1,327.61	659.06	39
Montana	315.07	1,006.84	6
Nebraska	463.77	758.25	24
Nevada	410.10	774.19	21
New Hampshire	279.76	633.21	44
New Jersey	2,292.55	798.24	18
New Mexico	671.39	1,164.41	5
New York	3,478.65	516.78	50
North Carolina	1,734.22	647.20	42
North Dakota	243.26	998.12	7
Ohio	3,089.47	741.57	26
Oklahoma	1,229.05	996.48	8
Oregon	699.06	613.93	46
Pennsylvania	3,011.91	657.49	40
Rhode Island	213.52	548.61	49
South Carolina	909.92	681.19	34
South Dakota	195.34	739.90	27
Tennessee	1,328.73	688.61	32
Texas	7,745.94	1,198.83	4
Utah	472.14	833.26	13
Vermont	144.03	652.67	41
Virginia	1,747.92	717.06	29
Washington	1,397.55	704.22	31
West Virginia	635.67	923.14	10
Wisconsin	1,191.99	635.28	43
Wyoming	407.77	2,418.51	2
United States	$72,378.04	$756.08	

Source: Tax Foundation.

Seminar Explores Future Tax Policies

On February 7, the Tax Foundation co-sponsored with the law firm Baker & Hostetler an all-day seminar exploring "The Direction of Federal Tax and Budget Policy in the 1990s." The event was covered by C-SPAN.

Senator Orrin Hatch (R-Utah), a member of the Senate Finance Committee, kicked off the event with a keynote address focusing on the budget deficit and the need for congressional focus on saving and investment. In addition, a number of former Members of Congress addressed the audience on topics ranging from the nature of the legislative process to health care policy. Among the former lawmakers: Tax Foundation Co-Chairman Bill Frenzel, Raymond J. McGrath, Guy Vander Jagt, Beryl F. Anthony, Jr., Richard T. Schulze, and Bill Gradison.

The conference included two panels on health care, covering the tax aspects of reform and the prospects for legislative disposition in 1994. Despite concerns expressed by congressional staff panelists on certain aspects of the competing proposals, there was a general consensus that a comprehensive health care reform bill could be enacted before the end of the year.

In the third panel, a group of tax lawyers, led by Kenneth Kies of Baker & Hostetler, provided a technical explanation of limitations on the deductibility of executive compensation; the treatment of excess passive assets of controlled foreign corporations; and the changes in the passive loss rules as they apply to real estate.

The final panel of the day, chaired by the Foundation's Tax Counsel Lynda Walker, comprised senior professional staff from the House Ways and Means Committee. Members of the panel agreed that even though tax legislation does not seem to be a priority this year, some level of tax legislative activity should be expected. Significant changes later this decade could come in the form of modifications to the individual and corporate tax structures, the introduction of a consumption tax, new saving/investment incentives, and international tax reform. •

FOUNDATION MESSAGE

Is BBA the Right Medicine for the Deficit?

Some issues, for better or for worse, just won't go away. This is the case with the proposed Balanced Budget Amendment (BBA) to the Constitution. Support for and attention on the amendment has waxed and waned now for decades. And it is once again up for a vote in the United States Senate thanks to the tireless work of Senator Paul Simon and some his colleagues.

There is much to be said in favor of the Balanced Budget Amendment, but there are also detractions both real and imagined. On the plus side is the obvious fact that the federal government has been unable for one reason or another to balance its books, with one exception, for over a generation.

One real downside to a balanced budget amendment is that the fight puts the focus on the deficit, rather than on spending or the distortions to the economy resulting from the tax system. However, if the amendment ever passes, then the focus will shift quickly to where the money is spent. When faced with raising taxes or finally coming to grips with government waste and ineffective programs, no self-preserving politician can expect to assault the overburdened American taxpayer with another tax increase and get away with it.

J.D. Foster
Executive Director
and Chief Economist

Another downside to the constitutional amendment, recently raised by numerous constitutional scholars up and down the political spectrum, is that if enacted the amendment is probably unenforceable, in which case the constitution may have been turned into a political billboard. This concern should not be dismissed lightly. The U.S. Constitution is one of our nation's most prized possessions. We should always be on guard against any measure that would in any way degrade it. Against this concern must be placed the very real prospect that, without the Balanced Budget Amendment, the federal budget will never be balanced in our lifetimes.

Alongside these real concerns are a number of issues of dubious merit raised by the amendment's opponents. For example, some argue that the amendment would reduce the ability of the federal government to react through fiscal stimulus to economic downturns. In theory this may be true, assuming, of course, that fiscal stimulus is indeed stimulative.

However, given the lengthy delay from when a recession is recognized to that point in time when a political decision to respond is made, subsequent legislation works its way through Congress, and the actual stimulus works its way into the economy, rarely has any effort at economic stimulus done more than make headlines.

The most disingenuous argument heard to date in opposition to the Balanced Budget Amendment is that the economy could not withstand the fiscal shock. As Senator Simon notes in his Front & Center article (pages 4 and 5), the Amendment doesn't require a balanced budget until somewhere around 1999. At a current deficit of around $175 billion to $200 billion, that means about $40 billion to $50 billion in deficit reduction per year depending on when we actually get started.

The tax-laden deficit reduction bill passed last summer is lauded for reducing the deficit by about $500 billion over five years. It is curious that the very people who argued that last year's deficit reduction was essential to the economy now argue that more of the same could wreck it. If $500 billion in deficit reduction was so great, why would another $500 billion be so bad?

Tax Foundation Charts Splashed Across Newspapers

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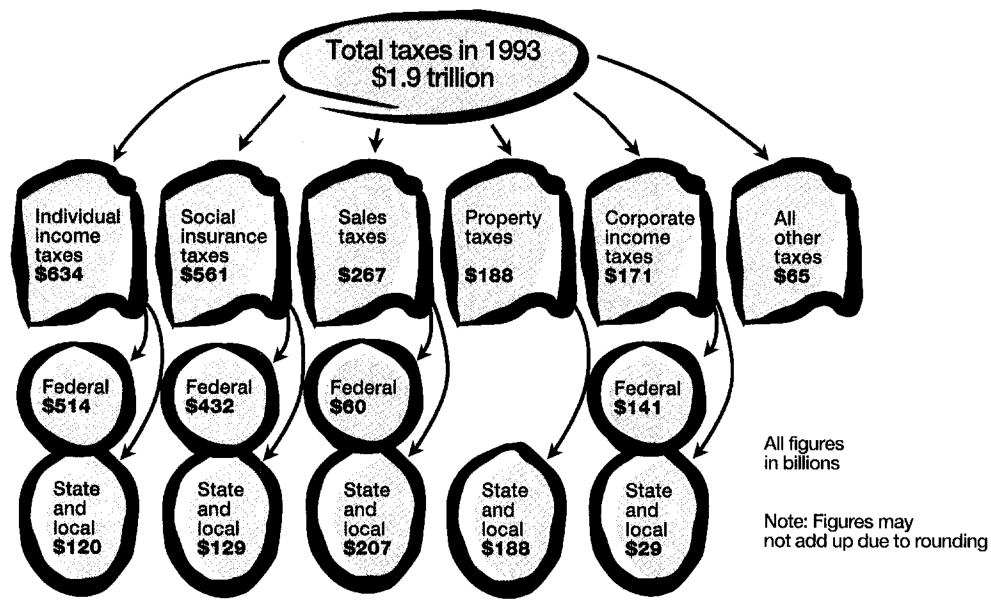
Tax Foundation graphs and charts were featured in dozens of newspapers across the country in January, when the Associated Press used them to accompany an article by reporter Jim Luther on changes in the tax code.

Under the headline "How Hard Do You Work for Uncle Sam?", the AP offered a pie chart with a breakdown of the typical American family's expenses; a bar chart detailing per capita federal tax burden from 1984 through 1994; a watch showing what part of the eight-hour work day we spend earning money to pay taxes; and a table listing the 10 states with the highest and lowest per capita federal tax burdens.

Also, the AP story featured a Tax Foundation graph created by Economist Chris Edwards specially for the article—a flow chart showing a breakdown of all taxes by source (see below). •

Our 1993 Tax bill

In 1993, Americans paid approximately $1.885 trillion in taxes to governments at the federal, state and local level. Revenue from the two largest types of tax – individual income and social insurance (or payroll) taxes – primarily goes to the federal government. Sales tax revenue mainly flows into state government coffers and property tax revenue is primarily collected by local governments, such as cities, counties and school districts.



Source: Tax Foundation estimates based on Bureau of Census data. AP/Karl Gude

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