TAX FOUNDATION'S **50th Anniversary Year** VOL. 31, NO. 7 NOVEMBER/DECEMBER 1987

TAX·FEATURES

Tax Foundation Marks 50th Anniversary; Honors Senator Moynihan for Public Service

Shadow Budget Committee Report Card Gives Congress and Administration Failing Marks for Fiscal Year 1987

By grading Congress and the Administration on five different aspects of budgetary performance, the Shadow Committee on the Federal Budget has handed down a report card that would make any self-respecting student cringe: A– for economic conditions (a judgment handed out prior to Wall Street's October 19 Black Monday); F for policy leadership; F for truth in budgeting; F for completion of required budget tasks; and for deficit reduction: a B for appearance, but a D for substance.

As bad as these grades are, they simply reflect the numerous budgetary failures and comparatively few successes that marked fiscal 1987.

The economy has not grown at the rate assumed in the budget, but it continues to demonstrate remarkable vigor, the report notes. The budget deficit was about $60 billion below the previous year's level, but much of the improvement was due to one-time factors that will not be available in future fiscal years. Congress changed the way the budget accounts for asset sales and other transactions that lower the deficit without producing real savings, but only after using billions of dollars of these tricks in the 1987 budget. Finally, Congress failed to enact a single regular appropriation bill by the start of the 1988 fiscal year, but its work was impeded by a recalcitrant President who refused to enter into negotiations with the Legislative Branch.

Even the one area of good performance is qualified by a "but". Good news about the deficit has been acccompanied by a sharp run-up in interest rates, possibly because investors fear that deficit reduction will be short-lived. If the big drop in 1987 proves to be just a blip in the upward trend of the deficit, the nation will pay a heavy price for the failure of the President and Congress to provide the leadership that would produce enduring deficit reduction.

Daniel Patrick Moynihan, senior United States Senator from New York State, will receive the Tax Foundation's Distinguished Public Service Award for 1987 at the Foundation's 50th Anniversary Dinner December 2. The Dinner concludes the Foundation's day-long conference on "Tax and Fiscal Policy — The New Agenda" at the Waldorf-Astoria hotel in New York City.

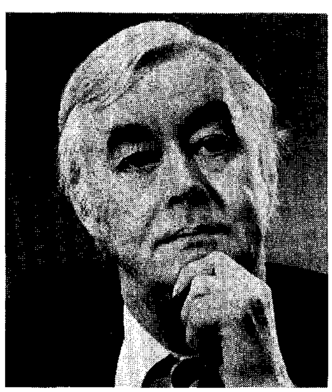
Hans W. Wanders, President of The Wachovia Corporation and Chairman of the Foundation's Board of Trustees, will present the award. A major policy address by Senator Moynihan will follow his acceptance.

Daniel Patrick Moynihan was elected to the United States Senate on November 2, 1976 and reelected in November 1982. The Senator serves on the Finance and the Environment and Public Works Committees and on the Select Committee on Intelligence; he is Chairman of the Subcommittee on Public Assistance of the Finance Committee.

Senator Moynihan has held Cabinet or Subcabinet posts under Presidents Kennedy, Johnson, Nixon, and Ford. He has served as United States Ambassador to India and as U.S. Permanent Representative to the United Nations. He has also held high administrative positions in New York State. His career in education includes posts at MIT and Harvard.

National Conference

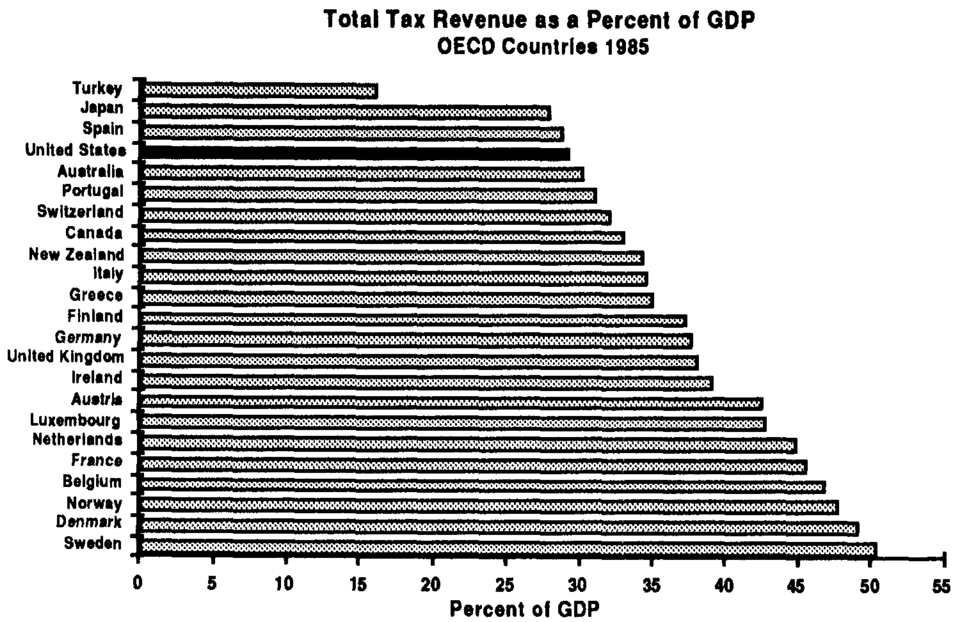
The morning sessions of the all-day program will focus on the economic outlook and the Federal Budget and will include presentations by Edgar R. Fiedler of the Conference Board, White House Senior Policy Analyst Bruce Bartlett, Harvey Galper of Peat Marwick Main & Co. and Allen Schick of the University of Maryland.



Jeffrey H. Birnbaum, Congressional Reporter for The Wall Street Journal and Coauthor of *Showdown at Gucci Gulch,* will keynote the conference luncheon.

The afternoon session will address "Tax Policy Post Reform," with presentations by J. Roger Mentz of Cadwalader, Wickersham & Taft and former Assistant Secretary of the Treasury of Tax Policy, and David H. Brockway, Chief of Staff of the Joint Committee on Taxation.

OECD Nations Show Great Diversity in Approach to Taxation



Percentage Distribution of Tax Revenues in Selected Countries by Source
Fiscal Year 1985

Country	Taxes on Income and Profits[a]		Social Security Taxes[b]	Taxes on Goods and Services			Property Taxes[d]	Other and Unallocable[e]	Total Tax As % Of GDP	Per Capita Taxes[g]
	Individ. Income	Corp. Profits		Total[c]	Consumption Taxes: General	Consumption Taxes: Specific				
Australia	45.1%	9.2%	-	32.5%	7.9%	20.3%	7.7%	5.5%	30.3%	$3,213
Austria	23.1	3.3	31.8%	32.6	21.0	10.4	2.4	6.8	42.5	3,714
Belgium	34.1	6.4	33.2	24.4	15.7	7.0	1.7	0.2	46.9	3,854
Canada	35.5	8.2	13.3	31.5	13.2	12.6	9.5	2.0	33.1	4,621
Denmark	50.2	4.8	3.8	34.2	20.0	12.9	4.3	2.7	49.2	5,573
Finland	46.6	4.0	9.0	36.7	21.2	15.1	3.0	0.7	37.3	4,116
France	12.7	4.3	43.6	29.4	19.9	8.7	4.6	5.4	45.6	4,216
Germany	28.7	6.1	36.5	25.6	15.8	8.7	3.0	0.1	37.8	3,869
Greece	14.0	2.7	34.9	43.3	17.2	21.5	2.7	2.4	35.1	1,178
Ireland	31.3	3.2	14.8	44.5	20.6	22.0	3.8	2.4	39.1	2,005
Italy	26.7	9.2	34.7	25.4	14.5	9.1	2.5	1.5	34.7	2,565
Japan	24.8	21.0	30.2	14.0	-	12.1	9.7	0.3	28.0	3,107
Luxembourg	26.3	18.2	25.5	23.9	12.8	10.5	5.6	0.5	42.8	4,748
Netherlands	19.5	7.0	43.9	25.8	16.3	7.3	3.5	0.3	45.0	3,879
New Zealand	60.0	8.4	-	23.2	10.4	11.7	7.1	1.3	34.3	2,304
Norway	22.5	17.0	20.6	37.5	18.2	18.2	1.7	0.7	47.8	6,668
Portugal	f	f	26.0	42.5	12.6	28.4	1.9	25.9[f]	31.1	676
Spain	22.6	5.5	41.5	26.4	14.1	12.4	2.8	1.2	28.8	1,226
Sweden	38.5	3.5	24.8	26.4	13.9	11.4	2.3	4.5	50.5	6,064
Switzerland	34.8	5.9	32.1	18.9	9.3	8.2	8.2	0.1	32.1	4,554
Turkey	33.7	11.6	5.1	44.0	28.5	15.1	5.6	-	16.1	170
United Kingdom	26.0	12.9	17.5	31.6	15.9	13.9	12.0	-	38.1	3,025
United States	35.7	7.1	29.4	17.7	7.4	7.9	10.1	-	29.2	4,740

[a] Includes taxes on capital gains.
[b] Includes taxes on self-employed.
[c] Includes import duties, profits on public fiscal monopolies, licenses, and other business taxes.
[d] Includes taxes on movable and immovable property, net wealth taxes, and estate and gift taxes.
[e] Includes general and selective taxes on payrolls which are not earmarked for social security purposes, and other taxes not elsewhere classified.
[f] Income and profit taxes are 25.9% of total taxes and are included under "other and unallocable", as they are not segregable between individuals and corporations.
[g] In U.S. dollars.
Source: Organization for Economic Cooperation and Developement.

Despite numerous economic and political ties, member nations of the Organization for Economic Cooperation and Development (OECD) display great disparity in how they structure their respective tax systems.

In 1985 (latest reported), the share of revenue raised by individual and corporate income taxes ranged from less than 18 percent in France and Greece to 69 percent in New Zealand, 57 percent in Denmark, and 54 percent in Australia. Nations which collect either a very small part of their revenues from social security taxes or none at all tend to derive a large share of their revenues from taxes on income.

Income taxes furnish about 39 percent of tax revenue in the 23 OECD countries combined. The U.S. share — 43 percent — ranks ninth highest.

France and Greece raised the least through individual income taxes at 13 and 14 percent respectively. By contrast, New Zealand derived 60 percent of its tax collections from this source. Denmark also raised more than half of its revenues from individual income taxes. The United States, ranked seventh among the member countries, raised 36 percent of all revenues through the personal income tax.

Corporate profits tax levies also generate significant public revenue for most of the member countries.

(Continued on page 5)

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Budget Watch

Federal Spending Jumps Trillion Dollar Hurdle

The Tax Foundation was established 50 years ago during the brief period between the Great Depression and World War II. The first of these crises led to the modern welfare state, the second to massive increases in defense spending. The growth of the Federal government has been a continuing story, however, which certainly did not end with these long-ago events. When the Foundation opened its doors, Federal spending was less than $10 billion a year; in the latest fiscal year, it exceeded a trillion dollars.

This article reviews the growth in expenditures during the past 50 years and discusses the implications for the Federal budget. The upward trend is summarized in Table 1 which displays total spending at 10-year intervals since 1938. The data show an incessant rise in Federal spending: in each of the selected years, spending has been higher than it was 10 years earlier. There have been few downturns in Federal spending, and all but one of these occurred after the cessation of war.

Inflation has accounted for a substantial portion of the spending increase, but the escalation is quite pronounced even when an adjustment is made for rising costs. Table 1 shows that in constant (inflation-adjusted) dollars outlays are 15 times higher than a half century ago. This trend has persisted in the 1980s despite widely-publicized claims of cutbacks in Federal spending. In constant dollars, fiscal 1987 spending exceeded the fiscal 1977 level by $200 billion. This is the largest real increase during any decade in American history.

There has also been a steep rise in relative spending, that is, in Federal outlays as a percentage of the gross national product (GNP). In the late 1930s, Federal outlays amounted to about 7 percent of GNP. The percentage had been much lower just a few years earlier, prior to the New Deal. Since then, relative spending has moved steadily upward; at almost 23 percent of GNP, it is now three times what it was a half a century ago.

The upward spiral in expenditures has been accompanied by a similar development on the revenue side of the budget. Revenues totaled 19 percent of GNP in the 1987 fiscal year, compared to only 6 percent 50 years earlier. But revenue growth has lagged somewhat behind that of expenditures and, as a result, budget deficits and the public debt have soared. In some recent years, the budget deficit has exceeded 5 percent of GNP, pushing total public debt to more than $2.5 trillion, and greatly increasing per capita debt (see chart below).

An understanding of the dynamic growth of Federal spending would be enhanced by reviewing developments in each of the past five decades.

1938–1947

By the late 1930s, the New Deal had turned emergency relief into permanent programs. The financial burden was modest at the outset — but the basis had been laid for a much larger Federal government in the future. Spending pressures during this decade were almost entirely war-related. Defense spending began to rise in the late 1930s and peaked in 1945 at almost 40 percent of GNP. Nondefense spending declined, both because economic recovery diminished the need for relief and because full mobilization dictated that resources not be diverted from the war effort. After the war, Federal outlays dropped sharply to only 12 percent of GNP in 1948.

1948–1957

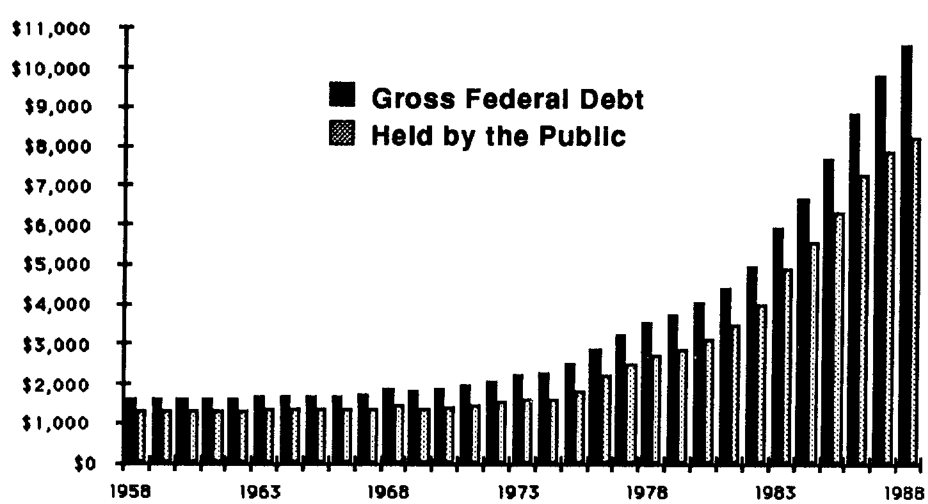
This period left an enduring imprint on Federal expenditures. The protracted cold war meant that defense spending would be maintained at a high level even in peacetime. Although the United States was not at war in 1957, defense claimed almost 60 percent of total outlays. Except for the Interstate Highway Program, the Eisenhower Administration did not undertake major domestic expansions. But neither did it roll back the New Deal programs. The social innovations of the 1930s were accepted as a legiti-

Table 1
Total Federal Outlays In Current and Constant (1982) Dollars and As a Percent of GNP, Selected Fiscal Years, 1938–1987
($billions)

Fiscal Year	Total Outlays	Outlays As % Of GNP	Outlays In Constant 1982 Dollars
1938	$ 6.8	7.7	$ 60.0
1947	34.5	15.4	212.8
1957	76.6	17.4	318.8
1967	157.5	19.8	488.7
1977	409.2	21.2	622.6
1987	1,016.9	23.0	862.9

Sources: The 1938 data are adapted from the Bureau of the Census, *Historical Statistics of the United States, Colonial Times to 1970;* the data for 1947–1977 are from the Office of Management and Budget, *Historical Tables;* and the 1987 estimates are from the Office of Management and Budget, *Mid-Session Review of the 1988 Budget.*

Per Capita Federal Debt at End of Year 1958—1988



mate, continuing responsibility of government in the 1950s.

1958-1967

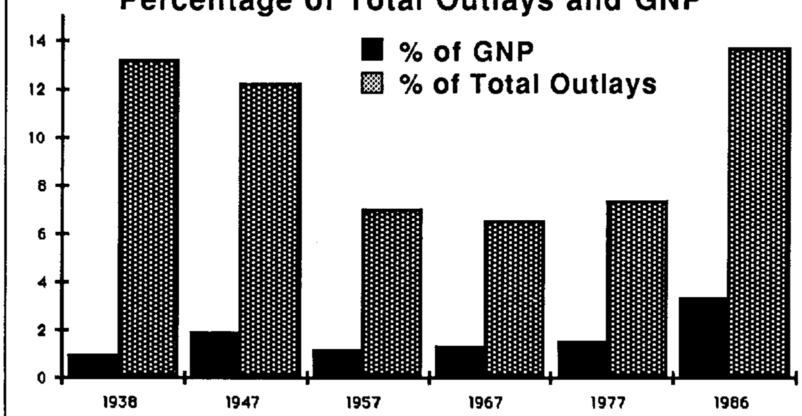
The Kennedy-Johnson years opened a new expansionary era in Federal budgeting. Expansion was spurred by the adoption of dynamic fiscal policies which called for tax cuts and spending increases to stimulate economic growth and by the enactment of ambitious Great Society legislation. These did not cost much at the start but some of them (especially Medicare and Medicaid) would become increasingly prominent in the future. During the first part of the 1960s, a vigorous economy made it possible for the government to expand without increasing its share of GNP. But escalation of the Vietnam War put pressure on the budget and produced a guns versus butter debate which has persisted for the past 20 years.

1968–1977

This period represented the end of the postwar boom during which economic growth had averaged more than 4 percent a year and the beginning of an austere period characterized by slower growth, higher unemployment, and bigger deficits. At first, various transfer programs, such as food stamps and social security, were enlarged, and a new sense of federalism led to the first revenue sharing program with the states and localities. Later, Congress established a new budget process in an effort to control Federal spending and deficits. Judging from the results, the new process has not been particularly successful.

1978-1987

The most recent decade has been dominated by the Reagan revolution, an attempt to rearrange budget priorities by building up defense forces, curtailing domestic spending, and reducing income tax rates. After startling success in his first year, the President has been locked in a protracted budgetary stalemate with Congress. Defense spending climbed rapidly in the early 1980s but has leveled off in recent years. Discretionary domestic programs have been cut back, but nowhere near the extent sought by the Administration, and transfers continue to claim a rising share of the budget. This has resulted in massive deficits and the enactment of the Gramm-Rudman-Hollings process which seeks a balanced Federal budget by the early 1990s.



Federal Outlays for Net Interest as a Percentage of Total Outlays and GNP

The Changing Composition of Federal Spending

Over the years, the composition of expenditures has undergone considerable change. Table 2 traces five categories of expenditure: defense programs, payments for individuals, grants to state and local governments, interest charges, and other (mostly discretionary domestic) programs. The trend is unmistakably clear: payments for individuals have become the most prominent part of the budget. Fifty years ago, these payments were barely one billion dollars; today, they total almost $500 billion and account for almost half of total Federal spending. Most of these payments are in the form of entitlements, which obligate the government to provide financial assistance to persons who meet the eligibility requirements established in law.

In addition to these payments, the budget finances two other types of transfers: interest charges and grants to states and localities. Recent deficits have compelled the government to allocate a rising share of the budget to interest payments. As the chart above demonstrates, almost 14 percent of the budget goes to pay interest on the public debt, just about twice the percentage of a decade ago.

Grants have had a roller coaster ride in the Federal budget. During the

(Continued on page 6)

Table 2

Types of Federal Outlays in Current Dollars and As Percentages of Total Outlays, Selected Fiscal Years, 1938-1986

($billions)

Outlay	1938*		1947		1957		1967		1977		1986	
	$	%	$	%	$	%	$	%	$	%	$	%
Defense	1.0	14.7	12.8	37.1	45.4	59.3	71.4	45.3	97.2	23.8	273.4	27.6
Payments for Individuals	1.1	16.2	9.1	26.4	17.0	22.2	43.2	27.4	196.3	48.0	448.0	45.3
State-Local Grants**	0.5	7.4	0.8	2.3	2.2	2.9	10.4	6.6	46.1	11.3	60.8	6.1
Net Interest	0.9	13.2	4.2	12.2	5.4	7.0	10.3	6.5	29.9	7.3	136.0	13.7
All other	3.2	47.1	9.1	26.4	10.7	14.0	29.5	18.7	54.5	13.3	104.7	10.6
Offsetting Receipts	n.a.	n.a.	-1.5	-4.3	-4.1	-5.4	-7.3	-4.6	-14.9	-3.6	-33.0	-3.3

Sources: Same as Table 1.

* Because of the different sources, 1938's figures are not strictly comparable to those for later years.

** Amounts shown for grants do not include grants which finance payments for individuals. Outlays for these grants are included in the payments for individuals category.

(OECD, *from page 2*)

Japan raised over one-fifth of its 1985 receipts by taxing corporate incomes, ranking highest among the OECD nations. Seven percent of total tax receipts were derived from corporate income taxes in the United States in 1985, close to the OECD average of 8 percent. At the low end, Greece raised just under 3 percent of its revenues by taxing corporate income.

Taxes on goods and services (sales or consumption levies) are second to income taxes as revenue-raisers in OECD countries. They provide an average of 30 percent of tax revenues. Governments in the United States raise just 18 percent of total receipts from such taxes, placing the U.S. 22nd among the 23 OECD members in terms of reliance on consumption taxes. Japan's consumption tax is the lowest of the OECD nations at 14 percent while Ireland gets 45 percent of its total tax revenue by taxing goods and services.

Social security levies follow income and consumption taxes as the third largest revenue source for OECD countries, providing about 24 percent of all tax receipts. Variations from country to country are significant, however. Australia and New Zealand do not levy social security taxes. Denmark gets less than 4 percent of its revenue from such taxes. By contrast, social security taxes accounted for more than 41 percent of total tax revenues in France, Spain, and the Netherlands. The United States ranked in the middle range, 11th among OECD countries, getting 29 percent of its taxes from social security collections. However, social security taxes in the U.S. have increased substantially from 16 percent of total tax revenue in 1965 to 29 percent in 1985.

Property taxes generally are not a major source of tax revenue among OECD nations, providing 5 percent of total taxes on average. In 1985, the United Kingdom ranked first in its reliance on property taxes (12 percent of total), followed by the United States and Japan at 10 percent.

Another way to compare tax systems among the major industrialized countries is to examine the size of their tax receipts in relation to economic production. The OECD measures this by gross domestic product, or GDP.

The ratio of tax revenues to gross domestic product averages 37 percent in the 23 OECD countries. By this measure, Sweden is the "most taxing" nation, with receipts coming to just over 50 percent of GDP in 1985. Denmark ranks second at 49 percent. U.S. taxes in 1985 cames to 29 percent of GDP, placing this country 20th among its OECD affiliates. At the low end were Japan and Turkey at 28 and 16 percent of GDP, respectively.

The table and chart on page 2 provide further details on the distribution of tax revenues in selected countries for fiscal year 1985.

THE FRONT BURNER

By Robert C. Brown
President, Tax Foundation

"The Yankee Trader — An Endangered Species?"

The Yankee Trader used to be the prototype of the enterpreneurial spirit, roaming the seven seas with American made goods in American made vessels manned by American sailors. Indeed, the right to make and sell goods to export markets was one of the issues behind the American revolution.

Well, as the songwriter says, "the times they are a-changin'." The trade deficit is one of the two chief millstones around the neck of the American taxpayer. (The other, of course, is the budget deficit, although it begins to look as if we may finally see some concrete progress toward real deficit reduction by the time this publication is off press.) Our balance of payments is a disaster. Our merchant marine is a shadow of its former self. We are not even capitalizing on our own technological breakthroughs. (We developed the VCR; only Japan makes and sells it.)

What is the solution the U. S. Congress threatens to foist on U.S.-based multinationals? A protectionist trade bill that will only worsen the situation. In the face of a major threat that our status as a world trader is becoming second rate, all Washington can do is close the borders, inviting retaliation by the other players in the game. To call such a step counterproductive is to overstate the obvious.

Where does the real solution lie? On September 18 of this year, the Wall Street Journal published a market valuation ranking of the world's 100 largest public companies. The U.S. could lay claim to 40 of those top slots. Not so bad, you might say, in this age of growing world economic unity. Maybe. Japan, which was literally on its knees just 30 years ago, owned 44 of the top 100. All other nations — Great Britain, West Germany, France, Korea, Taiwan, and any other you care to name — were, as mathematicians say, statistically insignificant.

Why this astounding fall from grace for the Yankee trader? Trade policy is a partial explanation. Another reason is tax policy. The United States does not — as do Japan, West Germany, The Netherlands, and others — encourage multinationals to be aggressive in developing overseas markets. Instead, we tax them so heavily that it is hardly profitable for them to compete. From a tax policy perspective, there are those who would say you were crazy if you started a multinational corporation and based it in the United States. A major improvement would be simply to treat our multinationals the way other major trading nations do.

In the key area of world trade competitiveness, tax policy driven almost exclusively by revenue considerations is causing side effects that are very, very harmful.

Public Finance:
An Information Sourcebook

by Marion B. Marshall
Tax Foundation Research Librarian

Oryx 287 pp 10/87 $45.00

Annotated bibliography of 1,150 selected books, articles, and periodicals. Focuses on the current status, issues, and problems of all aspects of public finance: theory; revenues—especially tax; financial management; and major expenditure, credit and insurance programs at all levels of government in the United States. A useful guide for the student, professional or interested citizen. It may be ordered from The Oryx Press, 2214 N. Central at Encanto, Phoenix, AZ 85004-1483.

(FEDERAL SPENDING, *from page 4*)

postwar era, they escalated to more than 10 percent of total spending. Over the past decade, however, their share has shrunk to 6 percent, and they now comprise approximately the same portion of spending as they did in the mid-1960s. As noted in Table 2, the amounts shown for these grants do not include payments for individuals (such as medicaid and aid to families with dependent children) which are passed through state or local governments. These payments now comprise half of all total grants to states and localities.

Defense is another category that has gone through ups and downs. Between 1957 and 1977, defense dropped from almost 60 percent to less than 25 percent of Federal spending. The recent buildup has increased the defense share of the budget, but it still is much lower than it was after World War II.

Discretionary domestic spending — the "all other" category — has been least successful in the competition for Federal dollars. This category accounted for almost half of total spending in 1938; it now gets only about 10 percent. This part of the budget finances the ongoing operations of Federal agencies, including such diverse and well-established activities as the national parks, health research, and space exploration.

Both payments for individuals and interest costs are forms of transfers from the Federal government to outside recipients of public funds. Together, they comprise almost two-thirds of the budget. The growth of these transfers has important implications for the Federal budget.

Budgeting Now More Dependent On Economic Performance

When the Federal government began to use the budget in the postwar period as a key instrument of fiscal policy, transfers were seen as automatic stabilizers that would restrain the economy when it was overheated and stimulate it when it was weak. But the increasing impact of transfers has made their role in budgeting both structural and cyclical. Transfer spending rises when the economy is strong as well as when it is weak. Rather than the budget balancing the economy, the economy can unbalance the budget. In some recent years, more spending has been added to the budget by changing economic conditions than by discretionary policies.

Annual Rise in Spending Mostly Due to Entitlements

Most transfers are mandatory entitlements whose level cannot be determined by budgetary or appropriation decisions alone. Unless the law establishing the entitlement is changed, the government must pay the required amount, regardless of economic conditions or other demands on the budget.

The cost of most entitlements goes up automatically, without any action by the President or Congress. The aging of the population, price changes, and other developments add greatly to annual transfer payments. Largely because of these entitlements, three quarters of the Federal budget is classified by OMB as "relatively uncontrollable under existing law." There is, of course, no inherent reason why Congress cannot control spending better by changing existing law. But it takes a great deal of political muscle to do so.

Budgetary Power Redistributed In Congress

The rise of transfers has shifted spending power from the appropriations committees to authorizing committees. At one time, the appropriations committees had control of virtually all Federal expenditures. Today, however, these committees have jurisdiction over barely one-half of the budget and effective control of only one quarter. While authorizing committees, which have jurisdiction over legislation dealing with transfer programs, have enhanced their budget role, budgeting has become a more turbulent process as the numerous participants in the process vie for power.

The growth of transfers is not likely to be reversed, though it probably will be much slower in the next 50 years than it was in the past 50. The Federal government has had great difficulty adjusting its budget practices to this reality. The political deadlocks and budget deficits of recent years suggest that the necessary adjustments have not been made.

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