TAX FOUNDATION

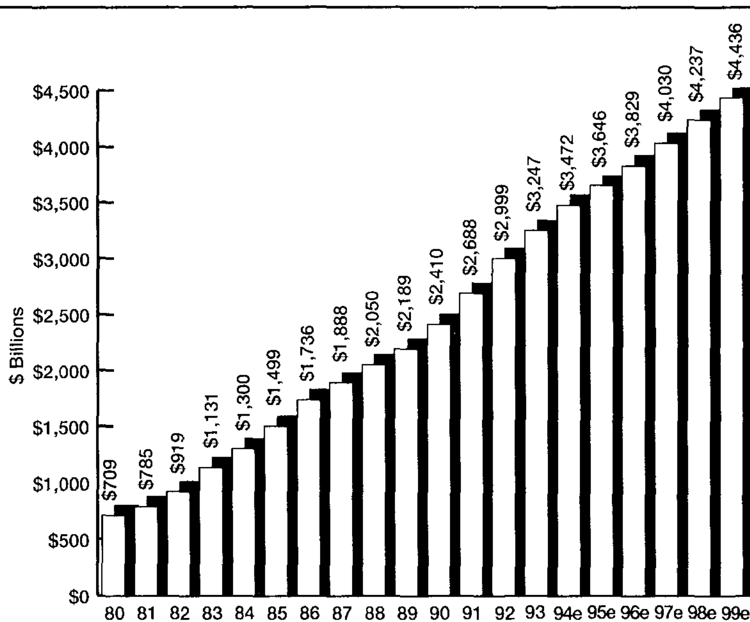
TAX FEATURES

March 1994 Volume 38, Number 3

National Debt Continues on Non-Stop Flight Upward Despite Lower Deficit Forecasts

In the wake of the recent legislative defeat of a Balanced Budg et Amendment in the U.S. House of Representatives and the United States Senate (see page 7), a Tax Foundation analysis of the latest budget shows that without further action the federal public debt is expected to rise from $3,472,412,000,000 in Fiscal Year 1994 to $4,436,299,000,000 in FY 1999—an addition of almost $1 trillion in new debt over the next five years (see *Chart 1*).

Chart 1: Federal Public Debt
FY1980 - FY1999e



Source: Office of Management and Budget.

If every man, woman, and child were invoiced for his/her share of this year's federal public debt—which includes principal owed by the government to the private sector—the bill would come to $13,345 apiece, or $53,380 for a family of four. By 1999, those figures are projected to rise to $16,281 per individual and $65,124 per family of four.

The public debt is lower than the often-quoted gross federal debt, which includes the federal public debt plus the amount of money the government has borrowed from federal trust funds, including the Social Security Trust Fund. In FY 1994, the gross debt will total almost $4.7 trillion, or $17,970 for every U.S. citizen.

The rapid rise of the national debt in recent years is due to the large annual budget deficits that Congress and the president continue to allow. The debt grows as each annual deficit adds to the accumulated borrowings of previous years. In his recent analysis of the president's new budget, Tax Foundation Economist Chris Edwards noted that, although current deficit projections are lower than last year because of the improved economic outlook, they will increase if the economy performs more poorly than forecast.

National Debt *continued on page 3*

FRONT & CENTER

In Defense of the Business Meal and Entertainment Deduction

Rep. William J. Jefferson (D-La.)

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Proposed H ealth Care Taxes Go Beyond Cigarettes

An increase in the federal cigarette excise may be the most talked about tax provision in the Clinton administration's proposed health care bill, but the revenues from that tax hike actually represent less than half the total proposed tax increases in the plan. And that doesn't include the largest revenue source for the plan: Employer/employee payroll premiums.

According to a Tax Foundation analysis of a recent Joint Tax Committee report, the Health Security Act contains 20 tax provisions which in all are projected to raise $114.2 billion in the five years between fiscal year 1996 and FY 2000. The revenue effect of 14 of the 20 tax provisions in President Clinton's health care plan are provided in the adjacent table; six of the 20 provisions were scored as having negligible revenue effects, and are not included in the table.

The proposed 75¢ increase in the federal excise on a pack of cigarettes is projected to bring in $54.3 billion over five years, or less than half of the total revenue from new taxes. An annual assessment on large employers that elect to form corporate health alliances, equal to one percent of payroll, is projected to provide $7.6 billion between 1996 and 2000. And another $12.7 billion would come from a temporary assessment on employers who have plans that obligate them to pay medical costs for retirees between the ages of 55 and 65.

In addition, the table includes the Congressional Budget Office estimates of revenues flowing to the regional health alliances from mandatory employer and employee "premiums." By FY 2000 these mandated payments will raise a total of $1,254 billion—or about 10 times the revenues projected under the increase in the cigarette excise.

The Joint Tax Committee noted that some of its revenue estimates vary significantly from the administration's projections. For example, the administration estimates that the one percent payroll tax would generate $24 billion between 1996 and 2000. The JTC's lower estimate of $7.6 billion is based on the committee's less optimistic predictions as to how many companies will actually form corporate alliances. •

Estimated Revenue Effects of Tax Provisions in the Health Security Act ($ Billions)

Tax Provision	FY1996	FY2000	FY1996-2000
Increase in excise tax on cigarettes by 75¢,with comparable increases on other tobacco products.	$11.4	$10.3	$54.3
Assessment of 1 percent of payroll on large employers electing to form corporate health care alliances.	1.4	1.4	7.6
Temporary assessment on employers with retiree health benefit costs.	**	5.1	12.7
Recapture of certain health care subsidies received by high-income individuals.	**	1.7	5.9
Modification to self-employment tax treatment of certain S corporation shareholders.	0.2	0.5	2.2
Extending of Medicare coverage hospital insurance to all state and local government employees.	1.6	1.4	7.6
Health benefits disallowed under cafeteria plans.	**	4.2	10.1
Deduction for health insurance costs of self-employed individuals.	0.7	2.3	-7.9
Elimination of special rules applicable to certain taxable insurance companies.	**	0.1	0.4
Qualified long-term care service treated as medical care.	*	-0.1	-0.4
Treatment of long-term care insurance.	*	-0.5	-1.5
Tax treatment of accelerated death benefits under life insurance contracts.	0.1	-0.1	-0.5
Tax credit for cost of personal assistance services required by employed individuals.	*	-0.1	-0.4
Income and payroll tax effects of employer mandate and other non-tax provisions.	0.1	11.8	24.0
Total	$13.9	$33.4	$114.2
Health alliance funding:			
Employer premiums	$30.0	$300.0	$952.0
Employee premiums	10.0	94.0	302.0
Total	$40.0	$394.0	$1,254.0

* Loss of less than $50 million
** Effective date after 1996.

Source: Joint Tax Committee (JCS-1-94, February 8, 1994); Congressional Budget Office.

National Debt

Continued from page 1

According to the CBO, if real economic growth is one percentage point lower each year than currently assumed, the five-year deficit total will be $429 billion higher than projected because of lower tax revenues and higher spending on programs such as unemployment benefits.

Higher interest rates than projected would also increase the deficit as borrowing costs for the federal government increase. According to the CBO, interest rates one percentage point higher than planned would add $145 billion to the five-year deficit total. These changes could significantly affect the growth of the debt in future years.

Chart 3 shows the annual additions in the federal public debt from 1980 through 1993, as well as the administration's projections for 1994 through 1999. *Chart 2* totals these increases for five-year periods. In President Clinton's recently proposed five-year budget, the public debt grows a total of $964 billion. This is a clear sign that the administration and Congress are a long way from stemming the red ink that has plagued government finances over the past few decades.

The dramatic rise of the national debt is a recent phenomenon. For most of the previous half-century the debt stayed fairly stable in real terms, relative to population growth. As *Chart 4* shows, per capita debt in constant 1994 dollars was $4,275 in 1940 and $7,256 in 1980. More impressive, the public debt actually fell as a percent of gross domestic product during that period, from 45 percent to 27 percent.

That trend has been reversed in the last two decades of this century. Between 1980 and 1990, per capita public debt almost doubled in real terms, from $5,664 to $11,031 in constant 1994 dollars. By 1999 that figure is projected to increase almost $3,000 more. The public debt as a percent of GDP climbed to 44 percent in 1990, and to 52 percent this year. Although OMB expects that figure to peak in FY1994, it will not fall below 50 percent by 1999.

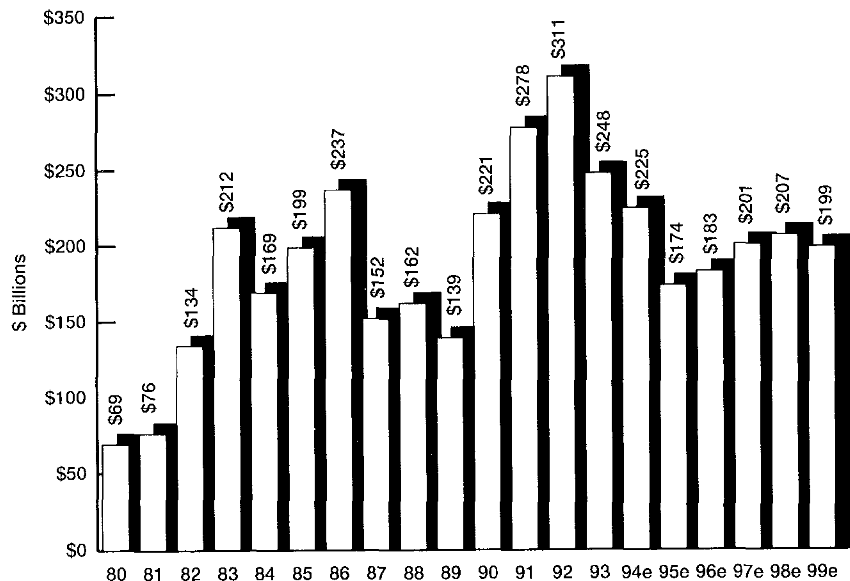
Rapidly rising "mandatory" expenditures, as discussed in recent studies by Mr. Edwards, are among the clearest reasons for this jump in the debt. Over the past five years, while inflation grew at a modest cumulative 19.4 percent, the mandatory portion of the budget—including Social Security, Medicare, and Medicaid—soared 51 percent. Over the next five years, while defense spending will fall 8 percent and non-defense discretionary will rise just under 10 percent in cumulative terms, mandatory spending is expected to rise another 40 percent. ●

Chart 2: Federal Debt Growth in Five-Year Periods FY 1980–1999e

Years	Addition to Public Debt
FY'80–FY'84	$660 billion
FY'85–FY'89	$889 billion
FY'90–FY'94e	$1,283 billion
FY'95e–FY'99e	$964 billion

Source: Office of Management and Budget.

Chart 3: Annual Addition to Federal Public Debt FY1980 – FY1999e



Source: Office of Management and Budget.

Chart 4: Public Debt, Selected Years (FY1940 – FY1999e)

Fiscal Year	Public Debt ($ Billions)	Per Capita Debt	Per Capita Debt (1994$)	Public Debt as % GDP
1940	$42.8	$324	$4,275	44.8%
1980	709.3	3,115	5,664	26.8
1990	2,410.4	9,642	11,031	44.0
1994e	3,472.4	13,345	13,345	52.3
1999e	4,436.3	16,281	13,953	50.7

Source: Tax Foundation; Office of Management and Budget; Bureau of the Census.

In Defense of the Business Meal and Entertainment Deduction

Rep. William J. Jefferson (D-La.)

A year ago I gave my support and my vote to the administration's economic recovery program because I believed it was a good first step along the long road to fiscal solvency for our nation, and I continue to believe that. The economic package did contain, however, a provision that I feel is inconsistent with the overall goal of economic recovery. This provision reduced the meals and entertainment deduction from 80 percent to 50 percent. Last fall, I introduced legislation that would restore the business meal and entertainment deduction to 80 percent. I was joined by 41 of my colleagues from every region of the country, who share my concern with the action taken on this issue during the 1993 budget reconciliation debate.

Back in 1986 proponents passed this reduction with the argument that the industries affected could absorb it without serious dislocations. They were wrong then and they are wrong now.

All of us, regardless of where our districts are located, have an interest in this restoration. What district does not have restaurants and theaters? What district doesn't depend on travel and tourism dollars to contribute to the local economy? What district doesn't have constituents who drive trucks for a living and salespeople who travel during the work week—all of whom rely on travel and/or business meals?

Reductions in the deductibility of business meals and entertainment translates into a regressive tax on business people and job losses for those they employ. It is a punitive measure that penalizes different classes of business people. As a result of the initial lowering of the business meal deduction in the Tax Reform Act of 1986 (TRA86) from 100 percent to 80 percent, truck drivers, who are mandated by law to rest in between long drives, can only deduct part of their meals; salespeople who eat on the road and who depend on the meal as a business necessity have cut down on their entertainment; the food service industry, which is the largest retail employer in the country, hired 700,000 fewer people; the live performing arts industry, which already operates on negligible profit margins, closed 25 theaters.

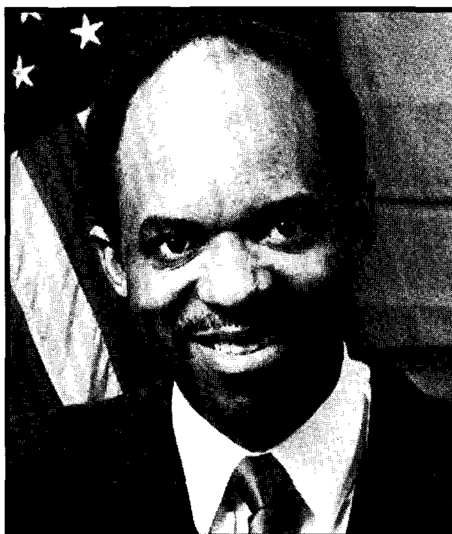
Back in 1986, proponents passed this reduction with the argument that the industries affected could absorb it without serious dislocations. We heard more of the same argument last year. Well, they were wrong then and they are wrong now.

Every region of the country, especially the major urban centers, will experience job losses as a result of the most recent action on this issue. Who will employ the actors, ushers, musicians, and ticket takers who no longer have a theater to employ them? Will the truck driver lose his job? And what about all the restaurant employees—the busboys, dishwashers, line cooks, and waiters? Which of them will lose their jobs from a decrease in business?

These are all decisions that business people will have to make now that the business meal and entertainment deduction has been reduced further to 50 percent. You can say that they will find other places to cut, that people will continue to do business the same way they always have. But the evidence puts that conclusion in doubt. Studies show that businesses must change their spending habits once they reach a certain threshold, called the bottom line. In the case of business meal deduction, 50 percent takes them over that threshold.

The food service industry stands to lose over 165,000 jobs nationwide as a result of the reduction of the deduction to 50 percent. Some of the employees in our largest cities, however, will be the biggest losers. People working in Chicago spent an estimated $1.3 billion

This issue is not, as it was originally presented, about taking away one more unnecessary privilege of the rich, corporate "fat cats." This issue is about jobs and about the future of our cities.



on business meals last year. The city alone took in over $128 million in tax revenues as a result of its food and beverage tax. This year, however, it is estimated that $130 million will be lost in business meals because of the newly lowered deduction. Additionally, the city will lose $12.6 million in tax revenue and about 5,700 people will lose their jobs. In a city with a 7.1 percent unemployment figure, this change in the tax law will have a devastating effect.

Similar results will affect a number of other major urban centers. New Yorkers will spend about $2.7 billion on business meals this year and the city coffers will take in $255 million in tax revenues. With an unemployment rate of 12.1 percent, New York City can hardly afford any provisions that will add to the numbers of unemployed.

In Los Angeles, business people will spend on average $1.2 billion this year on marketing meals, and the city will take in $175 million in taxes as a result. The restaurant industry will realize a loss of about $239 million in sales, which will translate into a tax loss of $17.3 million for the city and a loss of over 10,000 jobs in the industry. The unemployment figure for the city of Los Angeles remains high. Given its recent history and the economic peril throughout the entire state, L.A. cannot absorb this kind of job loss without potentially disastrous consequences.

In my city of New Orleans, businessmen and conventioneers were expected to spend $320 million on business meals and entertainment in 1993, generating $32 million in sales tax revenue for the state and local coffers. The New Orleans Chamber of Commerce projected that in New Orleans alone, the 50 percent deduction would translate into 1,600 lost jobs that would produce a loss of $18 million for the local economy. That is a pretty big hit for a city government that is barely getting by today.

The theater industry, an integral part of many major urban centers, stands to lose as well. New York's Broadway theaters are entirely dependent on ticket sales for their livelihood, and 20 percent of the tickets sold are for business entertainment purposes. The lowered entertainment will translate into a weekly loss of six percent of ticket sales. This may not, at first blush, seem like a lot, but a six percent loss in an industry with inherently small profit margins is enough to close a large number of Broadway shows.

The lower deduction is very unfair to medium and long-haul trucking companies and their drivers, whether employees or independent contractors, who incur a large amount of legitimate and unavoidable business meal expenses. Many drivers must eat all meals away from home 200 or more days per year. These meals are usually eaten at truck stops and other modest establishments. The drivers either are reimbursed for those meals at the federal per diem rate or make use of the business meal deduction. Denying 50 percent of that modest and unavoidable expense is inequitable tax policy. Must truck drivers now skip breakfast to make up for the increase in price they experience because they can only deduct 50 percent of the cost of a meal?

In 1996, Atlanta has the honor of hosting the Summer Olympics. As a result, that city will be swarming with millions of people who will spend billions of dollars before, during, and after this spectacular event. Atlanta expects to welcome countless foreign tourists whose travel will be a legitimate business expense and who will market their products by means of business meals and various forms of entertainment, all of which will be 100 percent deductible in their own countries. Americans looking to conduct business in Atlanta will thus be placed at a competitive disadvantage.

Over 46 million visitors arrive in the U.S. every year and add an estimated $72 billion to our national and local economies. Travel and tourism is the third largest retail industry in the country, with a payroll in excess of $83 billion. This industry provides hundreds of thousands of jobs to those who traditionally have a difficult time facing economic dislocation—women, minorities, and teenagers.

Clearly, this issue is not, as it was originally presented, about taking away one more unnecessary privilege of the rich, corporate "fat cats." This issue is about jobs and about the future of our cities. Cities such as New York, Atlanta, Chicago, Los Angeles, and my own city of New Orleans will absorb the largest impact of this provision at a time when we are desperately looking for ways to revitalize our cities within severe federal budget constraints. A restoration of the business meal and entertainment deduction to 80 percent is one way to start to accomplish this end.

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

Corporate Minimum Tax Achieves Goal—But at High Cost

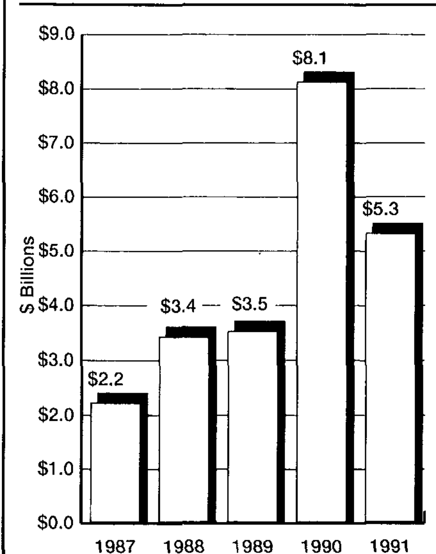
The new corporate Alternative Minimum Tax (AMT), established by Congress in 1986, has achieved its goal of reshuffling tax liabilities more evenly among corporations and industries, says a new analysis by the Tax Foundation. But while the AMT has increased "fairness" according to some, it has also provided a disincentive to investment, has hit firms hard during economic slowdowns when they can least afford it, and has added substantial complexity to the tax system.

In his latest *Special Report*, "A Primer on the Corporate Alternative Minimum Tax" (March 1994, No. 30), Economist Chris R. Edwards explains how the AMT works, and discusses why it is considered one of the most complex and burdensome provisions in the corporate tax code.

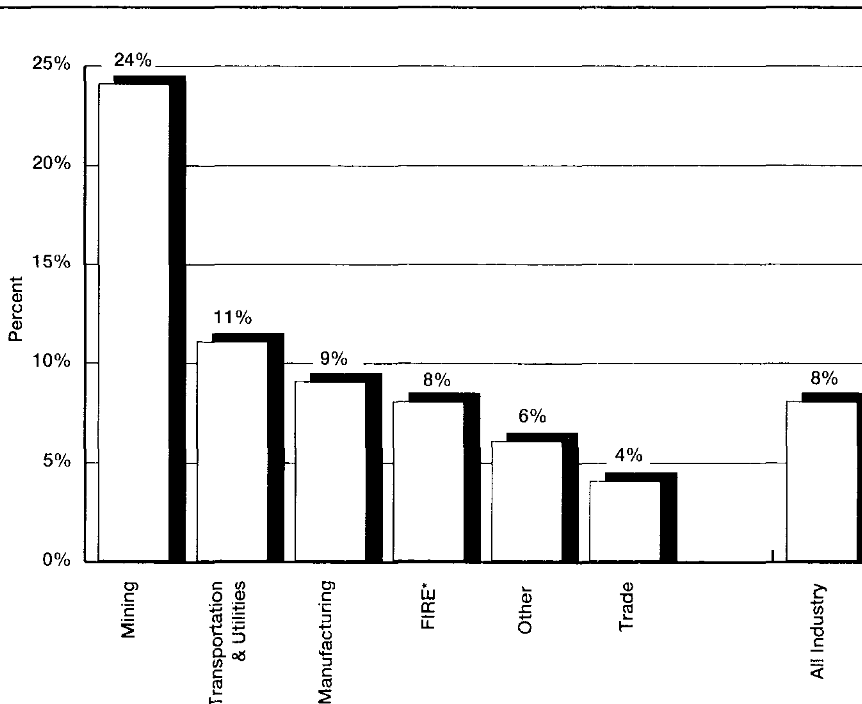
The report provides a handy introduction to this complicated important area of federal taxation.

A tougher AMT was enacted in 1986 to ensure that corporations reporting net income would not avoid significant tax liability through exclusions, deductions, and credits. Since then, tax collections from many corporations have significantly increased and collections are more evenly distributed among firms and among industries.

Corporate AMT receipts were $5.3 billion in 1991 (see accompanying chart), the most recent year figures are available, down from $8.1 billion in 1990, but up from AMT payments during 1987 through 1989. Although 30,400 corporations paid AMT in 1991, 78 percent of that amount was paid by a few hundred large corporations with assets greater than $500 million.



Source: Tax Foundation; Internal Revenue Service.



* Finance, insurance, and real estate.
Source: Tax Foundation; Internal Revenue Service.

The primary problem with the AMT, says Mr. Edwards, is that the goals of the policy are achieved at the cost of a lower level of total capital investment in the economy.

Modifications in the Omnibus Budget Reconciliation Act of 1993 should alleviate some of the complexities and investment disincentives in the AMT. But the economic cost of lost investment and the resources wasted on tax compliance efforts are still high. The AMT increases the complexity of the corporate tax system significantly because companies effectively face a dual tax system with different tax rates and deduction rules under the AMT and regular tax systems. The AMT also complicates business investment planning because calculating the after-tax return from an investment becomes more uncertain.

Finally, says Mr. Edwards, the AMT has the perverse effect of raising a firm's effective tax rate during economic slowdowns, when companies can least afford the increased tax burden. ●

Balanced Budget Amendment Falls Short in U.S. Senate

The Senate voted March 1 on Sen. Paul Simon's Balanced Budget Amendment. The 63-37 vote was four short of the two-thirds approval needed to pass a constitutional amendment. (A March 17 vote in House of Representives fell 12 votes short of the necessary margin.) Following is how Senators voted.

Yes–63

Bennett (R-UT)	Hatch (R-UT)
Bingaman (D-NM)	Heflin (D-AL)
Bond (R-MO)	Helms (R-NC)
Boren (D-OK)	Hollings (D-SC)
Breaux (D-LA)	Hutchison (R-TX)
Brown (R-CO)	Jeffords (R-VT)
Bryan (D-NV)	Kempthorne (R-ID)
Burns (R-MT)	Kohl (D-WI)
Campbell (D-CO)	Lott (R-MS)
Chafee (R-RI)	Lugar (R-IN)
Coats (R-IN)	Mack (R-FL)
Cochran (R-MS)	McCain (R-AZ)
Coverdell (R-GA)	McConnell (R-KY)
Craig (R-ID)	Mosely-Braun (D-IL)
D'Amato (R-NY)	Murkowski (R-AK)
Danforth (R-MO)	Nickles (R-OK)
Daschle (D-SD)	Nunn (D-GA)
DeConcini (D-AZ)	Packwood (R-OR)
Dole (R-KS)	Pressler (R-SD)
Domenici (R-NM)	Robb (D-VA)
Dorgan (D-ND)	Roth (R-DE)
Durenberger (R-MN)	Sasser (D-TN)
Exon (D-NE)	Shelby (D-AL)
Faircloth (R-NC)	Simon (D-IL)
Feinstein (D-CA)	Simpson (R-WY)
Ford (D-KY)	Smith (R-NH)
Gorton (R-WA)	Specter (R-PA)
Graham (D-FL)	Thurmond (R-SC)
Gramm (R-TX)	Wallop (R-WY)
Grassley (R-IA)	Warner (R-VA)
Gregg (R-NH)	Wofford (D-PA)

No–37

Akaka (D-HI)	Leahy (D-VT)
Biden (D-DE)	Levin (D-MI)
Baucus (D-MT)	Lieberman (D-CT)
Boxer (D-CA)	Mathews (D-TN)
Bradley (D-NJ)	Metzenbaum (D-OH)
Bumpers (D-AR)	Mikulski (D-MD)
Byrd (D-WV)	Mitchell (D-ME)
Conrad (D-ND)	Moynihan (D-NY)
Dodd (D-CT)	Murray (D-WA)
Feingold (D-WI)	Pell (D-RI)
Glenn (D-OH)	Pryor (D-AR)
Harkin (D-IA)	Reid (D-NV)
Hatfield (R-OR)	Riegle (D-MI)
Inouye (D-HI)	Rockefeller (D-WV)
Johnston (D-LA)	Sarbanes (D-MD)
Kassebaum (R-KS)	Stevens (R-AK)
Kerrey (D-NE)	Wellstone (D-MN)
Lautenberg (D-NJ)	

FOUNDATION MESSAGE

The Achilles Heel of Health Care Reform

President Clinton's health care reform proposal has been battered and beaten from virtually every point on the compass. Republican supporters of similar managed care-type proposals quibble over details, while supporters of free-market approaches continue to hammer away at the need for greater market freedom. Democratic supporters push for greater government involvement in some cases, less in others, while supporters of single-payer plans and similar varieties of socialized medicine continue to try to make their case in subcommittee and floor debates.

Industry groups, led by the insurance industry's Harry and Louise, have geared up to make their voices heard and are clearly having an effect. Watching over all this is the national press, which continually shifts its focus from the underlying issues to the political scoresheet of whether the president is up or down from yesterday.

J.D. Foster
Executive Director and Chief Economist

Yet, despite all that the death of the president's health care reform are, as the saying goes, greatly exaggerated. Readers may recall that the 1986 Tax Reform Act, which was the last undertaking of similar import and dimension, was pronounced dead a thousand times before it was finally brought to President Reagan for signing.

Though the plan may eventually pass and give the president a great legislative victory, if enacted in its current form it will be a terrible economic failure. The problem? The true linchpin to the Clinton plan is not the cigarette tax, nor even the employer mandates, but the complicated set of price controls on which the plan relies—in the form of various caps, fee schedules, oversight boards, and other regulations to slow the growth of medical costs.

In an open letter to the president, printed in the *Wall Street Journal*, a group of 565 economists argued that such controls produce shortages, black markets, and reduced quality, and must eventually fail. This is correct, of course, which means the one sure bet in the whole health care proposal is that these price controls will eventually fail. When they do, the federal deficit will increase by over $110 billion annually, and continue to grow, according to a recent study by DRI/McGraw Hill. This compares with about $33 billion of annual tax increases currently in the Clinton plan.

Given Washington's proven predilection for reducing the deficit through tax increases, this increased spending will probably mean an increase in taxes of $100 billion annually— equivalent to an 18 percent increase in personal income tax receipts compared to 1994's projected receipts, or a 77 percent increase in corporate income taxes. Obviously, tax increases of this magnitude would probably also spell the end of any hopes of even modest economic growth, let alone creating the resources we need as a nation to address other problems like chronic unemployment, depressed wage growth, environmental cleanup, etc.

Even without the Clinton reform's eventual price control failures, Medicare and Medicaid are projected to grow by $158 billion, or nearly 70 percent by 1999 from 1994 levels. One of the motivations that has driven health care reform to this point is the widespread recognition that the current federal funding arrangement for health care is headed toward disaster. The Clinton plan's reliance on price controls not only fails to prevent this result, it accelerates and assures it.

Unique *Barclays* Supreme Court Case Sure to Set State Tax Precedent

TAX FEATURES

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The most important state tax issue pending before the U.S. Supreme Court in its current term concerns the constitutionality of Califor-nia's use of the worldwide combined method of income tax reporting (WWCR)—also known as the unitary method and as formulary apportionment. A new study by Tax Foundation Special Counsel J. Dwight Evans examines the tax issues and foreign tax policy concerns involved.

The issue is presented in two companion cases: *Barclays Bank, PLC v. Franchise Tax Board*, which involves a foreign-based multinational group of corporations, and *Colgate-Palmolive Company v. Franchise Tax Board*, which involves a U.S.-based multinational group.

All governments require the use of some method to determine the amount of taxable income earned within their jurisdictions by taxpayers conducting business across their borders. While major trading nations—including the U.S.—use one formula for income tax reporting, California uses a different formula. The central constitutional issue in both the Supreme Court cases is whether the use of WWCR by California violates the commerce clause of the U.S. Constitution. From an economic perspective, the key disagreement between California and Barclays is whether California's WWCR method results in international double taxation.

The *Barclays* case is unique: Through the filing of *amicus* briefs in the Supreme Court, the U.K. government, supported by 19 foreign countries, has challenged the validity of California's WWCR under the foreign commerce clause of the Constitution, while the U.S., as an *amicus curiae*, is supporting the state against that constitutional challenge.

While the Reagan and Bush administrations sided with the U.K on this issue, the Clinton administration sides with California. This change in policy led the U.K. to announce that it intended to activate a retaliatory tax measure against U.S.-based firms doing business in the U.K. and California unless there was a satisfactory resolution of the WWCR tax problem by the end of 1993. Under pressure from the Clinton administration, effective as of January 1, 1994, California has prospectively amended its method of taxation in order to satisfy the foreign objections. The U.K. has deferred retaliation but has advised the State Department that the California legislation has not resolved the worldwide combined tax problem.

If California loses the cases, it could lose approximately $4 billion in tax revenue in the form of tax refund payments and the loss of tax revenue from pending assessments, plus interest. If California wins, the U.K. and other foreign government may retaliate.

Mr. Evans concludes that, in retrospect, California's decision to extend combined reporting worldwide to U.S. and then foreign-based multinational corporations has opened Pandora's box of tax troubles for international business and itself, as well as the U.S. government and its major trading partners. In the *Barclays* and *Colgate* cases the U.S. Supreme Court is now in a position to do something about closing the box. ●

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