TAX FOUNDATION Since 1937

TAX FEATURES

www.taxfoundation.org *February 1998 Volume 42, Number 2*

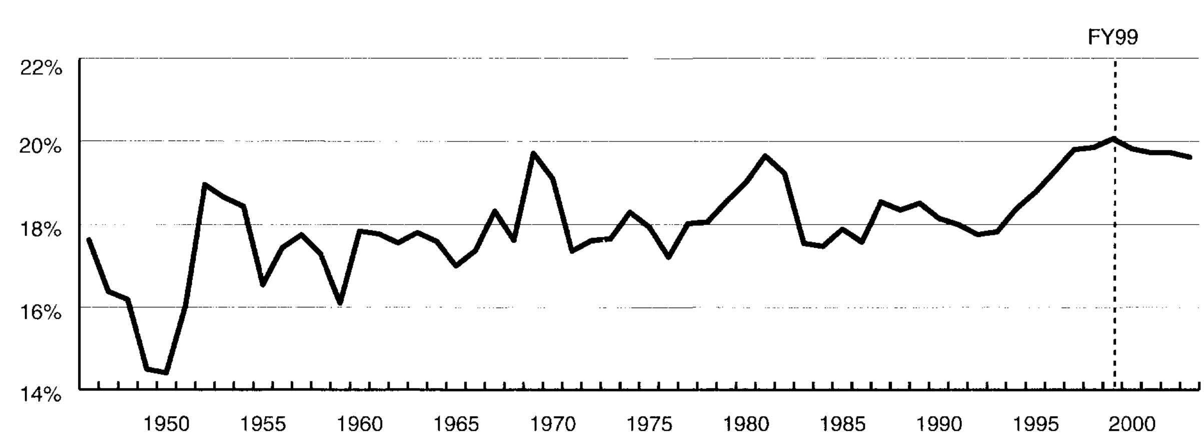
Record Level of Federal Receipts Expected to Continue Under President's FY 1999 Budget

The Clinton Administration's federal budget plan over the next five years, if implemented, will fill federal coffers to record levels, according to a new report from the Tax Foundation. The analysis of the President's FY 1999 budget shows that, under the President's proposals, federal receipts would average 19.8 percent of GDP during FY 1999-2003. Such levels exceed both recent and historical averages. So far during the 1990s, federal receipts have averaged 18.5 percent of GDP. During the entire postwar period (1946 to the present), they have averaged 17.8 percent of GDP.

Titled "The President's FY 1999 Budget," Special Report No. 75 by Senior Economist Patrick Fleenor provides an overview of the trend in federal receipts and outlays. Mr.

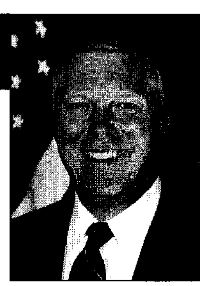
Budget *continued on page 2*

Chart 1: Federal Receipts as a Percentage of GDP, FY 1962–2003p



Source: Tax Foundation based on OMB data.

FRONT & CENTER



Taxes – Time for Reform is at Hand

Rep. Richard A. Gephardt (D-Missouri)

4-5

Record Level of Federal Receipts Expected

Budget

Continued from page 1

Fleenor observes that if taxes are the measure, the era of big government is far from over: Under the Clinton budget, the share of the nation's resources claimed by the federal government will remain at historic levels at least into the next administration (see Chart 1).

Charts 2 and 3 provide a visual demonstration of the changes in both federal receipts and outlays over the past four decades.

In Chart 2, the upward trend in mandatory spending — primarily entitlements such as Social Security and Medicare, along with net interest payments on the federal debt — is clearly evident by the thick black line. The mandatory trend line, which stood at approximately 35 percent of federal outlays in 1962, by 2003 is expected to stand at 70 percent of total spending. Conversely, nonmandatory spending, particularly national defense outlays, have shrunk dramatically as a portion of the total budget.

In Chart 3, the most visible change since the early 1960s is the increase in the proportion of social insurance taxes as a percent of total receipts. In the early 1960s, they were roughly 20 percent of the budget; today they rival the individual income tax as the largest source of revenue for Uncle Sam.

Chart 2: Federal Outlays by Type, FY 1962–2003p

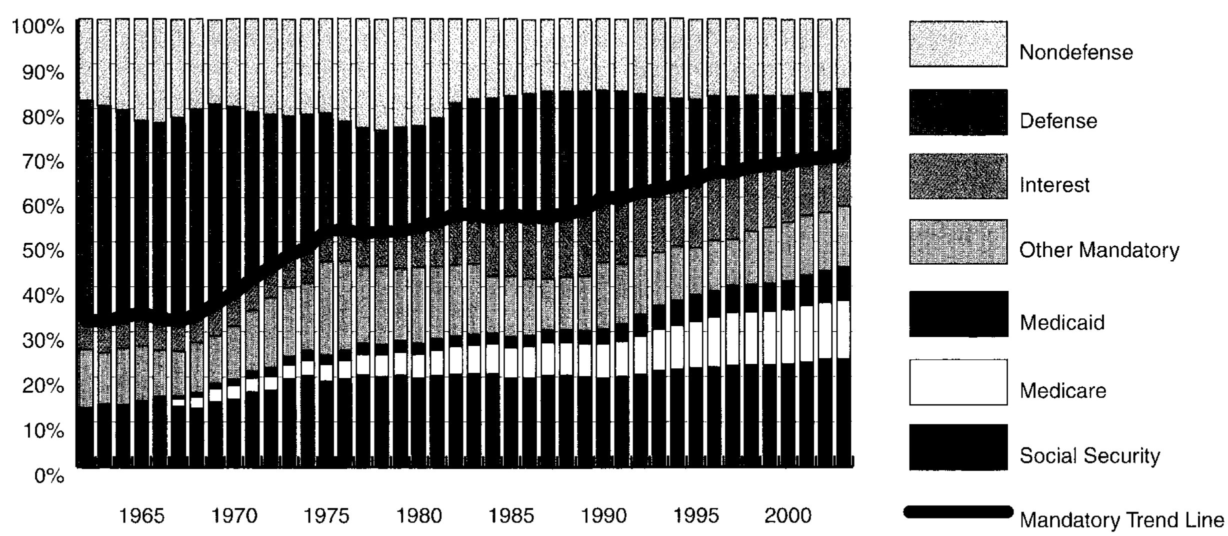
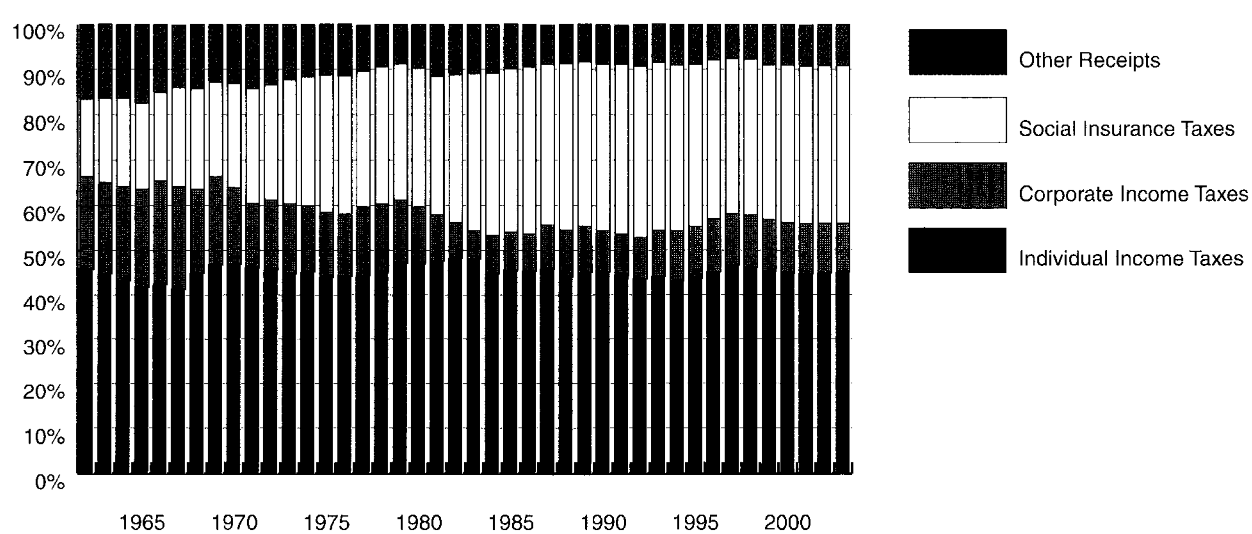


Chart 3: Federal Receipts by Type, FY 1962–2003p



Source: Tax Foundation based on OMB data.

Annual State Tax Collections Climb Over $400 Billion

State tax collections grew by 4.9 percent between 1995 and 1996, climbing to a total of $419 billion, according to the Tax Foundation's latest state analysis. The three fastest growing categories of state collections were death and gift taxes (8.2 percent growth), individual income taxes (6.9 percent growth), and public utility taxes (6.4 percent growth).

For the most part, politicians weren't to blame for the growth: economic expansion in 1996 accounted for most of the growth in state tax collections. In fact, in his *Special Report* "State Tax Rates and 1996 Collections," Economist Scott Moody observes that on a national basis, growth in personal income outpaced the growth in state taxes by about 1 percent. (That compares with a decade-long trend where state tax growth climbed slightly faster than personal income growth.) The five states that had the highest tax growth relative to personal income growth between 1995 and 1996 were Alaska, New Hampshire, Wyoming, North Dakota, and Iowa. The five states that had the highest personal income growth relative to tax growth were Hawaii, Arkansas, Michigan, New Mexico, and California.

In his study, Mr. Moody demonstrates that the various measurements of state tax burden can differ substantially. For example, both Mississippi and New Jersey show a large disparity between their per-capita and per-$1,000-of-personal-income rankings — but in opposite directions (see chart). Mississippi is ranked 35th in terms of tax burden per capita, but is ranked 9th in terms of tax burden per $1,000 of personal income. On the other hand, New Jersey is ranked 14th in per capita tax burden, but 42nd in terms of tax burden per $1,000 of personal income. The disparity can be traced to the relative per capita income levels of the two states. Per capita income in Mississippi is about 58 percent of that in New Jersey, while the southern state's tax system is more progressive than the northern state's.

Mr. Moody reports that 10 states enacted legislation for 1997 that altered individual income tax laws via changes in deductions, exemptions, and tax credits. Four states changed some or all of their individual income tax rates: Delaware, Kansas, Nebraska, and New York.

Moreover, while only three states changed their basic sales tax rates in 1997, and four states increased their gasoline excise rates, 8 states raised their cigarette taxes. In fact, Indiana, Maine, Oregon, and Utah virtually doubled their tax rates for a pack of cigarettes.

State Tax Collections Per Capita and Per $1,000 of Personal Income with Ranks (FY 1996)

				Rank	
	Total ($Millions)	Per Capita	Per $1,000 Personal Income	Per Capita	Per $1,000 Personal Income
Alabama	$5,257.8	$1,230	$61.12	46	35
Alaska	1,519.1	2,506	102.57	3	2
Arizona	6,409.4	1,447	67.76	30	27
Arkansas	3,708.7	1,478	77.94	27	13
California	57,746.7	1,811	71.47	12	21
Colorado	4,820.2	1,261	49.06	45	49
Connecticut	7,830.2	2,392	70.60	4	22
Delaware	1,688.3	2,329	84.02	5	7
District of Columbia	2,480.7	4,567	133.81	1	1
Florida	19,699.3	1,368	56.47	41	44
Georgia	10,292.4	1,400	60.92	37	36
Hawaii	3,069.3	2,592	102.07	2	3
Idaho	1,857.0	1,562	78.72	20	12
Illinois	17,277.3	1,458	54.32	28	45
Indiana	8,437.0	1,444	63.92	31	30
Iowa	4,440.5	1,557	69.81	21	23
Kansas	3,978.8	1,547	66.77	23	28
Kentucky	6,489.3	1,671	84.40	16	5
Louisiana	4,906.3	1,128	57.35	48	43
Maine	1,896.6	1,526	72.60	25	19
Maryland	8,166.7	1,610	58.31	18	41
Massachusetts	12,453.4	2,044	68.61	7	26
Michigan	19,128.7	1,994	79.93	8	10
Minnesota	10,055.5	2,159	84.13	6	6
Mississippi	3,862.5	1,422	80.92	35	9
Missouri	7,300.1	1,362	59.17	42	40
Montana	1,256.4	1,429	74.36	33	16
Nebraska	2,369.5	1,434	62.58	32	34
Nevada	2,889.3	1,802	69.29	13	24
New Hampshire	837.1	,720	27.06	51	51
New Jersey	14,384.9	1,801	57.47	14	42
New Mexico	3,060.6	1,787	95.00	15	4
New York	34,150.0	1,878	64.35	10	29
North Carolina	11,882.3	1,623	73.08	17	18
North Dakota	985.3	1,530	74.88	24	15
Ohio	15,649.5	1,401	59.71	36	39
Oklahoma	4,617.8	1,399	71.58	38	20
Oregon	4,415.7	1,378	59.73	40	38
Pennsylvania	18,725.0	1,553	62.62	22	33
Rhode Island	1,549.2	1,565	63.67	19	31
South Carolina	5,113.0	1,382	69.20	39	25
South Dakota	730.3	998	47.72	50	50
Tennessee	6,184.6	1,163	52.97	47	46
Texas	21,259.1	1,111	49.88	49	48
Utah	2,914.0	1,457	74.34	29	17
Vermont	841.0	1,428	63.58	34	32
Virginia	8,900.4	1,333	52.88	43	47
Washington	10,586.5	1,913	75.97	9	14
West Virginia	2,770.9	1,517	83.57	26	8
Wisconsin	9,616.8	1,864	79.92	11	11
Wyoming	626.0	1,301	60.36	44	37
All States (a)	$418,606.1	$1,581	$64.79		

(a) Does not include the District of Columbia.
Source: Tax Foundation, based on Commerce Department,, Census Bureau and Bureau of Economic Analysis data.

FRONT & CENTER

Taxes — Time for Reform is at Hand

By Rep. Richard A. Gephardt (D-Mo.)

Following are excerpts of a speech by House Democratic Leader Richard A. Gephardt before the Commonwealth Club of California in January 1998:

We are about to enter a period where our leadership will be tested again, and one of the defining questions will be an issue that most Americans love to hate — the federal income tax.

Benjamin Franklin made the oft-quoted comment that "in this world nothing can be said to be certain, except death and taxes". No one likes either subject very much. There's not much anyone can do to improve on the inevitability of the first subject. But if we aggressively pursue a just and fair tax reform in Washington, we can make paying taxes simpler and fairer for all American families.

Just days ago, millions of tax forms started arriving in mailboxes all across the country. People are beginning to sit down at their kitchen tables, pulling their shoeboxes of receipts out wondering how much they owe Uncle Sam.

> ***My plan would have almost 75% of taxpayers pay at no more than a 10% rate. For most Americans, that would be a significant reduction from current rates. And my plan would drastically streamline the tax code through the elimination of deductions. A majority of taxpayers would not have to file an income tax return with the federal government.***

They see a tax code riddled with preferences, gimmicks and loopholes — many of which they don't qualify for or certainly don't understand. They see a tax return that takes far too much time and effort to calculate. And to add insult to injury, they see taxes that are simply too high.

The tax code is fundamentally flawed. But there is also something wrong in an economy where people have to work so hard — spending more and more time at their jobs away from their family, their friends, and their children. So today I want to talk about tax reform — not only the need for it, but putting it in perspective, the perspective of hard-working Americans.

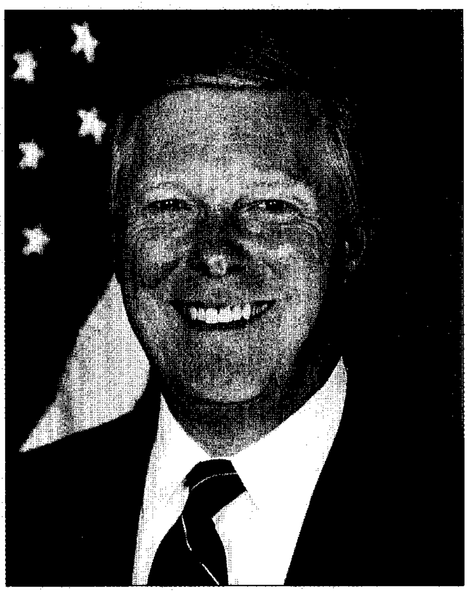
We need a tax code that works for working America. That asks everyone to pay their fair share, but doesn't require them to do acrobatics in the process. A tax reform that lifts up working Americans in their effort to improve their lives, not drags them down.

Over two years ago, I announced my vision for reforming the federal income tax system. Dubbed the Democratic flat tax by the pundits, it differs in many respects. My plan would reduce rates for all taxpayers — not just those at the top of the ladder. From a clerk at the neighborhood hardware store to the CEO of a Silicon Valley software company, rates would drop by as much as one-third.

My plan, which I intend to introduce April 15, would have almost 75 percent of taxpayers pay at no more than a 10 percent rate. For most Americans, that would be a significant reduction from current rates. And my plan would drastically streamline the tax code through the elimination of deductions. A majority of taxpayers would not have to file an income tax return with the federal government. For those that do file, most could use a postcard sized tax form.

To reduce tax rates, the current tax base would be dramatically broadened and $50 billion in corporate welfare would be eliminated. The proposal would retain the current progressivity of the tax code and would not increase the deficit. This reform would sharply reduce the $300 billion and 4.5 billion hours per year now spent on tax filing, tax preparation, and complicated strategies for tax avoidance.

Unlike a consumption or flat tax, the 10 percent tax treats all income the same. Whether a taxpayer earns money from hard work or from investment, the tax treatment will be identical. This reform would free the economy from a distort-



ed tax code. My plan takes away the power from the back rooms in Washington and puts it back in the hands of taxpayers.

But there is a natural skepticism in the American people — a belief that politicians will not be able to resist the temptation to create new special interest loopholes and pay for them by raising the rates again. To prevent that, to protect fundamental reform once it passes, my proposal would require a majority of voters across the country to approve future income tax increases in a referendum.

I have made three major changes to the plan I introduced two years ago. The changes were made after listening to people share their concerns. The changes were made possible by the economic growth we've experienced over the last two years.

First, my plan retains the exclusion on employer-provided health care. Now the plan protects both your home and your health.

Second, my plan eliminates the marriage penalty — the feature of today's tax code that can actually impose higher tax burdens on married couples.

Third, we've increased the standard deduction and personal exemptions: a family of four would pay no federal income tax on the first $27,500 in income, And, we've been able to raise the coverage of the 10 percent rate so that the same family would pay no more than a 10 percent rate on income up to $61,000.

These changes reflect my determination to enact a reform that both lightens the load and simplifies the process for the vast majority of American taxpayers. In every aspect — from fairness to simplicity to protecting the integrity of the balanced budget to promoting economic growth — Democratic tax reform bests both Republican tax reform proposals.

Let's talk about fairness. The Republican flat and sales tax cures are worse than the disease. They seek to enact the largest redistribution of wealth in our history — and all in the wrong direction. And they seek to create a system which either explodes the deficit or forces deep cuts in education, the environment, and health care.

Progressivity is not designed to punish the wealthy for their economic success. The idea behind it is to lighten the tax burden on those who are working hard to move into and stay in the middle-class. Republican plans gut progressivity under the guise of fairness. They shift the tax burden down the scale, lightening the load on the wealthy. This is the cruelest kind of class warfare — by the wealthy, for the wealthy, paid for on the backs of working people. By Republicans who are constantly accusing others of class warfare.

At a time when Americans are enjoying increased levels of employment but stagnant wages, it is imperative to give some relief to those struggling to support their families. My plan lowers the tax rates for all filers, providing a real benefit to working people.

Indeed, average taxes for the vast majority of people making less than $200,000 would be cut. Sixty-two percent of all taxpayers would see a tax cut under my plan. About one-quarter would see no change in their tax bill — although a simpler system will clearly be of enormous benefit. Only 13 percent of all taxpayers would end up paying more. They're the ones who have so abused the code that everyone is forced to pay more.

My plan accomplishes what the Republicans do not. My proposal reduces the rates paid by all taxpayers. The Republican flat tax plan also would eliminate some deductions and loopholes. But they use savings largely to finance lower rates on the wealthy. Democratic reform insists that savings be used to lower tax rates for all Americans, not just those at the top.

Let me turn to the issue of simplicity. The Republicans worship at the altar of tax simplicity, but their reforms have a huge price tag for working Americans. Both the 10 percent and the Republican flat tax would simplify tax filing. Under my plan, many Americans would not have to file at all. Both plans would enable individuals to file their taxes on a form the size of a postcard. But the Armey plan is simple — and simply unfair — by shifting the tax burden to the middle class.

My plan proves it is possible to have a very simple tax system without sacrificing the principle of fairness. My plan delivers both.

At first glance, the Republican sales tax appears to be simple and non-bureaucratic. But a closer took shows this could be the most complicated new system. State sales taxes are easy to collect because of their relatively low rate. But a national sales tax of 20 percent or more would invite non-compliance, and would require a whole army of new tax agents to effectively enforce.

Now let's talk about the deficit. Another test of tax reform is whether it is deficit friendly — whether it can accomplish its goals without blowing a big new hole in the budget. We turned our back on the "spend now, pay later" mentality of the 1980s and have restored some fiscal sanity. It took us 17 long years to dig out from a mountain of debt. We shouldn't return to an era of big deficits to finance tax cuts for the wealthy.

Tax reform must not wreck our hard-earned fiscal health. My plan is fiscally responsible and revenue neutral. And unlike the Republican plans, it doesn't blow a hole in the deficit.

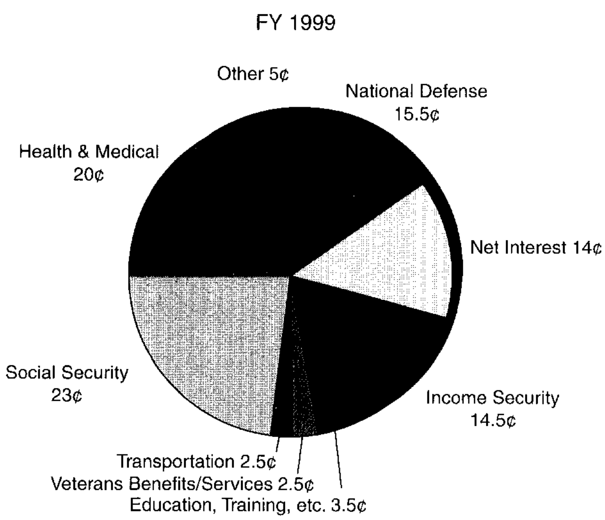
Let's work to achieve a system which will treat all Americans with fairness and dignity. And let's give all American taxpayers the break they deserve.

The Tax Foundation invites a national leader to provide a "Front and Center" column each month in Tax Features. *The views expressed in these columns are not necessarily those of the Tax Foundation.*

How Uncle Sam Will Spend Your Tax Dollar in 1999

How will your federal tax dollars be spent in FY 1999? According to the latest federal budget, the typical tax dollar will be divied up far differently than in past decades.

The graph below shows how the FY 1999 federal budget dollar likely will be spent. As a comparison with previous budgets (depicted at the right) demonstrates, major changes have occurred over the years.The biggest changes in the last two decades can be found in how much Uncle Sam spends on health-related programs and on national defense. In FY 1979, the federal government spent 9.5¢ out of every tax dollar on health — primarily Medicare and Medicaid. In FY 1989, government health costs had risen to 11.5¢, and today that portion of the federal dollar has climbed to 20¢. On the other hand, the portion of defense spending has fallen from 28¢ out of every tax dollar in FY 1979, to 26.5¢ in FY 1989, to 15.5¢ in FY 1999.

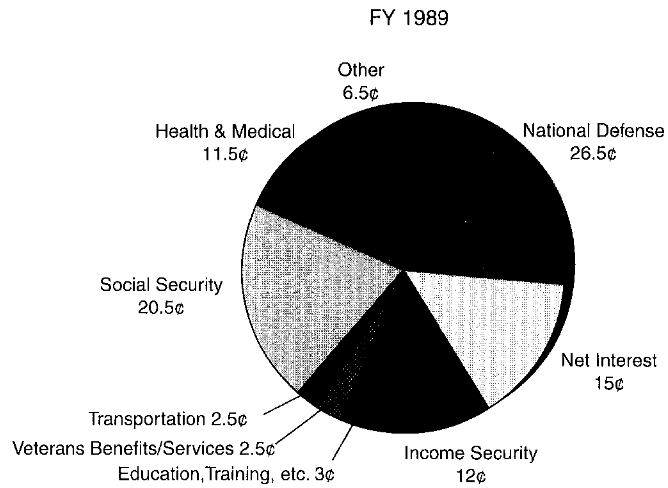


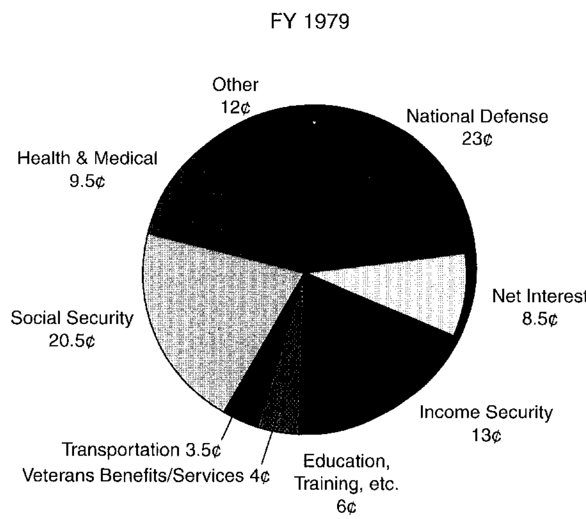
Net interest payments on the federal debt have risen significantly since FY 1979, when they represented only 8.5¢ out of every dollar of federal expenditure. But they have stabilized over the past decade, at around 14¢.

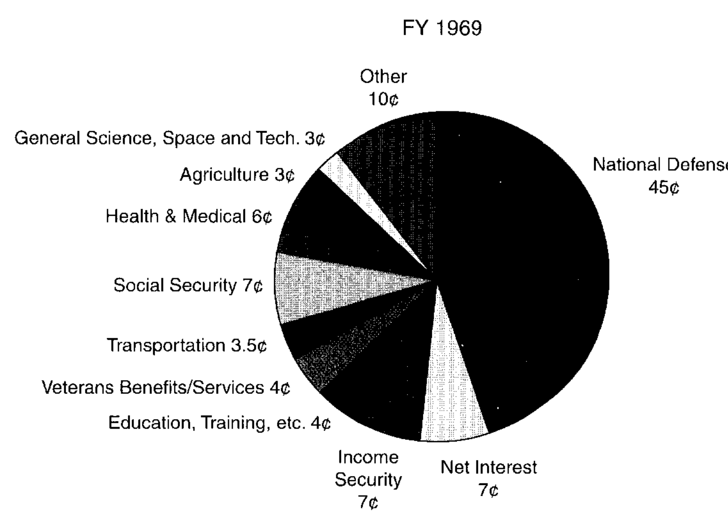
Social Security outlays have climbed ever so slightly over the past two decades, from 20.5¢ out of every federal tax dollar in FY 1979 to 23¢ today. However, when compared to 30 years ago, the change has been significant: Social Security payments have tripled as a portion of the budget since FY 1969.

The FY 1999 budget shows how relatively minor a role discretionary spending — such as defense, education, agriculture, and transportation — has assumed over the past few decades. Mandatory spending, including net interest and entitlements, now represents about 74¢ out of every federal tax dollar, while discretionary outlays represent only about 26¢. In contrast, back in FY 1969, the portions were reversed: discretionary spending represented roughly 70¢ out of every federal tax dollar — 45¢ of which went to national defense — while entitlements and net interest payments took up about 30¢.

Not only has the allocation of the tax dollar changed, so has the price: per capita federal taxes in FY 1999 will be $6,277, compared to $5,150 (in constant dollars) a decade ago.







FOUNDATION MESSAGE

Save Social Security First By Doing (Next to) Nothing

J.D. Foster, Ph.D.
Executive Director & Chief Economist
Tax Foundation

With the release of the President's budget for Fiscal Year 1999 we begin another chapter in the never-ending budget battle. The new dimension in the budget is the prospect of surpluses arising as early as this year. Coming as they do at a time when price stability reigns and the economy is robust and balanced, budget surpluses offer a unique opportunity to address fundamental issues in fiscal policy.

Which brings us to the second major development in the President's budget, namely his call to "Save Social Security First." To review the bidding, Social Security is a $ 393 billion program that is currently running surpluses of about $90 billion annually. But it is projected to run deficits continually after about 2011 and to go bankrupt around 2029, hence the need to "save" it.

At the same time, taxpayers and savers need to be saved from Social Security. Tax Foundation analysis, and that of others, has shown that Social Security offers a terrible rate of return as a pension system when measured against private alternatives. Thus it is vital to address Social Security, but we should both "save" Social Security from bankruptcy, and save taxpayers from Social Security.

President Clinton's call to save Social Security is precisely the kind of leadership the Nation needs from its President. There is a serious problem, it must be addressed, and this is an excellent time to do so since the projected budget surpluses give us the financial wiggle room we need to make the parts fit together. Only one problem, however — his call represented a pause more than a policy.

What evidence is there to support such an assertion? Simply this. There is no policy. Just exactly what does the White House propose the Congress enact to save Social Security? What benefits should be adjusted and when? What taxes should be altered and when? What eligibility requirements should be changed and when? On all these questions and more, the President's budget is silent, nor has there been any grand policy roll-out in the days and weeks since.

Using current surpluses to save Social Security without a plan to fix Social Security is a non-policy policy. If the Congress did nothing with these surpluses, they would be used to buy back federal debt. Under the President's initiative, presumably, the surpluses will be used to buy back federal debt. No difference. Even if a special fund is established to hold the repurchased debt, this would be mere bookkeeping legerdemain with zero economic meaning.

In short, the President's budget initiative on Social Security is to do nothing, for now at least. Perhaps not surprisingly, congressional Republican leadership appears inclined to endorse such a non-policy. In so doing they foreclose their options to cut taxes, but they also avoid a tax cut fight they apparently are unprepared to wage. And they avoid the embarrassing spectacle of watching Republican Members trip over themselves to spend the surplus as fast as their "big spending" Democratic colleagues. So with both sides rallying around the Social Security battle cry, everyone can proclaim their fiscal responsibility and loyalty to the nation's seniors, all the while doing for Social Security reform exactly what would have been done without this initiative, namely nothing.

Now let's look at the bright side. For one thing, the President has publicly stated that there is a problem with Social Security's finances. To paraphrase an old saying, why save something if it ain't in trouble. Thus the President has further stripped the veneer of legitimacy from those who proclaim the current system sound.

For another thing, while the President has come up with billions of dollars of new spending, he has also said that we should use the surpluses to save Social Security. While the intellectual inconsistency is obvious, it is still better for keeping spending in check that he has publicly planted his flag and claimed the surpluses in the name of Social Security.

And while buying back federal debt in the name of Social Security is a holding action at best, even so it has its benefits. Even without some illusory effect on interest rates, buying back federal debt would reduce future federal interest expense and thereby improve the likelihood of future surpluses. Indeed, $10 billion in repurchased debt in 1999 translates into about $700 million in reduced interest expense in 2000. If these interest savings are used to buy back more debt, then every $10 billion in repurchased debt would yield over $10 billion in surpluses over the next ten years. The point is, buying back federal debt today creates greater opportunities for more pro-active policies tomorrow. Of course, there's no way to predict how these surpluses would eventually be used, either for tax cuts or spending increases, but that's a risk all sides take.

For improving the economy and improving lives, buying back federal debt is a sad second best policy. But if it preserves our options for Social Security reform and if it keeps the spenders hands out of the cookie jar, then we should not shortchange the advance made when President Clinton made Social Security reform a national priority.

Ways & Means Solicits Tax Foundation Perspective on 1998 Tax Reduction

TAX FEATURES©

Tax Features© (ISSN 0883-1335) is published 10 times a year by the Tax Foundation, an independent 501(c)(3) organization chartered in the District of Columbia. Annual subscriptions to the newsletter are $15.

Tax Foundation
(202) 783-2760 Tel
(202) 942-7675 Fax
www.taxfoundation.org
taxfnd@intr.net

At the request of the House Ways & Means Committee, Dr. J.D. Foster, Executive Director and Chief Economist of the Tax Foundation, testified in February on the importance of focusing on tax rates as the centerpiece of any tax reduction program in 1998.

The key to both tax relief and tax simplification, he observed, is through reform of the tax rate structure. "I would urge the Committee to eschew narrow, targeted tax changes in favor of reducing marginal tax rates. Whatever distortions exist in the federal income tax... they are given greater effect the higher are the marginal tax rates to which taxpayers are subjected. Conversely, reducing tax rates reduces virtually all the distortions created by the tax code that rob the economy of vitality and rob Americans of greater opportunity and prosperity."

To demonstrate the widespread benefits of marginal tax reduction, Dr. Foster observed:

- If a concern is the tax burden on families generally, then rate reduction will help.
- If a concern is the marriage penalty, then rate reduction will help, without the complexity inherent in most solutions to this problem.
- And if the goal is to encourage additional investment in plant and equipment, then rate reduction is the answer because it would reduce the cost of capital, particularly if the rate reduction is extended to corporate income tax rates. Rate reduction lessens the tax on dividend and interest income, and if extended to capital gains, it can further reduce the tax burden on capital gains.

Reducing marginal tax rates, Dr. Foster noted, is the key to successful tax relief. Among the reasons he gave for favoring tax rate reduction:

Dr. J.D. Foster, far left, appears before the House Ways & Means Committee on February 4. At far right is former Joint Tax Committee Chief of Staff Kenneth Kies.

"It is simple. A great many tax cut proposals would increase the tax complexity for those few taxpayers who would qualify. It's simplicity further enhances a public sense of its fairness. The Congress would not be perceived as bestowing relief on a select few. It is very flexible. Through the lowering of rates and raising of bracket points, the Committee has a great ability to fine-tune the amount of relief, again without complex special rules and effective dates. And it is easy to explain and therefore easily garners credibility and public support."

TAX FOUNDATION
Since 1937

1250 H Street, NW, Suite 750
Washington, DC 20005-3908