TAX FOUNDATION

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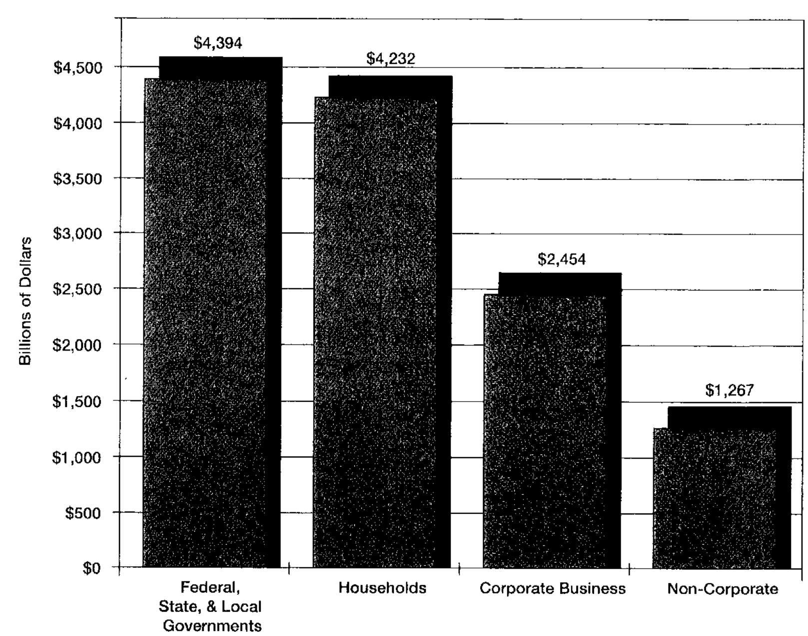
Foundation Documents Rising Government Debt
Government Debt Equals $16,835 Per Person

According to a new study by the Tax Foundation, by the end of 1993 federal, state, and local governments in the United States owed $4.4 trillion in credit market debt, an average of $16,835 for each American.

Chart 1: Credit Market Debt Outstanding by Borrower, End of 1993



Source: Federal Reserve Board.

In *Special Report* No. 40, titled "Federal, State, and Local Debt Piles Up," Tax Foundation Economist Chris R. Edwards observes that governments are the largest borrowers in the country—ahead of households, which borrow for home mortgages and other uses, and ahead of corporate and noncorporate businesses, which borrow to finance investments in buildings, machines, and other items (see Chart 1). Of the $4.4 trillion total, the federal government owes $3.3 trillion while state and local governments owe $1.1 trillion.

Federal Government Debt

Federal debt has been rising quickly as each annual deficit adds to the total accumulated national debt. The federal budget has not been balanced since 1969, an unprecedented 26-year string of budget shortfalls. The second worst string of unbalanced budgets in U.S. history occurred during the Great Depression and World War II when 16 budgets in a row went unbalanced.

The July Mid-Session Review from the Office of Management and Budget (OMB) projects that gross federal debt will rise to $6.26 trillion by fiscal 1999—an addition to the national debt of $1.59 trillion in just the next five years. Even when measured in constant dollars, federal debt rises 16

Debt *continued on page 3*

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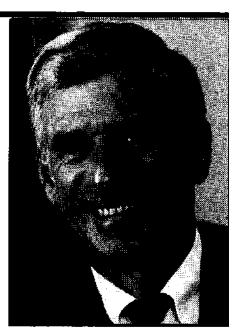
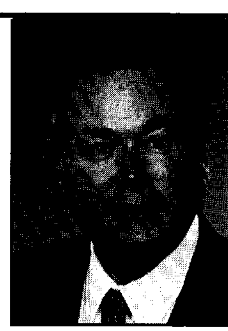




Restructuring and Simplifying the Federal Tax Code

Sens. David L. Boren (D-Okla.) and John C. Danforth (R-Mo.)

4-5

Unstable Tax Laws Lead to Greater Costs

In the 40 years since the passage of the Internal Revenue Act of 1954, 31 significant federal tax enactments have taken place, or on average one substantial amendment to the federal tax code every 1.3 years. Such instability in the tax code, says Tax Foundation Senior Economist Arthur P. Hall, creates economic uncertainty among taxpayers, which, in turn, generates economic costs.

In *Special Report* No. 41, titled "The Cost of Unstable Tax Laws," Dr. Hall examines the costs of continually changing the tax code. As part of his study, he lists a representative sample of the core sections of the federal income tax code, measuring the number of times these were amended. He also provides an "instability ratio" for each section, which divides the number of times a code section has been amended by the number of years it has existed. (The higher the ratio, the more unstable the code section.) The average instability ratio for the entire sample is 0.24, indicating that each section in the sample, on average, has been amended once for every four years it has existed within the tax code.

The chart on this page summarizes, in 10-year increments, the average number of times the income tax code sections in Dr. Hall's sample have been amended since the 1954 Act. It reveals that the code has become much more unstable during the past 20 years than it was during the 20 years immediately following the 1954 Act. Between 1976 and 1985, seven major tax bills were passed. Taxpayers in the most recent period, 1986 to 1994, have witnessed the passage of six major tax bills.

Disincentive and Compliance Costs

Dr. Hall observes that two types of costs are imposed on the U.S. economy when taxpayers face uncertainty about tax laws. First, uncertain tax laws (or the uncertainty of pending tax legislation) interrupt, distort, or stifle economic activity. Second, uncertainty adds to tax law complexity, which forces the private economy to expend valuable resources on the economically sterile exercise of tax research and planning, as well as tax compliance and litigation. For example, Dr. Hall estimates that the widespread taxpayer uncertainty that accompanied the tax changes embodied in the Revenue Reconciliation Act of 1993 cost the U.S. economy an estimated $20.5 billion. In comparison, based upon previously published Tax Foundation calculations, the 1993 cost of complying with federal taxes may have been as high as $184 billion. Though only a small fraction of that amount is related explicitly to the uncertainty of pending tax law changes, an actual change in the tax law, particularly with regard to the tax base, will often require a major planning and compliance effort on the part of taxpayers.

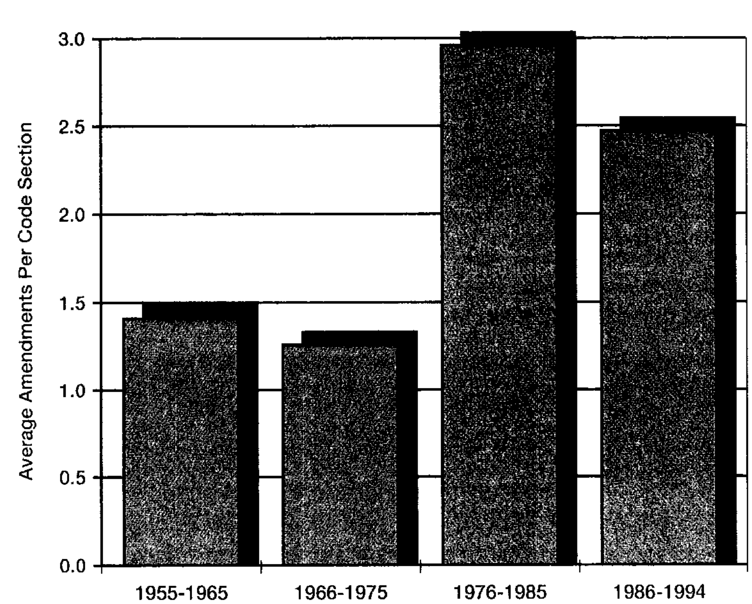
Unstable Tax Base

Tax law complexity is almost wholly related to tax base questions — that is, questions or uncertainty about the timing of taxable transactions and the definition of taxable income. Along with the rote exercise of recordkeeping, preparing financial statements, filing tax returns, and coping with tax audits, the high cost of tax compliance results from taxpayers' efforts to grapple with, and adjust to, these complex, and frequently changing, tax base questions.

Key sources of compliance cost that pertain especially to an unstable tax code are: (1) research and planning, (2) monitoring and participating in the tax legislative and administrative process, and (3) appealing IRS tax decisions and litigating tax disputes.

For the average Fortune 500 company, about 29 percent of the cost of federal income tax compliance falls under these three categories. Assuming that the 29 percent figure holds for all businesses (including sole proprietorships), then conservatively about $59 billion of the estimated $184 billion 1993 total cost of federal tax compliance is related to the above three categories. Only a portion of the $59 billion can be attributed solely to the instability of the tax code. Currently, no data exists to compute such a fraction with confidence. •

Instability in the Federal Income Tax Code Based on Selected Code Items



Source: Tax Foundation compilation from U.S. Code Annotated (Titled 26).

Debt

Continued from page 1

percent by fiscal 1999. In addition, interest outlays—which totaled $204 billion in fiscal 1994 and represented 13.8 percent of all federal outlays—are expected to increase to $282 billion, or 15.2 percent of all outlays, by fiscal 1999, according to OMB projections.

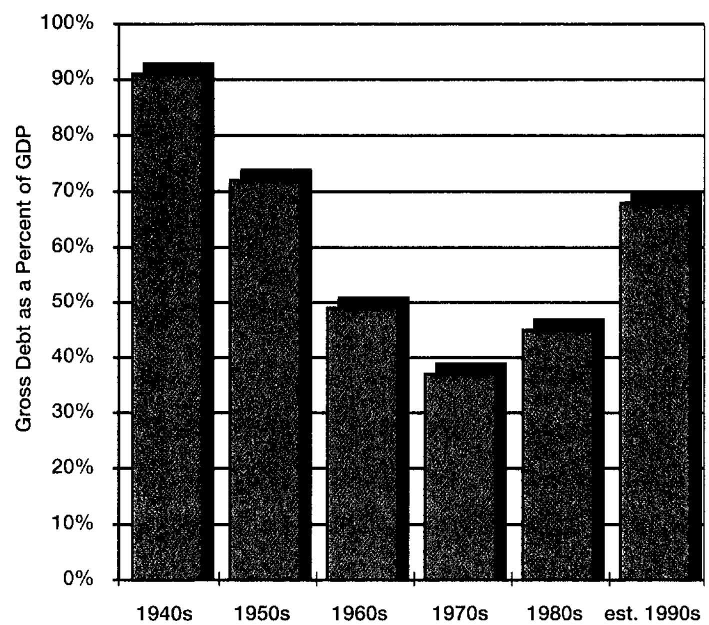
The federal debt load can be measured several ways. The "federal gross debt" of $4.67 trillion in fiscal 1994 includes $1.21 trillion of debt held by various federal trust funds, in particular, the Social Security Trust Fund. This portion of debt is, in effect, a liability owed by the federal government to itself and does not represent current borrowings from the private sector.

Excluding this portion of debt yields "debt held by the public," which totaled $3.46 trillion by the end of fiscal 1994. Public debt is a good measure of the federal government's debt load that taxpayer's would face if the federal government were to pay back all its borrowings. If each resident of the United States were billed tomorrow for his/her share of the federal public debt, he/she would have to pay $13,249 each.

A common way to judge the size of the government's debt is to compare it to the size of the economy that supports it. *Chart 2* shows that federal debt as a percentage of the nation's gross domestic product steadily fell for three decades following the massive World War II debt buildup. But the trend was reversed in the 1980s and 1990s, and by fiscal 1994 the gross federal debt was back up to 70 percent of the nation's GDP.

The good news is that the administration currently projects that this debt-to-GDP ratio will not rise much further throughout the 1990s. But in the longer term, this trend is not certain. The Congressional Budget Office, which projects budget trends out 10 years, currently estimates that the debt-to-GDP ratio will steadily rise all the way to fiscal 2004. Of course, if Congress balanced the federal budget, the federal debt would steadily diminish with respect to the size of a growing economy.

Chart 2: Federal Gross Debt as a % of GDP, Averages by Decade



Source: Tax Foundation based on OMB's Mid-Session Review, July 1994.

State and Local Government Debt

While overshadowed by concern about the national debt, state and local government debt has been piling up quickly since the early 1980s as well.

After hovering between $500 and $600 million (in 1993$) every year from 1965 to 1984, state and local debt outstanding soared in the 1980s and early 1990s, and now totals over $1 trillion.

While state and local debt growth during the past decade mirrored the growth in federal government debt, the dynamics of the two trends differ somewhat, notes Mr. Edwards. Federal debt is issued because federal politicians fail to balance the annual federal budget. In contrast, debt financing at the state and local level may be considered a sensible way to finance capital-intensive government projects. Local structures such as roads and schools provide benefits over many future years; debt financing provides a method for project costs to be spread over future years as well, to match these benefits.

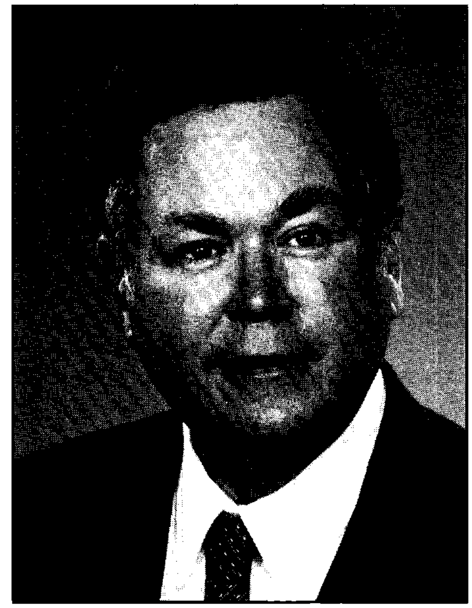
Of course, the benefit of using debt financing is gained at the expense of higher total government costs since interest payments must be made on borrowings. State and local governments in the United States spent $65 billion on interest in 1992—more than state and local governments spent on police and fire protection combined ($49 billion in 1992).

A sea change has occurred in state and local debt issuance over the past two decades. At the state level, general obligation debt fell from 50 percent of long-term debt

Debt *continued on page 7*

Restructuring and Simplifying the Federal Tax Code

Sens. David L. Boren (D-Okla.) and John C. Danforth (R-Mo.)



Sen. David L. Boren (D-Okla.)

In the aftermath of the Cold War, the ability of the United States to maintain its world leadership is no longer dependent solely on our military strength; instead, we must rely primarily on economic strength. Just as we once debated what weapons were necessary to ensure military might, we must now recalibrate the tools that contribute to economic growth. Moreover, just

Our economic strength is inseparable from our tax system. Yet the Congress has not scrutinized the Byzantine system of income taxation with these principles in mind.

as we set our military priorities with a knowledge of other countries' arsenals, we must shape our economic policy with an understanding of the economic weapons used by competing nations. During the Cold War, unilateral disarmament was unthinkable. Now economic policies made in a vacuum may just as surely lead the country into a disaster from which we will not be able to recover.

Our economic strength is inseparable from our tax system. Yet the Congress has not scrutinized the Byzantine system of income taxation with these principles in mind. After over two years of analysis and discussions with tax experts and economists, we hope to initiate this important national debate with the introduction of The Comprehensive Tax Restructuring and Simplification Act of 1994. This proposal can serve as the basis to construct a tax structure for the next century—to increase domestic savings and investment and improve productivity in a world characterized by a global marketplace.

In a nutshell, our proposal repeals $400 billion of individual, corporate and payroll taxes and replaces them with a Business Activities Tax (BAT). Among the changes to the individual income tax is a tripling of the standard deduction for low- and middle-income Americans. The Social Security portion of the payroll tax is cut in half; and the corporate income tax, which places a great burden on investment and productivity, is eliminated. In addition, the corporate income tax is entirely repealed. According to the Joint Committee on Taxation, this revenue-neutral package does not change the tax burden among income groups substantially, and it actually reduces the burden on the two lowest income classes.

The BAT is a simple tax that can be computed easily with the most basic financial data kept by businesses. The BAT is determined by subtracting the gross cost of property and services used by a business (business purchases) from the company's gross receipts from its sale of goods and services. The resulting amount equals the company's total business activity and is subject to a flat rate of 14.5 percent.

We want to emphasize that our package is revenue neutral. For every dollar of revenue raised by the BAT, a dollar in current taxes is eliminated. Don't be fooled by those who argue against significant tax reform because they fear it is a way to increase taxes. The level of taxation is inextricably linked to the level of federal spending and should be addressed in that context. The heart of our proposal is the need to collect revenues through a method that does not impair our economic security.

The current income tax system puts U.S. goods at a competitive disadvantage with respect to foreign goods. Under international trade rules, direct taxes like income and payroll taxes cannot be adjusted at the border. In other words, they cannot be imposed on imports or removed from our exports. Indirect taxes like the European value-added tax are border-adjustable; thus, countries with VATs can levy this additional tax on U.S. goods entering them. Perhaps that is one reason that over 80 countries, including all our major trading partners, rely on indirect taxes. The border-adjustable BAT, when used to replace direct taxes, will enhance the ability of American businesses to compete here and abroad.

Democrats and Republicans, public servants and private citizens, rich and poor, all recognize that the current means by which the federal government collects revenue is a mess. The sheer complexity of the system and the cost of compliance breeds resentment. For example, a 1993 Tax Foundation study found that the cost of compliance for businesses is 75 percent of the

Sen. John C. Danforth (R-Mo.)

revenue collected from them. Small businesses face an even higher compliance burden; they spend $390 to find that they owe the government $100. This situation is outrageous.

It is clear that modest changes and reforms are not sufficient. We can no longer tinker at the margin of the tax code. Let us begin this important national debate and restructure one of the strongest economic weapons we have—the federal tax system—to maximize efficiency, productivity, competitiveness and fairness. •

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

Unitary Taxation Moves from State to Federal Level

The issue of international tax policy is sure to emerge as an important issue in the upcoming Congress. A U.S. Supreme Court decision earlier this year involving the state of California and unitary taxation had the potential for creating a test of U.S. foreign policy in the face of retaliatory threats by major U.S. trading partners. (See *Background Paper* No. 8, "*Barclays* and *Colgate-Palmolive* Before the Supreme Court.") However, as reported by Tax Foundation Special Tax Counsel J. Dwight Evans in the October 10, 1994, issue of *Tax Notes*, the immediate threat was avoided as a result of California's recent tax reform.

In fact, the issue of unitary taxation might have subsided completely — except, as Mr. Evans notes in his article, some influential members of Congress have brought the issue to the federal level. These legislators are pressing the U.S. Treasury to abandon the arm's length standard of international transfer pricing in favor of a formulary approach.

In July 1994, Sen. Byron Dorgan (D-N.D.) and Reps. Richard A. Gephardt (D-Mo.) and David R. Obey (D-Wis.) introduced the Foreign Tax Compliance Act of 1994 (H.R. 4860 and S. 2342). In part, the act would "(end) enforcement breakdowns that now foster the underpayment of taxes on income from cross-border transactions by... (adopting) a more steamlined and efficient method of enforcing Federal tax laws involving multinational corporations, especially those based abroad, and in particular, the use by the Treasury Department of a formulaic approach in cases in which the current 'arm's length' transaction rules do not work."

The U.S. Treasury is not currently advocating the approach to multinational corporate taxation proposed by this legislation. •

1994 Tax Foundation
57th Annual Conference and Dinner

"Steering Tax Policy by Tax Neutrality"

Thursday, November 17, 1994
The Waldorf=Astoria Hotel
301 Park Avenue, New York, N.Y. 10022

• Registration/Lunch	12 noon	Empire Room
Tax Policy Service Award—Thomas S. Field, Publisher, *Tax Notes*		
• Conference Sessions	2:00 p.m.	Empire Room
• Dinner Reception	6:00 p.m.	Hilton Room
• Annual Dinner	7:00 p.m.	Empire Room
Distinguished Service Award—Sen. William V. Roth, Jr. (R-Del.)		
Distinguished Service Award—John A. Young, former President and CEO, Hewlett-Packard Company		

- Reservation deadline for the block of rooms reserved by the Tax Foundation is November 1, 1994. Call the Waldorf directly at (212) 872-4500.
- Conference and dinner reservations should be received by November 4, 1994. (Written cancellations for refunds accepted through this date only.)
- Questions about the conference and dinner should be directed to Renée Nowland, Tel.: (202) 942-7653, Fax: (202) 942-7675.

Conference Program

12:45 p.m.	Keynote Address	Rep. Dick Armey (R-Texas)
2:00p.m.	Panel One:	Saving in America
	Chairman:	Larry R. Langdon, Hewlett-Packard Company
	Panelist 1:	Laurence Kotlikoff, Boston University
	Panelist 2:	Peter Taylor, Senate Budget Committee (Minority)
3:00 p.m.	Panel Two:	A Neutral International Tax Policy
	Chairman:	E. Noel Harwerth, Citibank
	Panelist 1:	Norman Ture, Institute for Research on the Economics of Taxation
	Panelist 2:	Robert Mattson, International Business Machines Corporation
	Panelist 3:	William Brack, Office of U.S. Senator Hank Brown
4:00 p.m.	Panel Three:	Neutrality and the Treatment of Corporate Investment
	Chairman:	John P.Z. Kent, GTE Corporation
	Panelist 1:	Margo Thorning, American Council for Capital Formation
	Panelist 2:	Jane Gravelle, Congressional Research Service
	Panelist 3:	William Modahl, Digital Equipment Corporation
5:00 p.m.	*Closing Remarks/Adjournment*	

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Conference Fee:
Member-$100, Non-Member-$150
Reception/Dinner Fee:
$400/Person, $4,000/Table

Debt

Continued from page 3

in 1972 to just 26 percent by 1992. At the local level, general obligation debt fell from 65 percent of the total in 1972 to just 34 percent by 1992, as non-guaranteed local debt soared from $117 billion in 1972 to $382 billion by 1992, in constant dollars.

Government Debt by State

Government debt levels vary widely by state. On a per-resident basis, Alaska is in a league of its own with state and local indebtedness of $15,307 per capita in 1992. After Alaska, highly indebted states include Delaware, New York, Rhode Island, Utah, Massachusetts, Washington, and Hawaii—each with state and local debt of over $5,000 per resident. The District of Columbia would rank second after Alaska if it were a state, with a per-resident debt of $8,385. The least indebted state and local governments can be found in Idaho, Iowa, Mississippi, and Arkansas.

For the country as a whole, state and local debt rose 49 percent per resident between 1982 and 1992, in constant dollars. Eight states were successful in reducing their level of government indebtedness—Alaska, Oregon, Nebraska, Wyoming, New Mexico, Kansas, Iowa, and Washington. Five of these eight states had been among the most indebted back in 1982. Oregon, for example, had a state and local debt load 90 percent above the national average back in 1982, but by 1992 debt had been trimmed dramatically enough to fall 9 percent below the U.S. average.

But the level of indebtedness dramatically increased in some states over the past decade. In three states, California, Florida, and Indiana, per-resident debt more than doubled between 1982 and 1992. Of course, particular state circumstances must be considered in comparisons. For example, California and Florida zexperienced explosive population growth during the past decade and therefore required greater infrastructure investment than, for example, Indiana, whose population stagnated during this time period. •

FOUNDATION MESSAGE

The health care debate is over for 1994 and it seems that both advocates of aggressive reform and of incrementalism are breathing a sigh of relief that no legislation passed. As some congressional staffers predicted at the outset, either the Congress would pass a reform bill quickly, much as one downs castor oil, or nothing would happen because the more we learned about it, the more we would realize we had much more to learn. When a Member of Congress is in this position, the safest course to take is, in fact, to do as little as possible pending further study.

The costs and benefits of changing the health care system were the subject of two Tax Foundation conferences recently held in Richmond, Va., and Houston, Texas, and one we co-sponsored with the Michigan Chamber of Commerce in Detroit. At the time of the Richmond and Detroit conferences, the reform bill was just about dead in the House of Representatives and nearly as dead in the Senate. The conference in Houston, on the other hand, was held the morning after Senate Majority Leader George Mitchell (D-Maine) proclaimed health care reform dead for 1994. The consequences for our conference discussions were fascinating. Rather than dampening the discussion, the participants seemed to experience a liberation in their thinking.

J.D. Foster
Executive Director and Chief Economist

From the beginning of the debate on this issue, we have had three choices in reform: more government involvement along the lines of a Canadian-style system, better government involvement along the lines President Clinton proposed, and less government involvement with an emphasis on individual responsibility and bringing market forces fully to bear.

Despite strong support from a vocal minority, it became clear pretty early on that there was no broad support for a dramatic expansion of government in the health care system. Thus, the first option was dropped from the debate. Through the power of the bully pulpit President Clinton was able thereafter to restrict the debate to variations on the theme of how to make government involvement in the health care system work more effectively — what proponents liked to call managed competition. This debate will continue next year.

The option that was almost completely ignored throughout the debate was that of dramatically less government involvement. Once freed of worrying about the repercussions of Clinton-style reform for 1994, this option took center stage in the Houston conference. Participants discussed the use of medical savings accounts or health insurance tax credits in lieu of government spending and new bureaucracies to extend insurance to the uninsured, and how these devices would restrain health care spending and inflation by returning the individual as buyer of health care services to the marketplace. These and related ideas, though available for discussion in the form of separate bills introduced by Senators Phil Gramm (R-Texas) and Don Nickles (R-Okla.), were virtually ignored in 1994.

Probably to the chagrin of many in Congress, health care reform will still be at the top of the agenda in 1995. The difference this time will be that other options, like the Gramm and Nickles bills, are likely to be partners in the discussion. While this will not make for an easier debate, it does hold out the promise of reducing the number of the uninsured and restraining health care spending without government price controls.

State Seminars Examine Critical Issues in Health Care Reform Debate

TAX FEATURES

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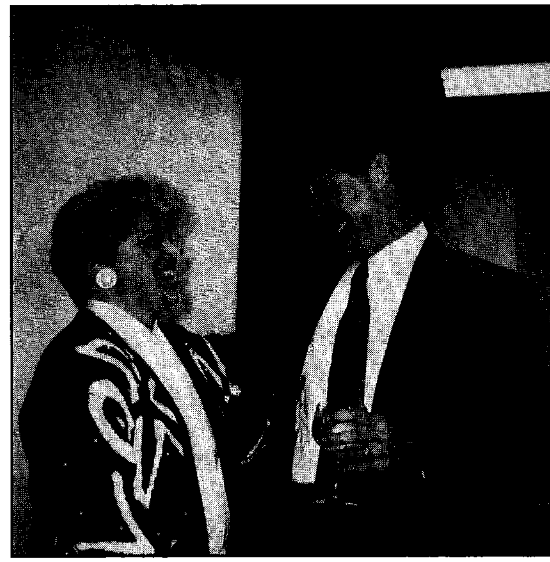
As part of its ongoing series of state seminars examining important issues in public policy, the Tax Foundation recently sponsored two such events, the first in Richmond, Va. (September 20); and the second in Houston, Texas (September 27), co-sponsored with the Texas Public Policy Foundation and Texas Citizens for a Sound Economy. These conferences were developed to provide a public forum for a nonpartisan discussion of the health care reform debate.

In Virginia, Donald Stern, M.D., Acting Commissioner of the state's Health Department, kicked off the event with a discussion of the status of public health America. Panel One featured four panelists — Laurens Sartoris, President of the Virginia Hospital Association; Ronald Bargatze, Executive Vice President of Trigon Blue Cross Blue Shield; David Whitaker, Ph.D., an economist at the University of Richmond; and Michele Davis, an economist at the Joint Economic Committee in Congress — discussing the current status of the health care system and health care legislation. Participants on Panel Two — which included Kim Barnes, Executive Director of the Richmond Area Business Group on Health; Robert Dolan, Ph.D., an economist at the University of Richmond; Doug Bandow, nationally syndicated columnist; and J. D. Foster, Ph.D., Executive Director at the Tax Foundation — examined the future of health care reform in the U.S. Ms. Kusiak anchored the program with a luncheon address on current reform efforts in Virginia.

Robert Mosbacher, Jr., President of Mosbacher Energy and author of a newly released book titled *Deep in the Heart: A Remedy for an Ailing Texas*, provided the keynote address in Houston. The first session featured Brant Mittler, M.D., of Physicians Who Care; Donald Huge, M.D., Medical Director of Sanus Health Plan/New York Life; Jeffery Talbert, a research associate at Texas A&M and former health care aide to Rep. Michael Andrews (D-Texas); and Michele Davis. The second session included Larry Andrews, Chief Executive Officer of Westbury Hospital; Charles Begley, Ph.D., a health care economist at the University of Texas School of Public Health; and Dr. Foster. State Senate Frank Madla, Jr., who serves on the Committee on Health and Human Services, provided the luncheon address. •



Dr. Donald Stern shares a laugh with Jane Kusiak at a recent health care seminar in Richmond, Va.

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