TAX FOUNDATION

TAX FEATURES

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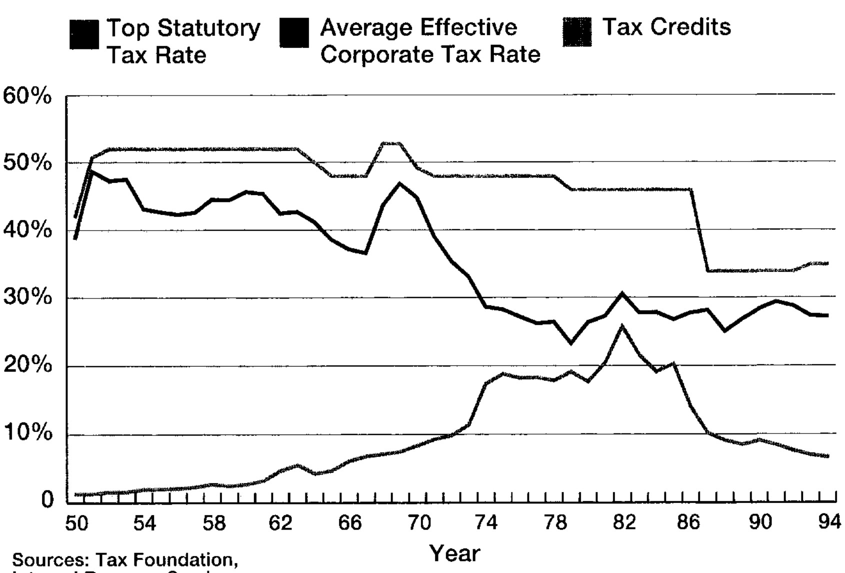
History of Federal Corporate Income Tax Highlights Average Effective Tax Rate

A new review of the federal corporate income tax by Tax Foundation economist Scott Moody traces the average effective corporate income tax rate since 1950. Influenced by fluctuating tax credits and marginal tax rates, the average effective tax rate (corporate taxes paid as a percentage of net income) is seen as critical to understanding the corporate income tax.

The report is Number 81 in the Foundation's Special Report series, entitled *The Federal Corporate Income Tax Since WWII.* It begins with an overview of corporate income tax collections, which have been slowly rising in real terms over the past 50 years. Receipts have fluctuated over time with the business cycle and enactment of various tax legislation. By 1994, the latest year of available data, corporate income tax receipts had risen to their second highest level over this time period.

Figure 1
Corporate Tax Rates and Tax Credits
1950 - 1994



Sources: Tax Foundation, Internal Revenue Service.

The Average Effective Tax Rate

Figure 1 at left shows an interesting pattern of average effective corporate income tax rates. From 1950 to 1970 the average effective corporate income tax rate hovered near 43 percent; from 1970 to 1974 the rate fell to around 28 percent; and from 1974 to the present, the average effective corporate income tax rate has remained in a fairly narrow range centered around 27 percent.

Over time, changes in the average effective corporate income tax rate stem from three legislative sources: changes in the marginal tax

Corporate Income Tax *continued on p. 6*

FRONT & CENTER

Pass the Line Item Rescission to Stop Pork Barrel Spending Constitutionally

Senator Tim Johnson (D-SD)

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Cigarette Shoppers and Smugglers Hit the Road to Avoid Taxes As Excises Climb

In a new study on the cigarette excise tax, Tax Foundation economist Patrick Fleenor explores the many different avenues that smokers use to buy tax-free or low-tax cigarettes, especially in states and counties where the excise tax is high.

The study appears as Number 26 in the Tax Foundation's Background Paper series and is entitled, *A Recent History and State-by-State Analysis of How Excise Tax Differentials Affect Interstate Smuggling and Cross-Border Sales of Cigarettes in the United States.*

The cigarette excise tax has been many politicians' favorite revenue raiser for years. Fleenor uses a sophisticated economic model of the cigarette market to look back as far as 1960 and follow the trends in taxation up to 1997, all the while examining the ways that the excise tax changed smokers' purchasing habits.

Almost all the methods smokers have used over the years to avoid highly taxed cigarettes involve crossing borders of some sort, often state borders. Therefore Fleenor devotes substantial study to the trends in cross-border cigarette purchases in all 50 states and the District of Columbia. Cross-border activity includes cross-border shopping, the organized smuggling of cigarettes, and the shifting of cigarette purchases to jurisdictions where the tax is lower.

Tax Avoidance in Cigarette Purchases Since 1960

Figure 1 illustrates trends in cross-border activity in the cigarette market. State and local cigarette taxes in fiscal year 1962 averaged 26.4 cents per pack (FY 1997 dollars), and approximately 5.6 percent of all cigarettes were procured through some type of cross-border activity.

This moderate level of taxation and tax avoidance gave way after the 1964 Surgeon General's report on smoking and health. To raise revenue and discourage smoking, politicians turned to cigarette excise taxes, and by 1972 average state and local cigarette taxes had climbed to 47.7 cents per pack. Fleenor estimates that by 1972, 11.1 percent of all cigarettes smoked in the U.S. were purchased through cross-border activity, especially cross-border shopping which more doubled from 0.8 percent of total cigarette purchases in 1965 to 2.0 percent in 1972.

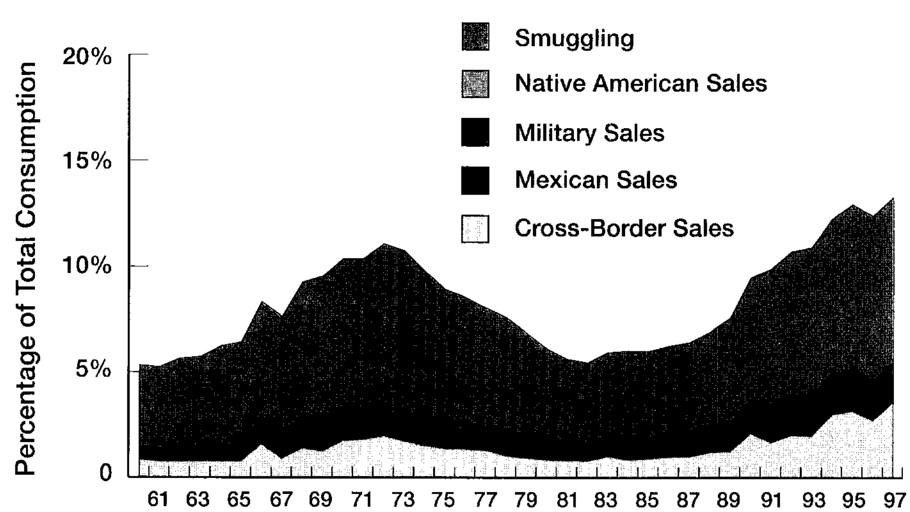
Cigarettes are compact, lightweight, and easily transported, an ideal product for both casual cross-border purchases and large-scale interstate smuggling. The rewards can be substantial, ranging from a $10.00 per carton savings for cost-conscious consumers to profits of $100,000 or more per truckload for interstate bootleggers. In 1965, 4.6 percent of all cigarettes smoked in the United States had been smuggled, but by 1972 this figure had reached 7.7 percent, drawing the attention of federal, state, and local officials.

In 1977 the Advisory Commission on Intergovernmental Relations (ACIR) published *Cigarette Bootlegging: A State and Federal Responsibility.* It concluded that cigarette tax evasion, which cost the high-tax states $391 million ($1.1 billion in 1998 dollars) in lost revenue each year, was primarily due to state tax differen tials and was a serious problem in 14 states and a moderate problem in another eight states.

In October of 1978, Congress enacted P.L. 95-575 which prohibits the transport, receipt, shipment, possession, distribution or purchase of more than 60,000 cigarettes not bearing the tax stamp of the state where the cigarettes are found. Possible punishments include prison, large fines and vehicle seizure.

The state governments' reaction to the ACIR report was mixed. They did not harmonize their excise tax rates, but most refrained from raising them dramatically, and the high inflation of the late 1970s reduced the per pack weighted-average cigarette excise tax to pre-1960 levels. As a result, the share of

Figure 1
Cross-Border Cigarette Sales by Supply Source and As a Percentage of Total Consumption
FY 1960–1997



Source: Tax Foundation.

total U.S. consumption that was supplied by cross-border activity fell by more than half, from 11.1 percent in 1972 to 5.4 percent in 1982.

This lesson was eventually forgotten. A new round of state and local cigarette excise tax increases began in 1983 and continues to this day. Fleenor estimates that the market share of cross-border activity reached 13.3 percent in 1997, exceeding the watershed levels of the early 1970s.

Tax Avoidance State by State

The current spate of tax hikes has not been uniform across the country. High-tax states like Massachusetts, Michigan, New York and Washington charge as much as $10.00 per carton in taxes. On the other hand, Kentucky, North Carolina, and Virginia go as low as 25 cents.

Table 1 details the supply sources for all 50 states and the District of Columbia. The jurisdictions whose taxable sales suffer the most are often cases where high- and low-tax jurisdictions abut one another. A similar contrast occurs when Native American tribal reservations or military bases are located in high-tax states.

The state-by-state data on cigarette shopping habits are striking. Washington, D.C., for example, which levies a $6.50 per carton cigarette excise tax, shares a border with Virginia where the tax is just 25 cents. As a result, per capita cigarette purchases in D.C. are only half what they are in Virginia.

New Hampshire sells more than twice as many taxable cigarettes as its neighbor Massachusetts, despite higher smoking rates in Massachusetts.

Politicians sometimes claim to have discouraged smoking when a tax hike causes dramatically lower taxable sales. Often, however, smokers have not been discouraged as much as they have been encouraged to shop elsewhere. In Michigan, for example, taxable cigarette sales fell 26.7 percent after the state raised its cigarette tax from $2.50 to $7.50 per carton. Meanwhile, sales in Indiana and other border states skyrocketed.

Like all titles in the Background Paper series, this study is available for $10, or $5 for contributors.

Table 1
State Cigarette Consumption by Supply Source
FY 1997

		Cross-Border Activity					Memo:
	Taxable Sales	Smuggling	Cross-border Shopping	Military Sales	Native American Sales	Mexican Sales	Weighted Per Pack State & Local Cigarette Tax ($FY 97)
United States	86.7%	7.8%	3.6%	0.6%	0.8%	0.5%	34.9¢
Alabama	94.8%	4.8%	–0.7%	0.0%	0.5%	0.0%	21.9¢
Alaska	91.5	2.6	0.0	0.8	5.1	0.0	40.6
Arizona	88.7	3.8	0.4	1.7	3.0	2.4	58.0
Arkansas	84.8	8.2	6.8	0.2	0.0	0.0	31.5
California	86.1	9.3	0.0	0.8	1.1	2.7	37.0
Colorado	95.2%	4.0%	0.0%	0.3%	0.5%	0.0%	20.0¢
Connecticut	87.2	11.7	–18.3	0.7	0.4	0.0	50.0
Delaware	94.9	4.8	–19.2	0.3	0.0	0.0	24.0
Florida	88.9	8.5	1.4	0.8	0.4	0.0	33.9
Georgia	97.6	1.7	–1.2	0.5	0.1	0.0	12.0
Hawaii	62.0%	26.7%	0.0%	11.3%	0.0%	0.0%	60.0¢
Idaho	89.1	8.6	–7.0	0.0	2.3	0.0	28.0
Illinois	83.2	6.2	10.5	0.0	0.0	0.0	50.0
Indiana	97.2	2.8	–40.1	0.0	0.0	0.0	15.5
Iowa	90.2	9.4	–1.2	0.0	0.4	0.0	36.0
Kansas	91.8%	5.3%	1.5%	0.4%	0.9%	0.0%	24.0¢
Kentucky	99.9	0.0	–9.3	0.1	0.0	0.0	3.0
Louisiana	95.3	4.2	–2.9	0.1	0.4	0.0	20.0
Maine	86.5	9.7	2.4	0.5	0.9	0.0	37.0
Maryland	78.0	8.1	13.2	0.6	0.0	0.0	36.0
Massachusetts	71.3%	10.2%	17.9%	0.3%	0.3%	0.0%	69.7¢
Michigan	69.7	22.7	5.4	0.1	2.1	0.0	75.0
Minnesota	95.7	2.6	1.0	0.1	0.5	0.0	48.0
Mississippi	95.0	3.9	0.3	0.4	0.4	0.0	18.0
Missouri	95.8	4.1	–7.3	0.1	0.0	0.0	20.1
Montana	92.2%	3.9%	–0.7%	0.0%	4.0%	0.0%	18.0¢
Nebraska	88.0	8.5	1.1	1.2	1.3	0.0	34.0
Nevada	86.5	8.9	–0.6	2.2	2.4	0.0	35.0
New Hampshire	94.4	5.2	–143.8	0.4	0.0	0.0	25.0
New Jersey	90.5	9.0	–24.9	0.2	0.3	0.0	40.0
New Mexico	82.8%	4.8%	–2.1%	0.6%	9.1%	2.7%	21.0¢
New York	64.4	15.7	18.4	0.6	0.9	0.0	58.9
North Carolina	99.0	0.1	–1.6	0.5	0.4	0.0	5.0
North Dakota	95.0	2.5	–0.4	0.6	1.9	0.0	44.0
Ohio	93.4	5.2	1.4	0.0	0.0	0.0	24.5
Oklahoma	89.0%	5.3%	–3.7%	0.9%	4.8%	0.0%	23.0¢
Oregon	82.9	14.1	–2.6	0.5	2.5	0.0	50.3
Pennsylvania	92.9	7.1	–6.4	0.0	0.0	0.0	31.0
Rhode Island	95.8	3.6	–9.1	0.4	0.2	0.0	61.0
South Carolina	99.0	0.6	–0.2	0.3	0.1	0.0	7.0
South Dakota	90.5%	4.2%	–1.0%	0.1%	5.2%	0.0%	33.0¢
Tennessee	96.9	2.1	0.9	0.1	0.0	0.0	13.0
Texas	83.0	10.3	1.6	1.8	0.7	2.6	41.0
Utah	81.8	13.4	–2.6	1.2	3.5	0.0	26.5
Vermont	88.2	11.8	–19.0	0.0	0.0	0.0	44.0
Virginia	98.4%	0.6%	–6.3%	0.8%	0.1%	0.0%	7.3¢
Washington	66.2	22.5	2.7	3.2	5.4	0.0	82.5
West Virginia	96.5	3.5	–8.7	0.0	0.0	0.0	17.0
Wisconsin	86.7	11.7	–2.9	0.0	1.6	0.0	44.0
Wyoming	97.0	2.1	–3.8	0.0	0.9	0.0	12.0
District of Columbia	61.8%	16.4%	19.3%	2.5%	0.0%	0.0%	65.0¢

Source: Tax Foundation.

Pass the Line Item Rescission to Stop Pork Barrel Spending Constitutionally

By Senator Tim Johnson (D-SD)

The Supreme Court's decision to overturn the line-item veto need not dismay the law's advocates. I have introduced a workable alternative bill, an expedited line-item rescission, that neither requires a Constitutional amendment nor creates an unwieldy and cumbersome process for enacting appropriations bills.

The Line Item Veto Act of 1996 was the product of a long search for an effective mechanism to control "pork barrel" spending. The law was designed to combat a well-known problem: unmerited items of spending are often buried in large, must-pass appropriations bills, escaping scrutiny on the floors of the House and Senate and leaving the President with the choice of accepting or rejecting the entire bill, warts and all.

The line-item veto gave the President the power to cancel an item of spending or a targeted tax break. This cancellation would take effect unless two-thirds of each house of Congress passed a motion disapproving the President's action. President Clinton used the line-item veto to cancel 82 spending items and targeted tax breaks.

On June 25, however, the Supreme Court held that the line-item veto law violated the Presentment Clause of the Constitution found in Article I, Section 7: "Every bill which shall have passed the House of Representatives and the Senate, shall, before it become a law, be presented to the President of the United States; if he approve he shall sign it, but if not he shall return it, with his objections to that House in which it shall have originated, who shall enter the objections at large on their journal, and proceed to reconsider it."

This clause is quite clear. The President does not have the power to sign a bill in part and veto it in part. As the Court stated in its majority opinion, "If the Line Item Veto Act were valid, it would authorize the President to create a different law—one whose text was not voted on by either House of Congress or presented to the President for signature."

Although I voted for the Line Item Veto Act, I have been an advocate of an alternative approach since my first term in Congress in 1987. That year, I introduced legislation to provide for expedited consideration of rescission measures introduced by the President. Under current law, the President may propose to rescind (or cancel) certain items of spending, but Congress is under no obligation to pay any attention to such a proposal. Expedited rescission, on the other hand, would set forth a process for Congress to consider and vote on the President's rescission bill. Passage of the bill by each house (followed by the presumptive signature of the President) would enact the spending cancellations into law.

Controversial items can be unearthed from inside large bills and considered on their merits. Rather than the excuses we have heard so often, members of Congress will have the opportunity to vote up or down on the approval of these spending items.

Some critics of this approach will argue that expedited rescission is too weak because it requires a majority vote of Congress to pass the measure rather than a two-thirds vote to override the President's veto. In my view, this argument misses the main point. The most important feature of any of the proposals introduced thus far is that controversial or unmerited items of spending can be unearthed from inside large bills and considered on their merits. Rather than recite the excuses we have heard so often, members of Congress will have the opportunity to vote up or down on whether these spending items should be approved.

In any event, the Supreme Court's recent decision has made it clear that advocates of a mechanism requiring a two-thirds vote in both houses of Congress to override the President will have to choose from one of two flawed approaches.

The first alternative is a Constitutional amendment. One obvious problem with this proposal is the inherent difficulty in winning support broad enough for amending the Constitution. Indeed, opponents of a constitutional amendment have strong arguments on their side, and these arguments have been bolstered by our experience with the legislative line-item veto prior to the Supreme Court's action. The opponents have long expressed their concern that enshrining a line-item veto in the Constitution would shift too much power to the executive branch.

When President Clinton exercised his power to use the legislative line-item veto, many Senate and House members reacted with angry criticism, even members who supported the law. Common complaints were that the criteria used to choose projects were either arbitrary or politically motivated. At least one senator who voted for the law changed his mind and supported the court decision to repeal it.

At a minimum, the limited experience with the legislative line-item veto

suggests that any mechanism of this kind will need modification and improvement as years go by. It is impossible for us to foresee all the possible circumstances under which this power would be used, or abused. The Constitution is not an appropriate place for experimentation.

The second alternative would provide for the separate enrollment of each and every line-item of the appropriations bills. In other words, appropriations legislation would be composed of hundreds of little "billettes," each of them delivered to the President for signature or veto. Although this approach would not require a Constitutional amendment, it would be unwieldy and cumbersome. In my view, it is hard to conceive why such legislative gymnastics are necessary when an expedited rescission process would satisfy the more critical objective of providing for an up-or-down vote on controversial spending items.

On the day that the Supreme Court announced its decision, I introduced S. 2220, the Legislative Line Item Rescission Act.

Highlights of S. 2220, the Legislative Line Item Rescission Act

♦ S. 2220 would amend the Congressional Budget and Impoundment Act of 1974 to provide for expedited consideration by Congress of budget items that the President proposes to cancel. The President would have 20 business days after the enactment of legislation to send a special message to Congress proposing to cancel budget items contained in that Act. The President may also submit a rescission measure at the same time as the President's budget is submitted, if the items proposed to be canceled were enacted since the previous budget was submitted.

♦ Subject to rescission are budget items in appropriations Acts, not including "direct spending programs" (i.e., entitlements) or the administrative expenses of Social Security. Also subject to rescission are targeted tax breaks regardless of whether they are included in appropriations Acts. Targeted tax breaks are defined as provisions that provide a benefit to a taxpayer or a limited class of taxpayers, not including tax benefits based on broad classifications such as income, number of dependents, or marital status.

♦ Before the close of the second day of business after receipt of the proposed rescission, either the Majority or Minority Leader of each House shall introduce the draft bill contained in the rescission message. If the Leaders fail to act, any member may introduce the bill. The bill will be referred to the appropriate committees. Committees shall have seven business days to report the bills, after which the bills will be automatically discharged and placed on the appropriate legislative calendars.

♦ Motions to strike items from the rescission bill would be in order. In the House, a group of fifty members would be needed to make such a motion. In the Senate, twelve members would be required. No other amendments would be in order (i.e., perfecting amendments, substitute amendments, etc).

♦ A vote shall be taken on final passage on or before the close of the 10th day of session after the introduction of the bill. If passed, the bill must be engrossed, certified, and sent to the other House within one calendar day.

♦ Parliamentary obstacles such as motions to recommit or motions to reconsider will be removed to allow for votes on final passage. If a House-Senate conference committee fails to act, any member will be able to reintroduce the President's rescission measure for expedited consideration, and no amendments will be allowed.

♦ Upon enactment of a rescission bill, the President will be directed to reduce the discretionary spending limits under section 251(c) of the Balanced Budget and Emergency Deficit and Control Act of 1985. When targeted tax benefits are repealed, the PAYGO balances will be adjusted.

Similar legislation has already withstood a great deal of scrutiny over the years, having passed in the House

Similar legislation has already withstood a great deal of scrutiny over the years, ... and a similar bill received the support of Senators Dole, Domenici, and Daschle in the 104th Congress.

of Representatives in the 102nd and 103rd Congresses. A similar bill received the support of Senators Dole, Domenici, and Daschle in the 104th Congress. President Reagan, in fact, included a proposal for a line-item rescission in his budget proposal for Fiscal Year 1989.

In my view, expedited line-item rescission will provide a highly-effective mechanism for the President to force a vote on unmerited spending and targeted tax breaks. When faced with such a vote, members of Congress will have to stand up and be counted on whether the spending should be approved. If a project survives this scrutiny, its funding will stand, but the cause of fiscal responsibility will be advanced.

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

Corporate Income Tax *from p. 1*

rate, changes in the tax base, and changes in tax credits. Moody follows all three through each decade from the fifties to the mid-1990s, explaining the ebb and flow of corporate taxes. See Table 1 below for details.

The average effective corporate tax rate remained over 40 percent throughout the 1950s due to high marginal tax rates and the excess profits tax. The 1962 enactment of the investment tax credit and a 1964 reduction in tax rates lowered the average effective corporate tax rate moderately. It fell to 36.5 percent by 1967 but surged upward after a 1968 retroactive 10 percent surcharge on all corporations before tax credits. This combined with the 1969 repeal of the investment tax credit to push the average effective corporate tax rate up to 46.9 percent.

The proliferation of tax credits in the early 1970s dropped the average effective corporate tax rate dramatically. The 1971 revival of the investment tax credit (renamed the "job development tax credit") and the new work incentive (WIN) credit rapidly lowered the average effective corporate tax rate to 28.6 percent in 1974, a rate it has varied from only slightly since.

The 1981 recession hit corporate receipts hard, creating an upswing in the average effective corporate tax rate as corporate receipts fell faster than expenses. This was an important political factor leading to 1981's reduction of marginal tax rates, creation of the research and experimentation credit, and other reforms.

The Tax Reform Act of 1986 responded to the tax neutrality and complexity issues that had been accumulating in the tax code since the early 1970s. It reduced virtually all marginal tax rates, including dropping the top marginal tax rate from 46 to 34 percent. It also phased out the lower graduated rates for corporations with taxable income greater than $100,000.

Single copies of this 4-page title in the Special Report series is available for $5. Subscribers to Special Report receive ten 4-12 page reports annually for $25.

Table 1
Federal Corporate Income Tax Rates
1950 – Present

1950	First $25,000	
	(Normal Rate)	23%
	Over $25,000	
	(Add Surtax of 19%)	42%
	Excess Profits Tax	30%
1951	First $25,000	
	(Normal Rate)	28.75%
	Over $25,000	
	(Add Surtax of 22%)	50.75%
	Excess Profits Tax	30%
1952	First $25,000	
	(Normal Rate)	30%
	Over $25,000	
	(Add Surtax of 22%)	52%
	Excess Profits Tax	30%
1953-1963	First $25,000	
	(Normal Rate)	30%
	Over $25,000	
	(Add Surtax of 22%)	52%
1964	First $25,000	
	(Normal Rate)	22%
	Over $25,000	
	(Add Surtax of 28%)	50%
1965-1967	First $25,000	
	(Normal Rate)	22%
	Over $25,000	
	(Add Surtax of 26%)	48%
1968-1969	First $25,000	
	(Normal Rate)	22%
	Over $25,000	
	(Add Surtax of 26%)	48%
	With 10% Surcharge	
	First $25,000	
	(Normal Rate)	24.20%
	Over $25,000	
	(Add Surtax of 26%)	52.80%
1970	First $25,000	
	(Normal Rate)	22%
	Over $25,000	
	(Add Surtax of 26%)	48%
	With 2.5% Surcharge[a]	
	First $25,000	
	(Normal Rate)	22.55%
	Over $25,000	
	(Add Surtax of 26%)	49.20%
1971-1974	First $25,000	
	(Normal Rate)	22%
	Over $25,000	
	(Add Surtax of 26%)	48%
1975-1978	First $25,000	
	(Graduated Normal Rate)	20%
	Next $25,0000	
	(Graduated Normal Rate)	22%
	Over $50,000	
	(Add Surtax of 26%)	48%
1979-1981[b]	First $25,000	17%
	$25,000 to $50,000	20%
	$50,000 to $75,000	30%
	$75,000 to $100,000	40%
	Over $100,000	46%
1982	First $25,000	16%
	$25,000 to $50,000	19%
	$50,000 to $75,000	30%
	$75,000 to $100,000	40%
	Over $100,000	46%
1983-1984	First $25,000	15%
	$25,000 to $50,000	18%
	$50,000 to $75,000	30%
	$75,000 to $100,000	40%
	Over $100,000	46%
1985-1986	First $25,000	15%
	$25,000 to $50,000	18%
	$50,000 to $75,000	30%
	$75,000 to $100,000	40%
	$100,000 to $1,000,000	46%
	$1,000,000 to $1,405,000[c]	51%
	Over $1,405,000	46%
1987[d]-1993	First $50,000	15%
	$50,000 to $75,000	25%
	$75,000 to $100,000	34%
	$100,000 to $335,000[e]	39%
	Over $335,000	34%
1994-Present	First $50,000	15%
	$50,000 to $75,000	25%
	$75,000 to $100,000	34%
	$100,000 to $335,000	39%
	$335,000 to $10,000,000	34%
	$10,000,000 to $15,000,000	35%
	$15,000,000 to $18,333,333[f]	38%
	Over $18,333,333	35%

[a] The Tax Reform Act of 1969 extended the Surcharge at a five percent rate from January 1, 1970 through June 30, 1970. On an annualized basis, the Surcharge would be 2.5 percent.

[b] The Revenue Act of 1978 repealed the corporate normal tax and surtax and in their place imposed a graduated rate structure with five brackets.

[c] The Deficit Reduction Act of 1984 placed an additional 5 percent to the tax rate in order to phase out the benefit of the lower graduated rates for corporations with taxable income between $1,000,000 and $1,405,000. Corporations with taxable income above $1,405,000, in effect, pay a flat marginal rate of 46 percent.

[d] Rates shown effective for tax years beginning on or after July 1, 1987. Taxable income before July 1, 1987 was subject to a two tax rate schedules or a blended tax rate.

[e] An additional 5 percent tax, not exceeding $11,750, is imposed on taxable income between $100,000 and $335,000 in order to phase out the benefits of the lower graduated rates.

[f] An additional 3 percent tax, not exceeding $100,000, is imposed on taxable income between $15,000,000 and $18,333,333 to phase out the benefits of the lower graduated rates.

Source: Tax Foundation.

FOUNDATION MESSAGE

CBO's 'Mean Reversion'

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

The Congressional Budget Office (CBO) has taken a lot of heat in recent years over its economic forecasts. Unlike days of yore, when government forecasters were criticized for offering up "rosy scenario" forecasts, the CBO is today suffering from a strong case of "mean reversion."

Of course, reversion to the mean is what all economists expect of long-term economic growth as the economy rides the roller coaster of domestic and external shocks like the current Asian crisis. But CBO has two important questions to answer about the way it uses its assumption of mean economic growth: Why is it playing a dominant role in the agency's short-term forecasting? And why does the agency assume that every period of growth above the mean is followed immediately by a bust of equal intensity?

Without a doubt, economic forecasting is risky business, whether of long-term trends or short-term results. Forecasts can be right for the wrong reasons, and they can be wrong because of factors no one could have foreseen. In all fairness, CBO's recent shortcomings in forecasting near-term economic growth should probably not be stressed too strongly because most private forecasters did no better. I doubt many of the Republican leaders who are currently outraged at CBO would expect a government agency to outperform private sector forecasters.

However, CBO's forecasts play an integral role in determining tax and spending policies. They're quite simply the most important forecasts made; so policy makers are understandably frustrated when the numbers are way off. Only a couple of years ago, in May of 1996, the CBO predicted economic growth for 1997 would be 2.0 percent, slightly below their standard assumption of between 2.1 and 2.2 percent. By January of 1997, the agency was in the calendar year of the forecast but still had only inched its estimate up over the mean to 2.3 percent. The rate ended up at 3.8 percent. As a result, the projected deficits are now surpluses, and an opportunity for a tax cut that would certainly have benefited the economy was lost.

In its forecasts for 1998, CBO repeated this pattern of initially slavish dependence on the mean figure, starting at 2.0 percent in January 1997, then dragging it up to only 2.7 percent in January 1998, and only breaking 3 percent with its Summer 1998 forecast. That's too little too late. And naturally for 1999, they return to their not-so-trusty, pessimistic assumption of 2.0 percent, once again making tax cuts almost impossible. One might reasonably argue that the Asian crisis justifies this one, but I don't think that's it. I think it's just "mean-ness."

Back to those angry Republican congressmen who happen to be the CBO's bosses. If they were being frustrated by low-ball estimates from the President's Office of Management and Budget, they might complain, but there'd be no bite to their bark. But this is their own Congressional Budget Office doing it to them, while even the Treasury Department's long-term annual growth rate is higher than CBO's, hovering between 2.3 and 2.4 percent. What's a tenth of a point or two between friends you say? Only about a trillion and a half dollars a year in revenue over the next ten years.

This critique of CBO's use of long-term growth assumptions in short-term forecasting is quite separate from discussing the merits of their long-term projections. But given the looming debate on Social Security, CBO's medium and long-term projections are probably even more important, and there are curious patterns there also.

First, CBO follows its standard 2.1 percent forecast for 1999 with a decline in the growth rate to 1.8 percent for 2000 and 2001. This is very strange indeed, but it is a definite pattern in CBO forecasts. Whenever the economy does better than expected, CBO insists on projecting the economy will do worse than expected in some later year. When you eat too much over Thanksgiving, then you diet for the next few weeks. That pattern may work for you and me, but there is no good reason to believe the economy must compensate for growing too much by growing too little later on as long as inflation remains in check.

The second curious pattern is that CBO projects that economic growth will jump to 2.4 percent in 2002, right after the second consecutive year of 1.8 percent growth. Then the economy will maintain this higher growth rate for three years before reverting once again to CBO's mean growth assumption of 2.1 percent. Recalling that projections of long-term economic growth are essentially the sum of labor force growth and productivity growth, it's hard to imagine what economic phenomenon four years hence CBO believes could cause such a jump.

CBO and everyone else may need to reconsider the definition of normal growth.

Finally, CBO and everyone else may need to reconsider the definition of normal growth. To be sure, perhaps CBO is correct and the Treasury Department overly optimistic. But in light of both agencies' tendency of late to be overly pessimistic in predicting the economy's near-term performance, a fundamental re-examination of economists' standard expectation for economic growth may be in order.

John W. Snow Named to Receive Tax Foundation's Distinguished Service Award

John W. Snow, chairman, president and chief executive officer of CSX Corporation, will accept the Tax Foundation's Distinguished Service Award at the Foundation's annual dinner November 19 in Washington, DC.

Each year the Tax Foundation names one person from the private sector who has contributed notably to the national discussion of sensible tax policies. Recent honorees include former USX Chairman and CEO Charles A. Corry, and GTE Chairman and CEO Charles R. Lee.

Mr. Snow was elected President and CEO of CSX in 1989. In the 1970s he served the Ford administration in several capacities, including Deputy Undersecretary of Transportation, and Administrator of the National Highway Traffic Safety Administration. He joined the Chessie System Railroads in 1977, holding several positions there and at the combined railroad system, CSX Transportation, Inc., before being elected president of the Chessie System in 1985.

Snow earned a Ph.D. in economics from the University of Virginia, a law degree from George Washington University and his bachelor's degree from Kenyon College.

John W. Snow, shown in the center, enjoys the Foundation's 60th Annual Dinner last year. He is flanked by the two award recipients of that evening, GTE Corporation chairman and CEO Charles R. Lee on the right, and U.S. Senator John Breaux (D-LA) on the left.

Second Roundtable Discussion Held to Clarify Tax Reform Transition Issues

On July 24 the Tax Foundation conducted another working session in cooperation with CSE Foundation on the subject of the transition rules that should accompany tax reform. The first meeting was in March, and both roundtables have had prominent members of the business community, congressional staff, and Washington-based policy groups in attendance.

The goal of the Tax Foundation's co-hosting the roundtable discussion is to educate advocates of tax reform about the need to plan the transition from the current system to whatever new system they favor. In particular, that transition should promote simplicity and avoid retroactive taxation. The Foundation's thinking on these issues is published as Number 23 in our Background Paper series, entitled *Principles and Practice of Tax Reform Transition,* by Dr. J.D. Foster, the Foundation's executive director and chief economist.

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