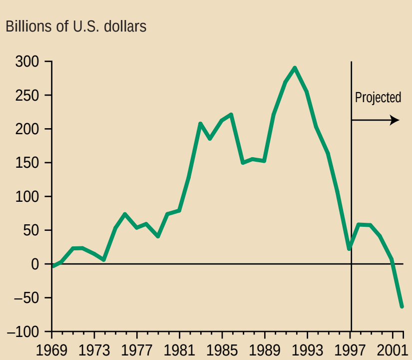
Counting Our Chickens

LAST YEAR CONGRESS passed, and the president signed, a budget agreement that made substantive changes to the existing tax code. With this agreement, both Congress and the White House have promised to achieve budget balance by the year 2002. To the dismay of many, deficits have been a continuing feature of federal budget policy for several decades (*Chart 1*). History tells a troubling story. In the 30 years following World War II, the deficit averaged just $6.6 billion annually. This era included two major wars—Korea and Vietnam—events that have historically generated large deficits. But in the post–Vietnam War era, the deficit mushroomed to an average of $183 billion annually, causing many observers both to ask why and to wonder how and when the nation could again achieve fiscal balance.[1]

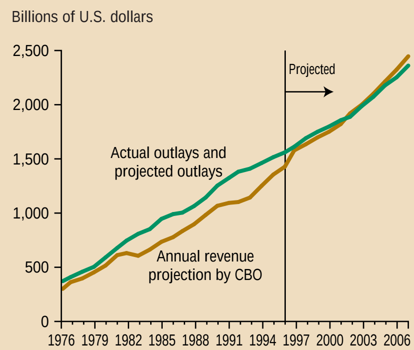
After peaking in 1992, recent deficits have fallen so rapidly that there is talk of budget balance even sooner than the predicted balance in 2002. This is very good news for a nation that is used to so much red ink and the steady buildup of its national debt. Unfortunately, there is already a good deal of talk about spending monies that we do not, as yet, have in the bank.

Chart 1
Federal Budget Deficit, 1969–2002



SOURCE: Office of Management and Budget.

Chart 2
Actual and Projected Federal Expenditures, 1976–2007



Before we begin "counting our chickens," it might be instructive to examine the historical fiscal record to see what lessons can be learned from the last 30 years of federal budget policy. Perhaps by studying why the deficit first expanded and why it has so stubbornly persisted, we can identify the flaws in our fiscal psychology that have led to a $5 trillion run-up in our nation's debt since 1969.

This article examines the history of federal deficits and investigates the question of whether the 1997 budget agreement should be counted on to achieve its stated purpose.

Thirty Years of Deficits

Several factors have been blamed for the deficits of the past 30 years: unbridled expansion in federal entitlement programs, overly generous tax cuts (passed to reverse a severe recession in 1980–82), excessive defense spending during the Reagan years and a burgeoning national health care bill. These explanations, among others, have been advanced to explain why federal cash flows have repeatedly wound up in the red.

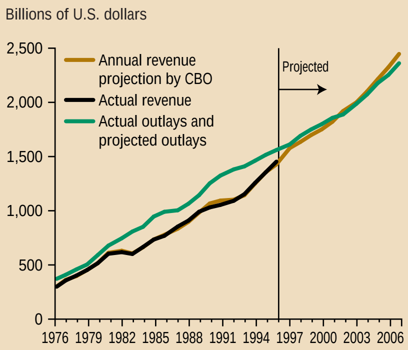
However, the central question that underlies these explanations is really a simple one: Are taxes too low or is spending too high? Whichever side one chooses, the main message should not be lost in the debate, namely, the *budget process* has failed repeatedly to deliver on its central promise: to constrain the nation to live within its means. In order to see what has happened, it is instructive to review the past three decades of federal budget policy.

As Chart 1 shows, deficits have been an ongoing feature of the federal budget since a small surplus last occurred in 1969. Since 1992, the deficit has fallen so rapidly that many in Washington are now speaking about budget surpluses in the near future and are already discussing what should be done with the extra revenue—either pay down the existing national debt or enlarge and/or add new spending programs.

The historical picture is clear on one point: expenditures have exceeded outlays since 1969 and will continue to exceed them at least through 1998. Additionally, expenditures have also exceeded both the Congress's own revenue projections and the growth in per capita income of taxpayers.[2] The very complex federal budget process seems incapable of matching expenditures to its own revenue estimates or, as average taxpayers would express it, living within its means (*Chart 2*).[3] Since Congressional Budget Office (CBO) projections have tracked actual tax revenues much more accurately than they have outlays (*Chart 3*), the inevitable result has been continuing deficits. Although the commonly advanced explanations all have some merit, they fail to explain all the evidence. To understand why, one has only to appreciate the vastly differing economic and tax climates that have, nonetheless, all produced exactly the same thing: deficits.

Chart 4 shows that since 1970, federal outlays have been greater than collected tax revenues. Although the 1981–83 period shows a decline in tax revenues collected, during all other years federal tax revenues grew faster

Chart 3
Actual and Projected Revenues and Actual Federal Expenditures, 1976–2007



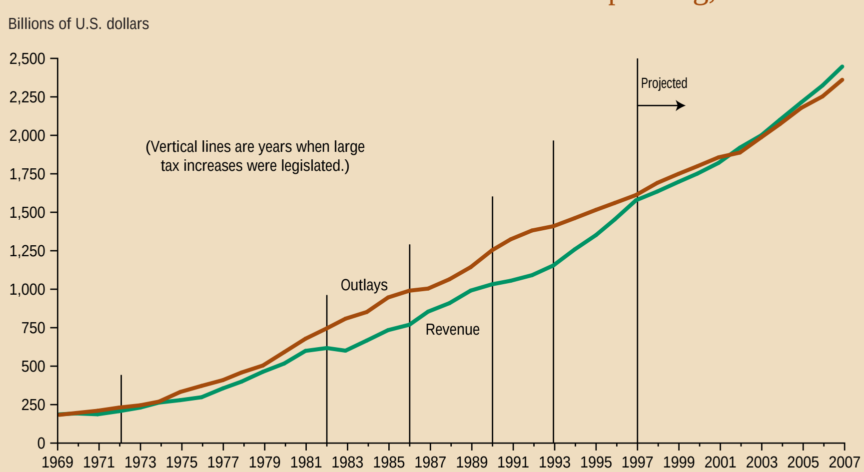
than the incomes that produced them. Over the past 30 years there have been *far more major tax increases than tax cuts*. Most people are familiar with the largest of such increases—the 1983 Tax Equity and Fiscal Responsibility Act package, the 1986 Tax Reform package and the 1990 budget deal between then-President Bush and Congress. They are also most likely aware of the increases during the past five years, such as the rise in marginal income tax rates in 1993, the reimposition of the federal aviation tax and the new telephone tax designed to connect all schools to the Internet. But there have been other changes accompanied by large tax increases about which the public is less aware—specifically, the payroll tax increases that began with rate and base changes in 1973 and were amended in 1986. These changes resulted in one of the largest tax increases in history and have contributed to the record growth of federal tax revenues during this period.

The payroll tax increased 43 percent between 1973 and 1997. The income base to which payroll taxes apply has risen 900 percent for Old Age Survivors Disability Insurance assessments and an incalculable amount for Health Insurance (Medicare/Medicaid) due to the elimination of an income cap for that tax in 1993.[4] As the unemployment rate falls—and it is the lowest now that it has been in over 40 years—payroll tax base collections grow as well. As a result, over 50 percent of American workers pay more in Social Security/Medicare taxes than they do in federal income taxes. As Federal Reserve Board Chairman Alan Greenspan recently put it in testimony before the House Budget Committee, "The best economic performance in decades has augmented tax revenues far beyond expectations while restraining countercyclically sensitive outlays."[5] In fact, workers today are paying four times the payroll taxes they paid in the 1960s.

The combined effect of rising tax rates and a strong economic expansion has been the catalyst by which we have been able to approach budget balance. In fact, 1996's combined federal and

The combined effect of rising tax rates and a strong economic expansion has been the catalyst by which we have been able to approach budget balance.

Chart 4
Actual Federal Tax Revenue and Government Spending, 1969–2007



SOURCE: Congressional Budget Office.

state/local tax bite as a percentage of GDP stood at 33.2 percent (19.4 percent federal and 13.8 percent state/local) and represented an all-time high for American taxpayers (*Chart 5*). These historically high rates of taxation, combined with strong economic performance, have pushed the federal deficit lower. Several factors other than tax rate changes and a strong economy are also responsible for rising tax collections: the stock market boom, which has pushed equity prices higher and resulted in rising capital gains tax collections; low unemployment, which has lowered spending and raised tax revenues; and low inflation, which has restrained expenditures tied to automatic cost-of-living adjustments. Low inflation also has lowered the interest rate structure, allowing federal debt to be financed more cheaply. Additionally, the end of the Cold War has allowed large real cuts in the defense establishment, and the one-time sale of spectrum rights by the Federal Communications Commission added billions to the Treasury. And as the savings and loan bailout concluded, sales of former thrift assets brought an additional $15 billion into the federal Treasury.

Low inflation also has lowered the interest rate structure, allowing federal debt to be financed more cheaply.

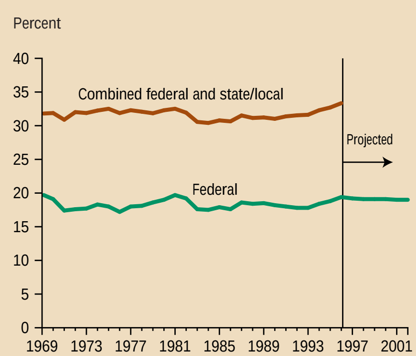
Although these factors contributed to narrowing the deficit, which has cheered the stock and bond markets, Chairman Greenspan sounded a note of warning in his October 8 testimony:

> Given the wider range of possible outcomes that we face for long-term economic growth, the corresponding range of possible budget outcomes over the next five to ten years has widened appreciably. In addition to the uncertainties associated with economic outcomes, questions may be raised about other assumptions behind projected receipts and outlays.
>
> With regard to the former, it is difficult to believe that our much higher-than-expected income tax receipts of late are unrelated to the huge increase in capital gains [*Chart 6*] which, since 1995, have totaled the equivalent of one-third of national income.
>
> …[On] the outlay side, the recently enacted budget agreement relies importantly on significant, but as-yet-unspecified, restraints on discretionary spending to be made in the years 2001, 2002, and thereafter. *Supporters of each program expect the restraints to fall elsewhere.* (Emphasis added)

In other words, *don't count the chickens just yet.*

What Chairman Greenspan was alluding to was the optimistic nature of the assumptions built into the projected budget balance: that economic growth will continue to be strong—with low inflation and low unemployment rates continuing; that unspecified cuts in spending scheduled for 2000 and beyond will actually be made; that Medicare spending will be reduced $135 billion over the next five years; and that no unforeseen national emergency will occur, requiring higher spending.

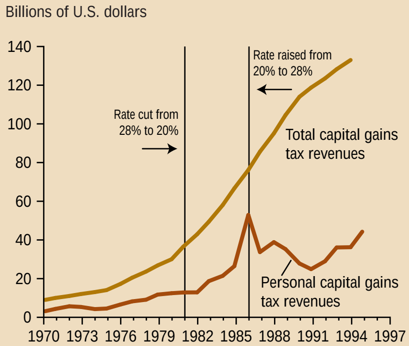
Chart 5
Federal and State/Local Tax Receipts as Percentages of GDP, 1969–2002



The 1997 Budget Deal

Numerous assumptions about the economy's performance and the government's spending and revenue levels are invariably incorporated into every budget agreement. But the 1997 agreement also amends the existing tax code in many substantial ways. An additional assumption is that these many tax code changes will not negatively affect the projections of revenues actually collected over the next five years. However, considering the number of changes in the 1997 law—there are 285 new sections, and 824 modifications to existing tax law—tax revenue projections

Chart 6
Taxes Paid on Capital Gains Income, 1970–97



SOURCE: Department of Treasury.

are going to be, at best, educated guesses. Congress's Joint Tax Committee will soon release its "Blue Book" on just these changes. Nonetheless, the book is 549 pages long. These changes include additional tax credits for children, the raising of estate tax caps, redefinitions of long- and short-term capital gains, the addition of a new form of Individual Retirement Account (Roth IRA) and significant educational tax credits and subsidies.[6]

Given the extreme complexity of these changes, it is unlikely that anyone can predict how all this will play out in terms of future tax collections. Any significant change in overall economic performance that might occur will only further complicate the forecasting picture. It appears that counting our chickens is a good deal harder to do than most of us realize.

Explanations and Evidence

In examining the explanations for the deficit record of the past 30 years, we can see the strengths and weaknesses of the ones most commonly proffered for budget red ink.

Tax Cuts Deprived the Federal Government of Sufficient Revenues. Although the top marginal income tax rate was cut in 1982 from 77 percent to 28 percent and the capital gains rate was cut from 28 percent to 20 percent, this explanation fails to account for the deficits between 1970 and 1983. Also, it neither addresses the fact that federal revenues have tripled since 1980 nor explains how federal tax collections could have soared in real terms (5.8 percent per year) between 1983 and 1989. This explanation further ignores the significant tax increases of 1972–73, 1982, 1986, 1990 and 1993 (see the vertical lines in Chart 4).

Defense Spending Caused the Deficits. This explanation has a superficial plausibility. During the Cold War, we had deficits. Now that the Cold War has ended, we seem to be on the way toward a balanced budget. However, the Cold War dates to 1946, and the deficit problem only started after 1970. Further, while it is true that defense spending rose in real terms during the early and mid-1980s (about 4.77 percent per year from 1981 to 1988), it is equally true that the increase occurred during a strong economic downturn that automatically pushed the deficit up in the early years. This buildup was not really very important for the federal government's fiscal position because defense's share of total federal spending only rose from 23.2 percent in 1981 to 27.3 percent in 1988. Although defense spending has been falling in real terms ever since, we have yet to reach budget balance because Congress has failed to restrain overall spending levels even despite such legislative efforts as the Gramm–Rudman–Hollings Act. In fact, defense is virtually the only major category of spending that *has been cut*—repeatedly—in real terms.

Entitlement Spending Grew Uncontrollably. There is truth here, as well. Social expenditures have outstripped inflation and grown every year. For example, between 1996 and 1997, while inflation was about 2.3 percent, defense spending increased only 2 percent. But during that time frame,

Predicting Tax Collections After Rate Changes Is Never Easy

The total amount of revenue that any tax will generate (ignoring fraud and the costs of making the collection) can be summarized in a simple formula:

Tax revenues collected = (percentage tax rate) x (relevant tax base)

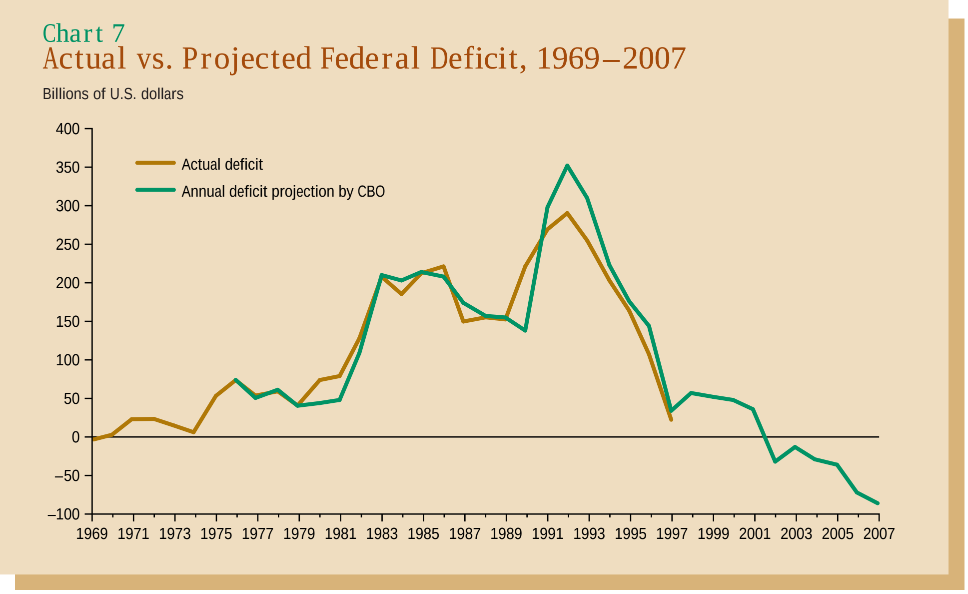
Tax revenues collected depends upon not one thing, but *two*. So setting tax rates and then making accurate projections about how changing these rates will affect revenues is very difficult.

In a static world in which the economic base remains unchanged as various rates are applied to it, predicting tax revenue changes would be easy. But in the actual, dynamic world in which people alter their economic behavior in response to a changing percentage in the tax rate, the issue becomes a good deal more complex.

The *disincentive effects* of taxation must be considered. Economists know that when you tax something, you will reduce its size. For example, if you increase the tax rate on the creation of wealth (the *base* in the equation), then wealth creation will be less than it otherwise would have been without the tax rate increase. This disincentive effect can be offset sometimes by overall economic growth, which tends to occur in capitalist economies even when they are saddled with increased tax rates. What makes predicting these tax effects so difficult is that both terms on the right-hand side of the equation always move in response to any change on the left-hand side, but they *may not move in the same direction*.

Given the tax equation above, it is obvious that economic downturns, which shrink the economic base, will result in lower overall tax collections even at static (or possibly even rising) tax rates, while steady economic growth (and inflation) can fill government coffers without any tax rate increase at all. Since growth is normal for our economy, we expect (and we typically observe) government tax collections to rise even at static rates of application. But we do not necessarily observe an increase in revenues collected when tax rates are legislatively raised.

The simple assumption that many people make is that a tax rate increase will always produce a rise in revenues, while a tax rate cut will always produce a decline in revenues. Evidence suggests that this view is simplistic and sometimes erroneous as illustrated in Chart 6, which shows capital gains rate changes in 1981 and 1986 and the subsequent revenues collected after those changes. The significant increase in revenues collected after the rate cut in 1981 is matched by the equally stark decline in revenues collected after the rate increase in 1986. In the former case, the base expanded fast enough to generate rising collections after the cut; in the latter, it shrank so that the tax hike produced less collected revenue even after a decade had passed. Although forecast errors sometimes make news, it is easy to see why they so often occur.



spending on Social Security rose 4.4 percent and Medicare 5.8 percent. Between 1969 and 1996, Medicare expenditures increased by 3,000 percent, Medicaid by 4,000 percent and Social Security by 1,300 percent. Overall entitlement spending rose 1,225 percent in the same period. Defense spending rose 222 percent but fell from 8.7 percent of GDP to 3.5 percent. Entitlement spending rose from 6.8 percent of GDP to 11.5 percent during the same period.[7] It is hardly surprising that, as military threats have seemed to recede, domestic spending would take its place. Yet the domestic spending growth rate is significant, and the projected retirement of the baby boomers could place incredible stress and strain on the Social Security and Heath Insurance programs. The budget agreement of 1997 does little to address the impending fiscal shortfalls that are projected for those programs. As Chairman Greenspan recently told a Senate committee:

> Unless Social Security savings are increased by higher taxes (with negative consequences for growth) or reduced benefits, domestic savings must be augmented by greater private saving or surpluses in the rest of the government budget to ensure that there are enough overall savings to finance adequate productive capacity down the road and to meet the consumption needs of *both* retirees and workers. (Greenspan's emphasis)[8]

Conclusion

It is possible that the long sequence of federal budget deficits is finally coming to an end, even though the deficit is predicted to rise from last year's $23 billion to $58 billion this year. It is far from clear, however, what is primarily responsible for the predicted budget balance after that. Evidence suggests that stronger-than-predicted economic growth, a booming stock market and prior tax rate hikes are primarily responsible for the rapid increase in federal tax receipts that will, in turn, lead to budget balance. Evidence also shows, however, that the act of matching expenditures with predicted revenues—the budget process itself—has been a major problem since 1969 and that overestimation of deficits (*Chart 7*) has been the major constraining factor on congressional spending. If deficits result from that process, then that process needs to be changed. Regardless, three important fiscal issues must be addressed as the nation enters the new millennium: Do we want the current high level of taxation to continue? Can we simplify the federal tax code so that average taxpayers do not run afoul of its labyrinthian structure? And what are we going to do about the projected Social Security deficit problem?[9] Just as there are historic moments when "opportunistic disinflation" occurs and monetary policy can more easily be changed from then on, so this may be a moment of "opportunistic fiscal balance" from which we can enter the next century in a fiscal position not seen in three decades. The nation can profit immensely from this development, provided that we accurately count our chickens.

—Robert Formaini

Notes

My thanks to Mike Cox and Jason Saving for useful suggestions and comments, and to Dong Fu for patient and thorough research assistance.

1 The huge annual borrowing required by the past 22 years' budget deficits has pushed the national debt from $366 billion in 1975 to over $5.3 trillion today.

2 These projections are carried out by the CBO, which was created in 1975.

3 A nice overview of the complicated—and spending-biased—budget process is in *Insight*, December 29, 1997.

4 *Social Security Bulletin*, Annual Statistical Supplement, 1996. The increase on the Health Insurance (Medicare/Medicaid) portion cannot be calculated in percentage terms due to the removal of the income cap altogether.

5 Testimony before the House Budget Committee, October 8, 1997.

6 A detailed overview of the 1997 changes and how they might affect average taxpayers can be found in Kathy Bergen's "Taxpayers Face Mind-Boggling Search for Choices Among a Maze of Tax Cuts," *Knight-Ridder/Tribune Business News*, December 1, 1997.

The best performing group of stocks in late 1997 has been tax preparation companies, a sure signal that investors know the tax code changes are complicated and that they will raise the revenues of these firms.

7 *Monthly Budget Review for 1997*, CBO.

8 Testimony before the Task Force on Social Security of the Committee on the Budget of the U.S. Senate, November 20, 1997.

9 One potential solution was offered by Harvey Rosenblum in "Why Social Security Should Be Privatized," *Southwest Economy*, Issue 3, 1997.