Published by

AMERICAN INSTITUTE *for* ECONOMIC RESEARCH

Great Barrington, Massachusetts 01230

RESEARCH REPORTS

Vol. LXI No. 21 November 7, 1994

The Shrinking Deficit

The Federal deficit for fiscal 1994 was $203 billion, down significantly from the deficits of $255 billion the previous year and $290 billion in 1992, and significantly less than forecast. A number of temporary windfalls contributed to this favorable trend. Fundamentally, the Government's financial situation has not changed, and in a few years the deficit is likely to balloon unless Congress acts to limit the growth of spending.

Most economic forecasts are wrong, and forecasts of the Federal deficit are no exception. The earlier the forecast, the more off-target it usually is. In January 1993, the outgoing Bush administration projected that the deficit for fiscal year (FY) 1994 would be $292.4 billion. The actual deficit for FY94, which ended September 30, was $203.4 billion, $89 billion less than predicted.

The Bush "baseline" estimate assumed that tax and spending policies would remain unchanged and that the economy would follow the path predicted by "Blue Chip" forecasters. The first assumption, at least, clearly was unrealistic given that a new administration was coming in. The deficit estimate by the Clinton administration in April 1993, as part of its first budget proposal, should have been more accurate than the Bush projection, since it incorporated all anticipated policy changes. It was — but it still was off the mark, overestimating the FY94 deficit by a hefty $60.7 billion.

As shown in the adjacent table, subsequent forecasts of the FY94 deficit were closer but still wrong. The estimate made by Clinton's Office of Management and Budget (OMB) in its Mid-Session Review in September 1993 (a month before the start of FY94) was off by $55.4 billion. The projection made by the OMB in April 1994, when the fiscal year was half over, was $31.4 billion too high. Finally, the projection made by the OMB in its July Mid-Session Review, with just 3 months left in the fiscal year, was the closest of all but still $16.7 billion too high.

Deficit forecasts necessarily are based on assumptions about economic factors that affect Government receipts and outlays, and the forecasts are highly sensitive to these assumptions. If price inflation is slightly higher than anticipated, or interest rates or the rate of economic growth are slightly lower, the impact on the deficit may amount to billions of dollars. It is virtually impossible to predict these things accurately *and* precisely a year or more in advance (economists make forecasts because they are asked to, not because they are good at it). This is one reason that deficit forecasts, especially the longer-term ones, often hit very wide of the mark.

Moreover, estimates in Presidential budget messages always are partly hortatory — they assume that the Administration's revenue and spending proposals will be adopted by Congress *in toto*. On the other hand, the Mid-Session Review estimates prepared and published by the OMB should, in theory, incorporate the actions taken by Congress; but in recent years Congress has delayed final action, until after the fiscal year has begun.

As shown in the chart on page 124, there is a cyclicality to the Mid-Session Review deficit-forecast errors. When the economy is in recession, as in 1990-91, they tend to be too low. When the economy is expanding, as in 1992-94, the estimates tend to be too high. Last year's estimate was $55.4 billion larger than the actual FY94 deficit. There were a number of reasons for this. Tax receipts were underestimated by about $16 billion, largely because the economy was stronger than expected. More important, outlays were overestimated by nearly $40 billion. In particular, the various independent agencies supervising the savings and loan "bailout" — the Resolution Trust Corp. and the FDIC's deposit insurance funds — actually made money, and made more than the Administration predicted.

In the early 1990s the thrift bailout caused the Federal deficit to balloon, as Federal agencies spent tens of billions to take over the assets and liabilities of insolvent financial institutions. Now, as the assets of these institutions are sold off (albeit often at far less than their book value), the resulting income is large enough to offset the agencies' current outlays. In FY94 this offset was greater than anticipated.

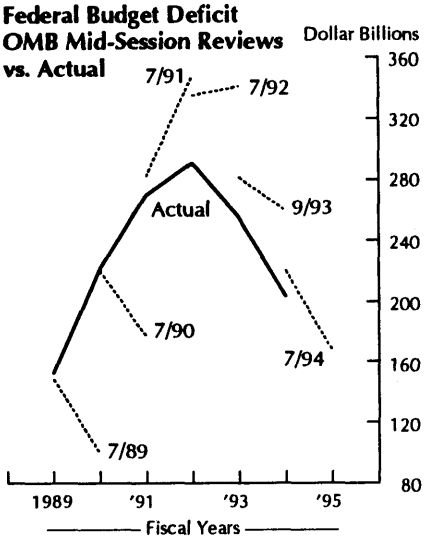
Spending on social programs run by the Department of Health and Human Services also was lower than expected. These include Social Security, Medicare, Medicaid, plus most other health and "welfare" programs. Outlays for these programs totaled $625 billion — about $11

A History of the Fiscal 1994 Budget Deficit Estimates
(In Billions)

			Over (Under) Estimate			
			Clinton			
Outlays	*FY1994 Actual*	*Bush 1/93*	*4/93*	*9/93*	*2/94*	*7/94*
Defense	$ 299.0	na	($ 4.2)	($ 4.3)	($ 0.6)	($ 1.0)
Social Security	313.9	na	0.2	1.4	0.8	0.9
Interest	296.3	$24.3	13.4	6.9	2.2	2.7
HHS	310.8	na	15.1	9.3	5.8	4.1
Agriculture	60.8	na	2.2	5.8	4.1	2.4
Transportation	37.3	na	1.8	(0.5)	(0.6)	(0.5)
Labor	36.9	na	0.6	(0.3)	0.2	0.0
Resolution Trust	4.1	na	14.3†	1.1	(0.6)	3.0
Other Agencies	7.4	na		15.9	4.2	2.1
All Other	94.0	na	11.2	4.2	7.7	5.7
Total Outlays	$1,460.6	$62.1	$54.8	$39.5	$23.3	$19.5
Less: Receipts	1,257.2	(26.9)	(5.9)	(15.9)	(8.1)	2.7
Deficit	($ 203.4)	($89.0)	($60.7)	($55.4)	($31.4)	($16.7)

na Not available. † Combined outlays for Resolution Trust *and* Other Agencies.

Federal Budget Deficit
OMB Mid-Session Reviews vs. Actual



billion lower than anticipated a year ago. Interest on the public debt also was $6.9 billion lower than predicted, presumably because both the deficit and the level of interest rates were lower than expected. (More strikingly, interest costs were a full *$24.3 billion* lower than projected by the Bush administration.)

If the Clinton people were significantly off in their predictions of how big the FY94 deficit would be, they at least were correct in predicting the direction of change in the deficit. It shrank to $203 billion in FY94 from $255 billion the previous year and $290 billion (the all-time peak in current dollars) in FY92. The deficit is widely expected to fall again in FY95 — to $167.1 billion, according to the estimate made by the OMB at its July Mid-Session Review. As the White House eagerly points out, if this happens it would mark the first time the deficit has decreased for 3 consecutive years since Truman was President.

Unfortunately, the similarity to fiscal conditions some 45 years ago ends there. In the mid-1940s the deficit was enormous (30 percent of GDP, compared to roughly 3 percent today) because of an enormous increase in Federal spending to finance World War II. To a degree unimaginable today, military spending dominated the Federal budget. In 1944, defense outlays accounted for 87 percent of total Federal spending. When the war ended, such spending decreased rapidly. By 1947, defense accounted for only a third of the budget, and total Federal spending had shrunk from $91 billion in 1944 to $35 billion, a 60 percent decrease. The then-huge deficit of $48 billion quickly became a small $4 billion surplus.

This trend was short-lived. By 1950, deficits had returned, and since then the Government has run deficits in all but 4 years. For the most part, these deficits have financed not temporary war-related spending but all types of Government programs, including rapidly growing "entitlements" and other social programs. The further surge in the nominal deficit in 1989-92 (see chart) largely was attributable to two additional factors. The huge expense of the savings and loan bailout, and the recession, which depressed the growth of tax receipts.

Since 1992 the impact of these two factors has receded, however. The economic recovery and the 1993 Clinton tax hike have boosted revenues, and the rate of spending growth has been significantly slower during the first 2 years of the Clinton presidency than during the Bush administration:

	Percent Change in Federal:	
	Outlays	*Receipts*
1992-94	5.7	15.2
1990-92	10.4	5.8
1988-90	17.7	13.5

In addition to reduced outlays for the bank bailout, defense spending has decreased sharply. In FY94, defense spending totaled $299 billion, compared to a peak of $318 billion in 1989. (These are current dollars, unadjusted for price inflation; in "real" terms, defense spending has fallen by 22 percent since 1989.) Relative to total Federal outlays, defense has shrunk during this period from 28 to 20 percent of the budget, a postwar low.

The historically low interest rates of recent years also have helped limit the increase in Federal spending. Interest payments on the public debt have continued to increase but at a much slower pace than a few years ago. From FY88 to FY90, interest payments increased by $51 billion. Over the next 2 years they increased another $27 billion. From FY92 to FY94, however, interest payments increased by "just" $4 billion, to $296.3 billion. Had interest payments continued to increase at the earlier pace, the Federal deficit would have been far larger.

Windfalls

These three factors were temporary windfalls, however. Their impact on Federal spending and on the deficit in future years is likely to be much reduced, for a number of reasons.

The Clinton administration currently estimates that defense spending will fall another $9 billion in FY95, but this may be overly optimistic. The Administration underestimated FY94 defense outlays by $4 billion. Some analysts think defense already has been cut too much, given the political uncertainties of today's world. Future "peace dividends" are likely to be relatively small, if they occur at all.

Likewise, the "interest rate dividend" appears likely to shrink. The cost of paying interest on the public debt is likely to accelerate now that the general level of interest rates is heading upward. The fiscal impact of the ongoing bank bailout, which has been one of the most volatile and least predictable elements of the budget in recent years, is likely to be smaller in the future, simply because the bailout now largely is completed.

Unlikely to Continue

Even the Clinton administration admits that the downward trend in the deficit is unlikely to continue much longer. According to the Administration's projections, FY96 will be the low water mark. The deficit is estimated to begin rising again in FY97. From 1997 through 1999, the annual deficit is projected to rise relatively modestly (by less than $50 billion). The Administration's forecast stops there; left unsaid is that the deficit is likely to increase rapidly in subsequent years.

Demographics will begin to squeeze the budget early in the next century, when the first baby boomers begin to retire. In the year 2007, the first baby boomers will turn 62 and become eligible to collect "early retirement" Social Security retirement benefits. A few years later, they will become eligible for Medicare (the medical program for the elderly). The rolls and costs of Medicaid (the medical program for the poor) also may swell as a growing elderly population turns to the Government to pay for custodial nursing-home care (which is covered by Medicaid rather than Medicare).

Outlays for these and other "entitlement" programs already drive the Federal budget. Spending on so-called "mandatory human resources programs" (bureaucratese for "entitlements") now accounts for half of total Federal outlays, compared to just one-fourth in 1960. As the number of people who automatically qualify for "mandatory" benefits on account of their age rapidly increases, these outlays will skyrocket, as will total Federal outlays.

The only way to finance these outlays would be by raising Federal tax receipts to unprecedented heights, or by allowing the deficit and public debt to balloon. Economic growth is unlikely to be rapid enough to enable the U.S. economy to "grow" its way out of the real burden of financing these obligations.

Fortunately, there is an alternative. Limit the increase in spending. "Discretionary" spending, *i.e.*, spending that does not "automatically" increase but requires annual appropriations by Congress, could be cut. Nondefense discretionary outlays currently account for only 18 percent of

the Federal budget, however. Capping them while allowing "mandatory" spending to increase without check will not be sufficient to control the growth in total Federal spending.

"Mandatory" programs are politically untouchable, however. Both Democrats and Republicans demonize anyone who suggests that cuts may be necessary. Both parties continue to promise, unrealistically, that benefits will never be cut.

Cut Now or Inflate

Perhaps the only feasible political solution is to act *now* to cut benefits *later*. This is what Congress did in 1983, when it approved a sweeping package of recommendations of President Reagan's National Commission on Social Security Reform. These included gradually extending the age at which beneficiaries become eligible to collect full retirement benefits from 65 to 67 — beginning in the year 2003. The current generations of retirees did not object because they were not affected. The baby boomers were not yet paying attention.

Currently, a bipartisan Commission on Entitlements and Tax Reform, chaired by Senator Bob Kerrey, is scheduled to present its own recommendations to President Clinton in December. If any proposals to cut or cap popular entitlements are to stand any chance of acceptance by Congress, they will have to apply mostly to future rather than current beneficiaries.

Another alternative is to inflate away the real value of the Government's obligations. Social Security benefits are largely protected from this threat under current law, in that benefits are indexed to increases in the cost of living.* But the provision for indexing, like every other aspect of the system, is subject to the will of Congress and could yet be restricted. As for Medicare, the "real" value of coverage already has shrunk as the schedule of "Medicare-approved" payments for medical procedures has failed to keep pace with the increase in actual charges. Holders of Government debt bear the clearest risk: Government bonds are not indexed for price inflation, and although there is little chance that the Government will not meet its nominal obligations, the real value of these claims could be far less than bondholders now anticipate.

In sum, the fiscal burden of the Government's social programs is likely to become urgent a decade or more from now. In the meantime, a looming financial shortfall in the Medicare and Medicaid programs could precipitate a fiscal crisis sooner. In short, the sharp decrease in the deficit since 1992 is the calm before the storm. It was largely the result of temporary windfalls related to the end of the Cold War, the resolution of the bank bailout, and an unexpectedly sharp decrease in interest rates. If the politicians are to make long-term progress on reducing the deficit *and* limiting the seemingly inexorable growth of Government, they will have to stop relying on windfalls and start making responsible choices. And voters will have to start rewarding them for doing so. ❑

* A notable exception: the income thresholds at which benefits become subject to income tax, $25,000 for singles and $32,000 for couples, is not indexed and has not changed since it was introduced in 1984. Had they been indexed for price inflation as measured by the Consumer Price Index, the thresholds would now be $35,000 and $45,000, respectively.

WHO PAYS THE CORPORATE PROFITS TAX?

Profits taxes probably are shifted to consumers in the long run, just like any other cost of doing business. As such, they function as a sales or value-added tax, but one that is far more capricious in the short term and far more subject to the fundamentally corrupt process of special-interest politics.

In 1909, Congress imposed a tax on corporate profits. This was 4 years before the passage of the 16th Amendment to the Constitution, which permitted Congress to levy taxes on individual income. Some historians believe that Congress imposed corporate income taxes because the Supreme Court had declared the individual income tax unconstitutional.

If so, it would reflect an early understanding that corporations do not pay taxes, they simply collect taxes on the Government's behalf. The burden of taxation must ultimately fall on individuals. The notion may have been that, with ownership of corporate equities concentrated among the wealthy, a tax on corporate profits would fall disproportionately on the incomes of the rich and the corporate income tax may have been enacted as an "end run" around the Constitutional prohibition that was the law of the land at the time (Article 1, Section 9, prohibited "... a capitation or other direct tax, unless in proportion to the census...").

In any event, the corporate income tax was retained even after the 16th Amendment permitted Congress to levy individual income taxes. The significance of corporate income taxes to Federal revenues has varied greatly over the years. For some years during World War II, they accounted for nearly half of Federal receipts, but during the postwar years they have decreased in significance and recently they have amounted to less than 10 percent of receipts.

The top *marginal* rate of Federal corporate profits taxation has varied from a low of 1 percent (between 1909 and 1916) to a high of 52.8 percent in 1968 and 1969. Many industries faced markedly higher rates on "excess profits" during World War II and again during the Korean War, as did many oil producers when the "windfall profits" tax was in effect (between 1980 and 1991). The current rate is 36 percent, but the decrease in the significance of profits taxes has not been simply a function of lower rates. The *effective* corporate profits tax rate usually has been much lower than the marginal rate, for the reasons discussed below.

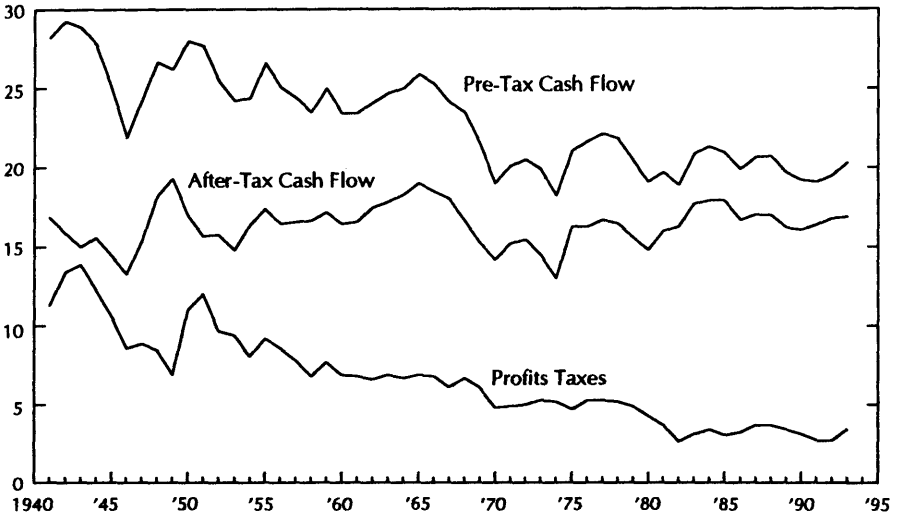
Who Pays?

To repeat, it appears likely that the corporate income tax was imposed in an attempt to tax the incomes of the rich.* However, there are several other candidates. A business's revenues are paid to vendors, employees, creditors and lenders (interest payments), and to tax collectors (for excise taxes, property taxes, payroll taxes, and other levies unrelated to profits). What is left after these payments belongs to the owners of the business, but taxing profits could affect payments to others as well as the prices paid by those who purchase the goods and services produced by the firm.

Few believe that profits taxes have an effect on wage rates or on indirect taxes levied on assets or payrolls. Some analysts have concluded that the corporate income tax is fully borne by all capital

* It may be noted that, if one really believes that profits taxes come out of the pockets of stockholders, *i.e.*, that corporations reduce their dividends by the amount that they must pay profits taxes, then corporate income taxes would appear to be regressive when individual incomes are also taxed (at progressive rates). For example, taxing $100 of corporate profits at 36 percent (the current rate), increases the taxes of someone in the lowest individual bracket (0 percent) by $36, but taxpayers in the highest bracket (39.6 percent) only pay $21.74 more. Presumably, in recognition of this possibility, Congress for many years provided for the exclusion of modest amounts of dividends on individual income tax returns (this exclusion was abolished in the 1986 tax reform).

Corporate Cash Flow and Profits Taxes as a Percent of Value Added*



* Nonfinancial corporate businesses. Cash flow is the sum of profits and capital consumption allowances. Profits taxes include Federal, state, and local taxes levied on profits, but exclude "indirect taxes" (property and sales taxes, etc.) as well as payroll taxes paid and/or collected by corporate businesses. Value added is the gross domestic product of nonfinancial corporate businesses.
Source: *National Income and Product Accounts.*

income earners (not simply stockholders),* on the basis of simplified models of behavior and estimates of various elasticities and ratios. However, the data suggest otherwise.

The accompanying chart shows the shares of gross product accruing to stockholders and profits taxes for U.S. nonfinancial nonfarm business corporations. We focus on such corporations because the taxation of financial businesses and corporate farms, as well as the measurement of the output of the former, involves a number of complexities (such as the creation of reserves or the presence of significant subsidies) not encountered in the nonfinancial sector. Because purchases of goods and services within the sector are netted out (and purchases from other sectors are excluded), gross corporate product is equivalent to value added.

What are Profits?

In compiling the chart, we plotted "cash flow" (profit plus depreciation). That amount is what is left over after the other claimants to a firm's receipts have been paid. The allocation of cash flow between profits and the consumption of assets is purely an arbitrary judgement of the accountants — the total will be the same no matter how the allocation is made. Auditors calculate depreciation for financial accounting purposes. The Internal Revenue Service accepts depreciation deductions according to what the law allows. And the Bureau of Economic Analysis (BEA) computes depreciation on the basis of the replacement cost of the assets. The latter is the only source of aggregate data, but the cash flows accruing to stockholders (as plotted in the chart) will be the same no matter how depreciation is computed.

As this chart clearly shows, profits taxes have decreased as a portion of value added, but that decrease mainly has been reflected in a decrease in the pre-tax cash flow accruing to the stockholders. Over the years, the after-tax cash flow has changed little as a share of value added, despite fluctuations. This strongly suggests that profits taxes are simply shifted to and collected from customers in the aggregate and over the long term. The tax becomes another cost of doing business that becomes embedded in the selling price. The profits tax would thus appear to be equivalent to a sales or value-added tax.

However, in contrast to a straightforward value-added tax, the profits tax is wildly capricious. Although the tax does seem to be shifted to consumer in the aggregate and in the long term, it *will* impact the shareholders of a given firm, when that firm's profits vary markedly in the short term. For example, if a hula-hoop manufacturer benefits from a revival of the fad for hula-hoops, its profits and profits taxes due will soar. If profits subsequently turn to losses, say, because the new plant comes on line just as the fad ends, the firm may be able to claim a refund for taxes paid in prior years. Perhaps more significantly, the taxes of a given corporation can vary enormously according to the extent to which it can take advantage of various "loopholes," excuse us, "tax incentives," that Congress have built in to the law.

Political Mischief

Thus the real mischief of a profits tax is that it opens the door for politicians to grant favors. One of the reasons the effective rate of the tax usually has been much less than the marginal rate has been that Congress often has permitted larger write-offs (for depreciation of plant and equipment, and for the depletion of mineral resources) than are indicated by financial or economic accounting, thereby reducing taxable income and profits taxes. Moreover, Congress has allowed various tax credits and various exclusions that have further reduced the tax. These have not been uniform over time or even across industries (some have been written so narrowly that they benefit only one company!).

Such "loopholes" reflect a history of lobbying in Washington, D.C. Some of the Nation's most talented and highly paid individuals devote their energies and talents to the work of obtaining legislation favorable to various special interests. When campaign contributions are solicited, those special interests no doubt remember which politicians have been "helpful." Much of this fundamentally unproductive work would cease if there were no corporate income tax.

Thus the reason we tax corporate profits may not be so much that nearly everyone thinks that someone else pays it, but that it is needed to help keep the money flowing to "the best Congress that money can buy." ❑

PRICE OF GOLD

	1992	*1993*	*1994*	
	Nov. 5	*Nov. 4*	*Oct. 27*	*Nov. 3*
Final fixing in London	$338.05	$372.00	$389.15	$383.90

* See, for example, a much quoted article by Arnold Harberger, "The Incidence of the Corporate Income Tax," in the *Journal of Political Economy*, June 1962.

Research Reports (ISSN 0034–5407) (USPS 311–190) is published twice a month at Great Barrington, Massachusetts 01230 by American Institute for Economic Research, a nonprofit, scientific, educational, and charitable organization. Second class postage paid at Great Barrington, Massachusetts 01230. Sustaining memberships: $16 per quarter or $59 per year. POSTMASTER: Send address changes to ***Research Reports***, American Institute for Economic Research, Great Barrington, Massachusetts 01230.