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It's April 17, Do You Know Where Your Taxes Are?

The growth in the Federal Government has been accompanied by marked shifts in both the sources and uses of Federal revenue. The portion of outlays covered by income taxes has decreased while the shares financed with payroll taxes and by borrowing have increased. Federal spending has increased slightly in relation to GDP over the past 3 decades, but its composition has changed markedly. Defense has not been the largest category for quite some time as transfer payments have increased to more than half of outlays. Significant spending cuts seem unlikely if such "entitlements" remain untouched.

Surprisingly few people understand where the Federal Government gets its revenue and what it spends it on. Most of the funds come from taxpayers (the rest is borrowed), but many people would be surprised to learn the breakdown of tax revenues. For example, personal income taxes account for only about two-fifths of total receipts. As for outlays, many people believe the Government spends far more on some programs (such as foreign aid) than it actually does and *vice versa*. Taxpayers are even less aware of how drastically the sources and uses of Federal revenue have changed over the years. The major role of Government has shifted from providing national security to serving as the middleman for a variety of income-transfer programs.

Where the Revenue Comes From

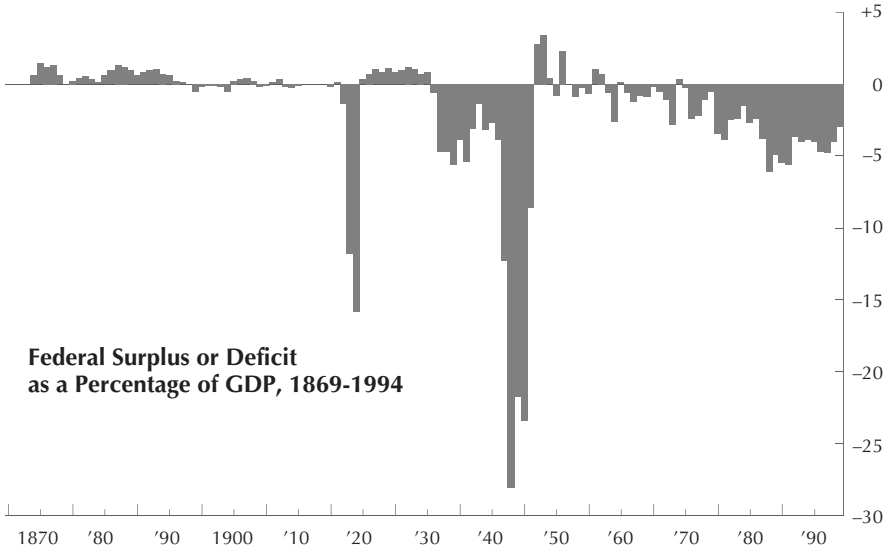
The Federal Government now spends over $1.5 trillion per year, the equivalent of 22 percent of Gross Domestic Product (GDP). A century or so ago, Federal outlays equaled about 3 percent of GDP, an amount that was financed almost entirely with excise taxes, primarily on alcohol and tobacco, and customs duties. Except during wars, the budget was in surplus more often than in deficit (see chart). Wartime deficits usually were followed by peacetime surpluses, enabling the Government to pay off some or all of its war-related debts.*

World War I changed this situation dramatically. The Government borrowed huge amounts then and, after it was over, outlays for veterans' benefits and interest payments on the greatly enlarged public debt kept Federal outlays significantly above prior levels. The passage of the 16th Amendment in 1913 provided a means of financing these expenditures. By the 1920s, income taxes rivalled excise taxes as the major source of Federal revenue, and the budget returned to surplus. This era of fiscal prudence ended with the depression.

After 1930, Government outlays increased rapidly and budget deficits became the rule rather than the exception. Increased expenditures for social programs led to significant deficits during the depression, and World War II boosted the deficits to more than 25 percent of GDP. The budget was in surplus for a few years after the end of the war, but it has rarely been so since.

The major change on the revenue side during the past 50 years has been a marked and steady increase of payroll taxes, which now are second only to personal income taxes as a source of Federal receipts, and, if trends continue, could become the largest source of receipts in a few years. Since the creation of the Social Security program in 1935, the payroll tax rate and the maximum wages subject to the tax have increased many times, and Congress has repeatedly broadened the portion of the work force required to participate in the Social Security system. By 1964, payroll tax revenue supplied one of every five dollars spent by the Government. Payroll tax revenue increased even more after the Medicare program was introduced and again after the 1983 Social Security reform legislation. In 1994, payroll taxes provided nearly one of every three dollars spent by the Government.

Including their employers' mandatory "contributions," most workers now pay more in Social Security tax than they do in income tax. The heavy burden of the Social Security tax, and other payroll taxes, means that the cost of an employee to an employer is much larger than what



* The national debt reached its all-time low under President Jackson.The total debt was $38,000 [yes, *thousand*] in 1837.

Sources and Uses of Federal Revenue

	1964	*1979*	*1994*
Total (dollar millions)	$118,528	$504,032	$1,460,914
Percentage of GDP	19.0%	20.7%	22.0%
Sources of Federal Revenue (as percentages of total)			
Individual income taxes	41.1%	43.2%	37.2%
Corporate income taxes	19.8	13.0	9.6
Social insurance taxes and contributions	18.5	27.6	31.6
Excise taxes	11.6	3.7	3.8
Estate and gift taxes	2.0	1.1	1.0
Customs duties	1.1	1.5	1.4
Miscellaneous revenues	0.9	1.8	1.5
Public borrowing	5.0	8.1	13.9
Uses of Federal Revenue (as percentages of total)			
Mandatory programs:			
Social Security	13.7%	20.4%	21.7%
Medicare	0.0	5.1	9.7
Medicaid	0.2	2.5	5.6
Income Security			
Federal employee retirement and disability	2.1	4.5	4.3
Unemployment compensation	2.4	1.9	1.8
Food and nutrition assistance	0.3	2.0	2.3
Supplemental security income	0.0	1.0	1.7
Family support assistance	2.3	1.3	1.1
Earned income tax credit	0.0	0.2	0.7
Other health	0.0	0.1	0.3
General retirement and disability	0.6	0.8	0.4
Housing assistance and other	0.0	0.0	0.0
Veterans benefits and services	3.6	2.7	1.4
Education, training, employment and social services	0.3	1.1	0.6
Other mandatory programs*	–2.3	0.4	–2.8
Total outlays for mandatory programs	**23.3%**	**43.9%**	**48.8%**
Net interest on the national debt	6.9	8.5	13.9
Total outlays for mandatory and related programs	**30.2%**	**52.4%**	**62.7%**
Discretionary programs:			
National defense	46.4%	23.2%	19.3%
International affairs	3.9	1.8	1.4
Domestic:			
Education	0.7	2.2	1.7
Transportation	4.3	3.4	2.6
Natural resources/environment	2.2	2.7	1.4
Income Security:			
Housing assistance	0.2	0.9	1.6
Other	0.3	0.6	0.8
Health	1.3	1.5	1.4
Veterans benefits and services	1.2	1.2	1.2
Administration of justice	0.4	0.8	1.0
Space and other technology	3.5	0.8	0.8
Training, employment, and social services	0.3	2.8	0.9
General government	1.3	1.0	0.8
Community/regional development	0.8	1.8	0.7
Energy	0.6	1.2	0.4
Agriculture	0.4	0.3	0.3
General science/basic research	0.7	0.3	0.3
Medicare	0.0	0.2	0.2
Commerce and housing credit	1.0	0.8	0.2
Social Security	0.3	0.3	0.2
Total outlays for discretionary programs	**69.9%**	**47.6%**	**37.3%**

* Includes Federal employee retirement funds and other undistributed offsetting receipts.

the employee gets. This "wedge" is a major disincentive to employment.

As indicated in the accompanying table, of every dollar spent by the Federal Government in 1994, roughly 37 cents was financed by individual income taxes; over 31 cents was provided by Social Security and other payroll taxes; just under 10 cents came from corporate income taxes, and another 7.7 cents came from the combined revenue from excise taxes, estate and gift taxes, customs duties and miscellaneous taxes. Of every dollar spent by the Government, 13.9 cents was financed by borrowing. The growing reliance on debt financing has led to a substantial increase in the share of the budget used to pay interest on the debt, as discussed below.

Where the Money Goes

As late as 1960, the Government spent over half its budget on defense, but the subsequent expansion of social programs* made defense spending shrink in relation to total outlays. By 1994, defense accounted for just one-fifth of the Federal budget.

The other four-fifths of the budget are taken up largely by three programs — Social Security, Medicare, and Medicaid — and by interest payments. Thirty years ago, two of these four items ate up 21 cents of every Federal dollar (Medicare and Medicaid were not introduced until 1965). *Now, these four items account for half of all Federal spending.*

Social Security is the single largest budget item, costing $317 billion in 1994. Not only do more people qualify for benefits than ever before, but numerous legislative changes (especially the adjustment of benefits to reflect increases in the average wage of current workers and for the cost of living) have made benefits far more generous than when the system was created and account for Social Security's ballooning share of Federal spending.

At 13.9 percent of the total, net interest is now the third largest item in the Federal budget, but it has been proportionately larger in the past. Interest on debt that was incurred to fight a war has been a large share of the budget when the war was over. As recently as 1948, the portion of the Federal dollar spent on interest payments was 14.6 percent, slightly higher than it is today. However, because total Federal spending now is much larger in relation to national income, today's 13.9 percent share represents a much larger burden on taxpayers. Last year's net interest payments of $203 billion were the equivalent of 3.1 percent of GDP, compared to 1.8 percent in 1948.

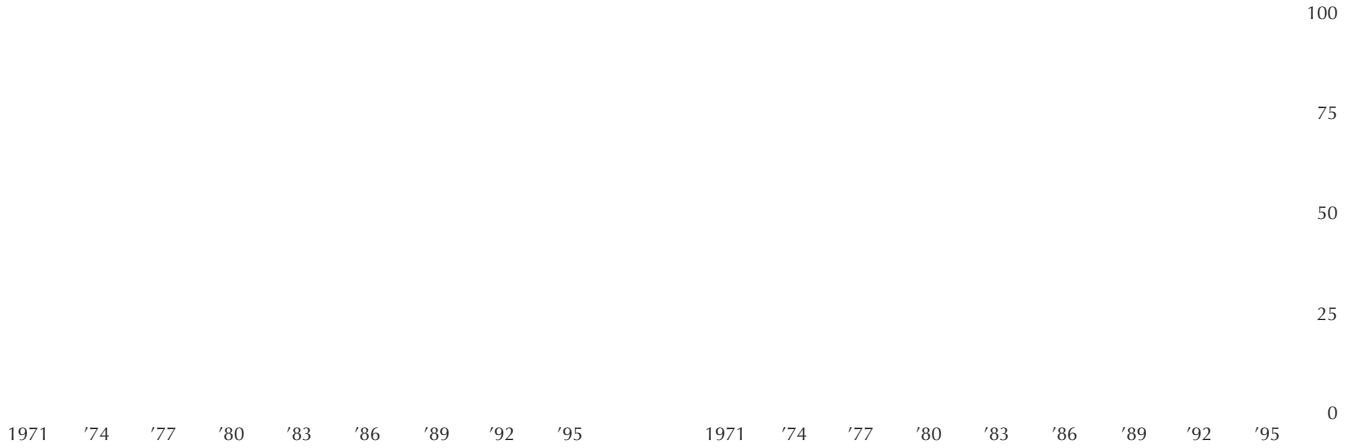
Aside from these few large items, the rest of the Federal budget is spread among programs that individually account for a relatively small share of the total. But the share of the budget accounted for by these other programs is not insignificant. The budget is so large that substantial savings could be realized by trimming even "small" programs. Their relatively small cost (especially when calculated as the cost per taxpayer per year, which reduces even billion dollar outlays to pennies per person) has been used as an excuse for the misuse and outright waste of billions of dollars of taxpayers' money.

Nonetheless, it is doubtful that lasting progress can be made toward restraining the long-term growth of Federal spending until changes are made in the large entitlement programs that dominate the budget. In this respect, the prospects for change appear to be brightening.

In his recent national address on the accomplishments and plans of House Republicans, Newt Gingrich seemed to open the door to entitlement reform when he referred to a plan to revamp Medicare by offering senior citizens a "series of new Medicare options." However, in the same speech he reiterated that "Social Security is off the table." In the near term, politicians probably will aim to crawl before they walk, targeting smaller programs first and hoping to win enough popular support to tackle the larger problems later.

Achieving any cuts promises to be exceedingly difficult, judging from the truculent tone of Gingrich's and the Republicans' critics. How serious politicians in Washington are about confronting this vocal opposition should become clearer later this year, when they are scheduled to present a plan for limiting spending and balancing the budget by 2002. ❑

* Especially those in which benefits can be claimed as an "entitlement" (these are shown in the table as "mandatory programs").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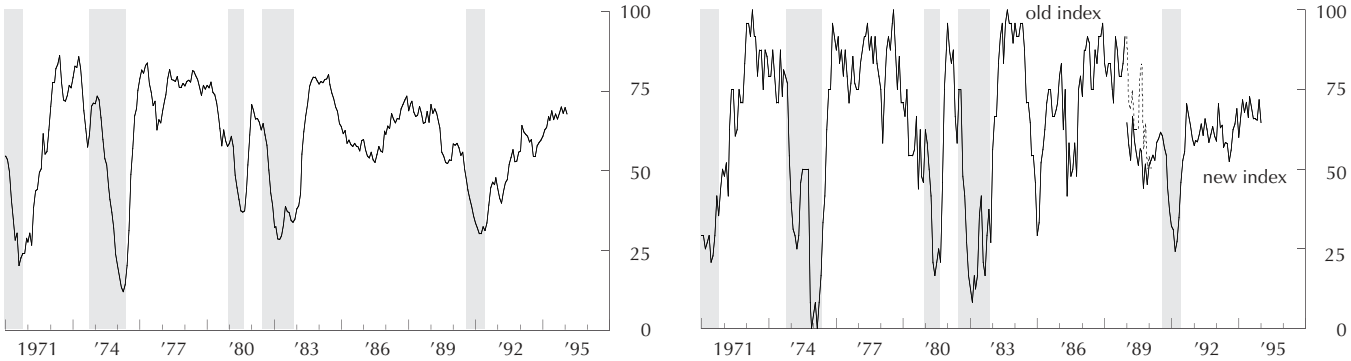
Diffusion Indexes of Nonagricultural Employment (left) **and Industrial Production** (right)
(percentage of industries reporting increased employment or production over 6-month spans)



Note: Data points for both indexes are plotted in the final month of each 6-month span. Sources: Federal Reserve Board Industrial Production release (industrial production new index); Commerce Department (industrial production old index and nonagricultural employment index).

However, as noted above, the leaders have yet to establish downtrends. Moreover, although the laggers are expanding vigorously, their levels remain well below those that preceded prior business-cycle peaks — the economy would seem to have a lot of room left before encountering the "bottlenecks" that have throttled back prior expansions.

Further evidence that considerable room remains for growth is provided by the two diffusion indexes plotted in the charts above. These indexes measure how widespread growth is across the economy. By historical standards, both indexes remain quite low. In every prior postwar expansion the diffusion index of industrial production, an index that measures the percentage of industries reporting increased production, has risen above 75 percent and in most instances it hit 100 percent at some point. This time the index has fluctuated within a relatively narrow band (between 52.5 percent and just under 73 percent). Given the index's past performance, prior to the onset of a recession, we would expect the index to at least break above 75 percent sometime during the cycle and remain there for several months.

The diffusion index of nonagricultural employment, an index that measures the percentage of nonagricultural industries reporting employment increases, is approaching its historical norms, but it too has yet to break the 75 percent level. Not until August of 1994 did the index manage to break 70 percent. Its current level of just below 68 percent also suggests that the expansion is far from over.

The behavior of any one series or index is no guarantee of future conditions and it is not necessary for these indexes to rise above 75 percent (or any specific level) before a recession sets in. Nevertheless, if the past is any guide to the future, the expansion could continue for quite a long time.

The economy now is in its fourth year of expansion. To date, only three postwar expansions have lasted longer. The Federal Reserve, fearful that the economy is overheating, has been trying to slow the economy's growth. Recent data suggest that the Fed's policies may have been effective in slowing the economy, but whether this will result in the "soft landing" Washington and Wall Street are always looking for remains to be seen. ❑

Statistical Indicators of Business-Cycle Changes

Change in Base Data					*Cyclical Status*		
Dec.	*Jan.*	*Feb.*	*Mar.*	***Primary Leading Indicators***	*Feb.*	*Mar.*	*Apr.*
–	–	–		M1 money supply	–	–	–
–	+	–		M2 money supply	–	–	–
+	+	–		Change in sensitive materials prices	+	?+?	?
+	+	–		New orders for consumer goods	+	+	+
–	+	+		Contracts and orders for plant and equipment	+	+	+
+	–	–		Index of new housing permits	+	?+?	?
+	–			Ratio of manufacturing and trade sales to inventories	?+?	+	+
+	–	–	–	Vendor performance	+	?+?	?
–	+	+	+	Index of common stock prices (constant purchasing power)	?	?	+
+	nc	–	–	Average workweek in manufacturing	+	+	+
+	–	–		Initial claims for unemployment insurance (inverted)	+	?+?	?+?
–	–	+		Change in consumer installment debt	?	?	?–?
				Percentage expanding cyclically	*80*	*80*	*67*
				Primary Roughly Coincident Indicators			
+	+	+	+	Nonagricultural employment	+	+	+
+	+	+		Index of industrial production	+	+	+
+	r–r	+		Personal income in manufacturing	+	+	+
+	–			Manufacturing and trade sales	+	+	+
+	+	+	+	Civilian employment to population ratio	+	+	+
+				Gross domestic product (quarterly)	+	+	+
				Percentage expanding cyclically	*100*	*100*	*100*
				Primary Lagging Indicators			
+	+	–	–	Average duration of unemployment (inverted)	+	+	+
+	+			Manufacturing and trade inventories	+	+	+
+	+	+		Commercial and industrial loans	+	+	+
rnc r	r+r	+		Ratio of consumer installment debt to personal income	+	?+?	+
r–r	–	+		Change in labor cost per unit of output, manufacturing	?	?	?
+	–	+	+	Composite of short-term interest rates	+	+	+
nc No change.		r Revised.		*Percentage expanding cyclically*	*100*	*100*	*100*

Under "Change in Base Data," plus and minus signs indicate increases and decreases from the previous month or quarter and blank spaces indicate data not yet available. Under "Cyclical Status," plus and minus signs indicate expansions or contractions of each series as currently appraised; question marks indicate doubtful status when shown with another sign and indeterminate status when standing alone.

PRICE OF GOLD

	1993	*1994*	*—— 1995 ——*	
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