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REAP Policy Paper No. 2 April 1992

REAP REFERENCE

GEN EC/POL/LAW

Decisions 1992: Facing the Fiscal Crisis

Everett Peterson, Danilo Alvarado and David Orden

As the serious part of this election year begins, Virginians confront various and conflicting claims about how to address national and state economic problems. Immediate concerns about recession and unemployment are juxtaposed with longer-term concerns about the national debt and prospects for continued large budget deficits. Proposals that may help to address the current economic slowdown may exacerbate the federal budget deficit and vice versa.

At the crux of this issue is a fundamental dilemma. The proportion of Gross National Product (GNP) accounted for by the sum of state, federal, and Social Security and insurance taxes was as high in 1990-91 as it was in 1980-81 (Figure 1). Even so, there are unprecedented federal deficits and budget crises in state after state. It is no wonder that taxpayers are angry and political leaders feel they have few options.

This REAP Policy Paper explores some of the dimensions of the fiscal crisis. It provides basic information about how the federal deficits have increased and the constraints this creates. While we do not, and can not, offer definitive solutions to these problems, we do hope to provide a basis for readers to draw conclusions about the economic claims put before them in the coming months.

Recent Federal Budget Deficits

A summary of the major legislation that has affected the federal budget deficit is presented in Table 1. The Economic Recovery Tax Act of 1981 (ERTA) was introduced to reduce a perceived high tax burden. The main provisions of ERTA were a 25-percent reduction in individual income tax rates over three years and an Accelerated Cost Recovery System to allow faster write-offs of business capital expenditures. Advocates of this legislation believed that lower tax levels would stimulate private investment and savings, promote economic growth, and result in higher tax revenues and a reduced deficit. The Congressional Budget Office (CBO) estimated at the time, however, that for a given level of growth in the economy, ERTA would reduce federal revenues by $747.1 billion through fiscal year (FY) 1986.

Unfortunately, the advocated growth-stimulating effects of ERTA did not materialize as the economy fell into a recession during 1981 and 1982. Federal expenditures increased by 11.1 percent while re-

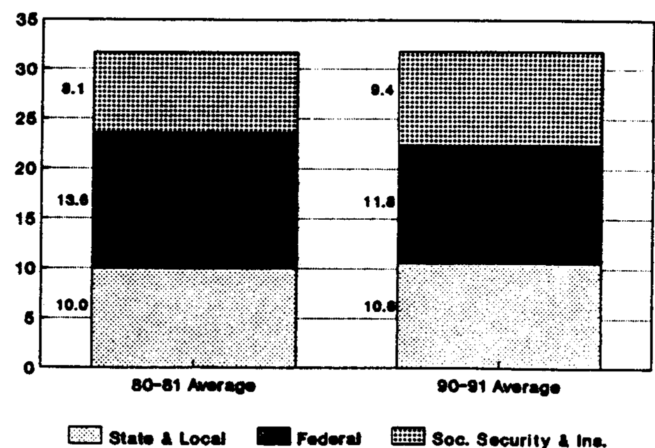

Figure 1. Taxes as a percent of U.S. GNP.

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ceipts rose by only 3.1 percent during FY 1982. This increased the federal deficit by $49.0 billion to a then-unprecedented level of $127.9 billion.

In hopes of reducing the federal deficit and increasing tax revenues, the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982 was implemented. This legislation reversed some of the 1981 tax cuts. The CBO estimated that TEFRA would increase tax revenues by $214.1 billion during the following five years. But despite this revenue, the federal deficit continued to grow. In four years, FY 1982-85, the deficit increased from $127.9 billion to $212.3 billion.

The deficits under TEFRA made it clear that revenue increases alone were not sufficient to balance the federal budget. Legislation was then introduced to try to control the deficit directly. The result was the Balanced Budget and Emergency Deficit Control Act of 1985, also known as Gramm-Rudman-Hollings (GRH). The aim of GRH was to set in motion expenditure controls, revenue increases, and a deficit-target program that would reduce the federal deficit to zero by FY 1991.

Although GRH has helped reduce the growth rate in federal spending, from an average of 8.7 percent during FY 1982-1985 to an average of 5.8 percent during FY 1986-1991, it has not controlled the deficit as initially intended. In 1987, only two years after GRH was passed, the 1991 deadline was deemed unattainable. Revisions to GRH set FY 1993 as the new target year in which the budget would be balanced.

In 1990, it again became obvious that the GRH targets could not be met. New legislation was intro-

Table 1. Estimated Effects of Tax Legislation and Actual and Projected U.S. Federal Budgets, 1982-95.

	Projected Effect of Legislation					Realized Budget		
	ERTA[a]	TEFRA[b]	GRH[c]	OBRA[d]				
FY	Revenue	Revenue	Original/ Revised	Revenue	Expenditure	Revenue	Expenditure	Balance
	billion dollars							
1979	-	-	-	-	-	463.3	503.5	-40.2
1980	-	-	-	-	-	517.1	590.9	-73.8
1981	-	-	-	-	-	599.3	678.2	-78.9
1982	-37.6	-	-	-	-	617.8	745.7	-127.9
1983	-92.7	18.0	-	-	-	600.6	808.3	-207.8
1984	-149.9	37.7	-	-	-	666.5	851.8	-185.3
1985	-199.3	42.7	-	-	-	734.1	946.3	-212.3
1986	-267.6	51.8	171.9	-	-	769.1	990.3	-221.2
1987	-	63.9	144.0	-	-	854.1	1003.8	-149.7
1988	-	-	108.0/144.0	-	-	909.0	1064.1	-155.1
1989	-	-	72.0/136.0	-	-	990.7	1144.1	-153.4
1990	-	-	36.0/100.0	-	-	1031.0	1251.7	-220.4
1991	-	-	00.0/64.0	18.0	-15.0	1054.0	1323.0	-268.7
1992[1]	-	-	28.0	33.0	-36.0	1170.0	1454.0	-284.0
1993[1]	-	-	00.0	32.0	-57.0	1251.0	1466.0	-215.0
1994[1]	-	-	-	37.0	-94.0	1332.0	1492.0	-160.0
1995[1]	-	-	-	39.0	-121.0	1416.0	1473.0	-57.0

[a] Projections at implementation of the Economic Recovery Tax Act of 1981.
[b] Projections at implementation of the Tax Equity and Fiscal Responsibility Act of 1982.
[c] Deficit targets of the Balanced Budget and Emergency Deficit Control Act (Gramm-Rudman-Hollings) 1985 and, revised, 1987.
[d] Projections at implementation of the Omnibus Budget Reconciliation Act of 1990.
[1] November 1990 CBO projections for 1992-95 assume compliance with the Omnibus Budget Reconciliation Act of 1990.

duced to further control government spending and increase tax revenues. The Omnibus Budget Reconciliation Act (OBRA) of 1990 was a five-year, $482-billion deficit-reduction package that consisted of two-thirds expenditure cuts ($323 billion) and one-third revenue increases ($159 billion).

In the first year after the implementation of OBRA (FY 1991), federal revenues fell short of the initial projection by $40 billion. Expenditures also fell $68 billion below the projected level, allowing an improvement in the anticipated deficit of almost $30 billion.

The outlook for FY 1992, however, is for higher deficits. Revenues for FY 1992 are expected to increase by $48 billion and expenditures by $131 billion from the FY 1991 levels. In January 1992, the CBO revised its estimate of the deficit for FY 1992 to $352 billion, a $83-billion increase from the actual FY 1991 deficit and a $68-billion increase from its November 1990 projection for FY 1992 shown in Table 1. Almost $62 billion of this increase in the deficit is expected to be accounted for by the cost of the savings and loan bailout, the Persian Gulf War, and the fall in tax receipts due to the economic slowdown.

How High Are Taxes?

The total tax burden has not fallen during the past decade despite the commitments of successive administrations in the White House to reducing federal taxes. There are two main reasons. First, Social Security and insurance taxes have increased from 8.1 percent of GNP in 1980-81 to 9.4 percent of GNP in 1990-91. This large increase is due to the establishment of the Social Security Trust Fund to provide support for the retirement of the baby-boom generation. Current contributions above current payouts are used to purchase long-term government bonds. Without these receipts, federal deficits would be even larger than reported; for example, the projected deficit would be over $450 billion in FY 1992.

The second reason for the rising level of total taxation is that much of the tax burden was not removed, but rather was shifted from federal to state and local taxes. This shift stems in part from the Reagan administration's attempt to diminish the role of the federal government and place more responsibility for programs on the states. With this added responsibility came the need to finance the costs of state-level programs. State and local taxes have increased from an average of 10.0 percent of GNP in 1980-81 to 10.6 percent in 1990-91, and are now almost as high as federal taxes at 11.8 percent.

How much would taxes have to increase to eliminate the annual federal budget deficit? In FY 1991, the federal deficit was 4.8 percent of GNP. If the federal government were to balance its budget, taxes would have to rise to 36.5 percent of GNP. Such an increase would require that every person pay over $1,000 in additional taxes.

Where Do the Federal Tax Dollars Go?

There have been major shifts in the composition of federal government spending in the 1980s. Non-defense expenditures—for schools, roads, and other tangible and intangible goods and services often associated with government activities—dropped sharply from over 23 percent of total expenditures in FY 1981 to 19.5 percent in FY 1982, as shown in Figure 2. (In 1981, each change of 1 percent represented a shift of about $7 billion.) Non- defense expenditures have continued to fall as a proportion of the total, to 16.4 percent in 1991. Defense expenditures, in contrast, rose from 21.6 percent in 1980 to 26.6 percent in 1987, but have subsequently fallen to 23.0 percent.

An increasing proportion of the federal budget has also been required for interest on the growing national debt. From 1980 to 1991, expenditures on interest payments have increased from 8.4 percent to 13.9 percent of the total, only slightly less than

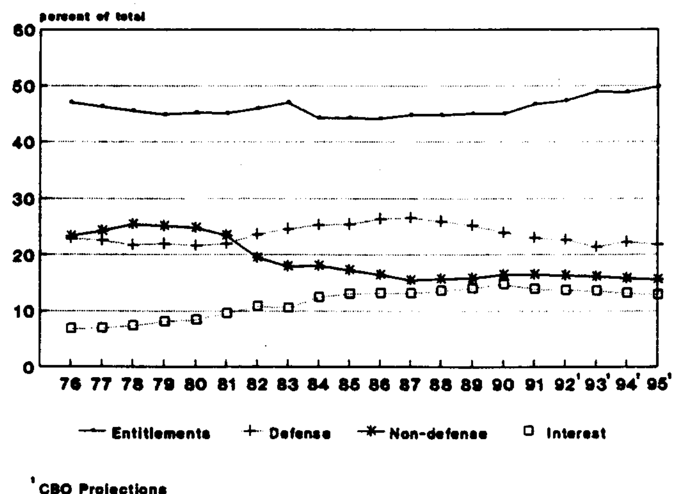

Figure 2. Distribution of Federal Expenditures.

non-defense expenditures! Resources previously used for schools, roads, and other non-defense programs are now being used for debt service.

Projections for the 1990s show that, under OBRA, there will be slight growth in total federal expenditures. Defense expenditures are projected to decrease to 21.8 percent of total expenditures by FY 1995 and non-defense expenditures and interest payments are expected to decline slightly, assuming interest rates remain low. Expenditures for entitlements (including Food Stamps, Medicare, Medicaid, and Social Security) are projected to increase from 46.7 percent of expenditures in FY 1991 to almost 50 percent in FY 1995.

Where Virginia Fits In

Virginians making their election-year decisions face the same hard choices as voters in every other state. In addition, the effects of changing federal priorities may be particularly pronounced in Virginia. The reason is illustrated in Table 2. On a per capita basis, Virginia ranks far above the national average in receipts from military payroll and contracts, but below the national average in receipt of Social Security entitlements. Shifts in federal priorities may thus have significant effects on the state's economy.

Table 2. Per Capita Social Security Benefits and Defense Receipts in Virginia and the U.S., 1988.

	Social Security	Defense	
		Contracts	Payroll
Virginia	$707.40	$1702.08	$1278.97
U.S.	$883.68	$511.65	$251.34

Conclusions

With rising levels of taxation and uncontrolled deficits, voters in Virginia and other states must decide what they want from government. It may be tempting to put this decision off in the short run in favor of efforts intended to revive the economy. But the unfortunate circumstance is that in the longer term the nation will either have to pay more to maintain the current level of government programs or pay the current tax level and receive fewer government services. This is the hard choice. Claims to the contrary don't face up to economic realities or responsibilities and should be evaluated closely in this election year.

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1992 Publication 448-302 / REAP P002

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