

SPECIAL REPORT

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The President's Fiscal Year 1995 Budget: Revenue, Entitlement Spending Rising Fast

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The Clinton administration has released its fiscal year 1995 budget amid good news about the nation's rebounding economy. The growing economy has led to substantial improvements in deficit projections compared to just one year ago. On outlays of \$1,518 billion and receipts of \$1,342 billion in fiscal year 1995, the FY'95 deficit is projected to be \$176 billion. Last fall

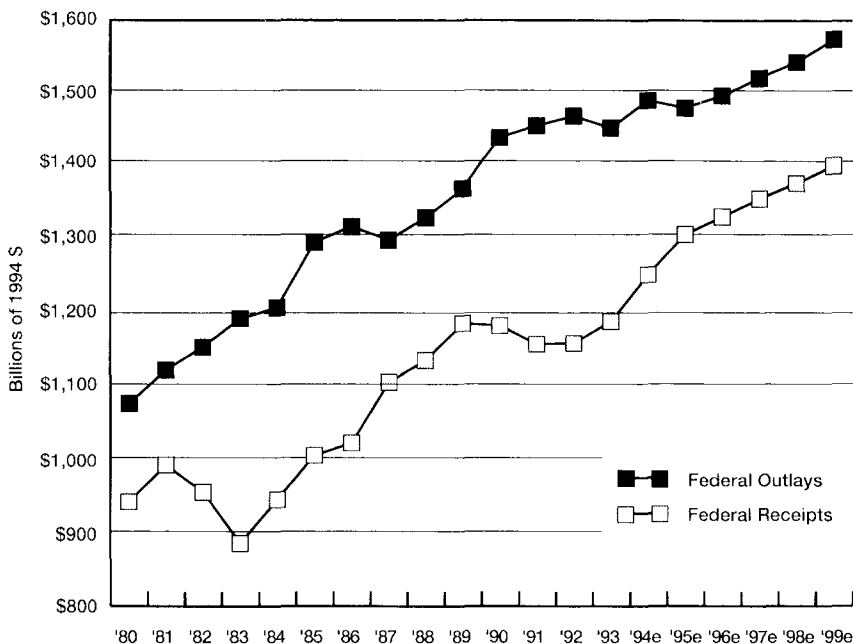
the administration had projected the FY'95 deficit would be \$207 billion.

Even though the president's budget does not make dramatic tax or spending changes, *Figure 1* and *Table 1* show significant growth in both receipts and outlays over the five-year budget plan. Federal outlays will grow as demands on entitlement programs—including Social Security, Medicare, and Medicaid—continue to expand. Federal receipts are projected to grow as tax revenue flows into the Treasury from stronger economic growth and higher tax rates enacted in last year's budget.

In fact, *Figure 2* shows that per-capita federal taxes will rise from \$4,824 in FY'94 to \$5,146 in FY'99, in constant 1994 dollars. Per-capita individual income tax revenue, which grew a total of only 4.4 percent over the period FY'80 to FY'93, is projected to grow 9.9 percent over the five-year budget plan. Per-capita social insurance taxes, which take the form of payroll deductions and fund Social Security and Medicare, rise 7.1 percent in the five-year budget projections. (See *Table 2*.)

(Figures and Tables in this report do not include changes in receipts or outlays that would occur under the president's health care plan. See page 5.)

Figure 1
Federal Outlays and Receipts
(Constant 1994 Dollars)



The Deficit

Figure 3 compares the deficit forecast made by the Congressional Budget Office (CBO) in March 1993 following the introduction of last year's budget, a forecast made by the Office of Management and Budget in September 1993 following enactment of the budget, and new projections released in the FY'95 budget. The difference between the latter two forecasts is primarily attributable to a stronger economy than was anticipated.

Table 1
Federal Outlays, Receipts, and Deficits (\$Billions)

Fiscal Year	Current Dollars			Constant 1994 Dollars		
	Total Outlays	Total Receipts	Deficit	Total Outlays	Total Receipts	Deficit
1980	\$591	\$517	-\$74	\$1,074	\$940	-\$134
1981	678	599	-79	1,120	990	-131
1982	746	618	-128	1,151	953	-198
1983	808	601	-208	1,190	884	-306
1984	852	667	-185	1,205	943	-262
1985	946	734	-212	1,293	1,003	-290
1986	990	769	-221	1,314	1,020	-293
1987	1,001	854	-150	1,296	1,103	-193
1988	1,064	909	-155	1,326	1,133	-193
1989	1,143	991	-153	1,365	1,183	-182
1990	1,253	1,031	-221	1,434	1,180	-253
1991	1,324	1,054	-270	1,450	1,155	-295
1992	1,382	1,092	-290	1,463	1,156	-307
1993	1,408	1,154	-255	1,447	1,186	-262
1994e	1,484	1,249	-235	1,484	1,249	-235
1995e	1,518	1,342	-176	1,474	1,303	-171
1996e	1,584	1,410	-173	1,491	1,327	-163
1997e	1,660	1,480	-181	1,515	1,351	-165
1998e	1,738	1,551	-187	1,537	1,372	-165
1999e	1,830	1,629	-201	1,568	1,396	-172

Source: Tax Foundation, OMB.

While the lower deficit projections are good news, they indicate the high sensitivity of budget projections to changing economic assumptions. This provides a warning that the deficit could balloon once again if the economy does not perform as well as assumed. According to the CBO, if real economic growth is one percentage point lower each year than currently assumed, the five-year deficit total will be \$429 billion higher than projected because of lower tax revenues and higher spending on programs such as unemployment benefits. Nonetheless, the administration's assumption of 2.7 percent average annual real growth over five years seems reasonable given that the 30-year average real growth (1964-1994) was 2.6 percent.

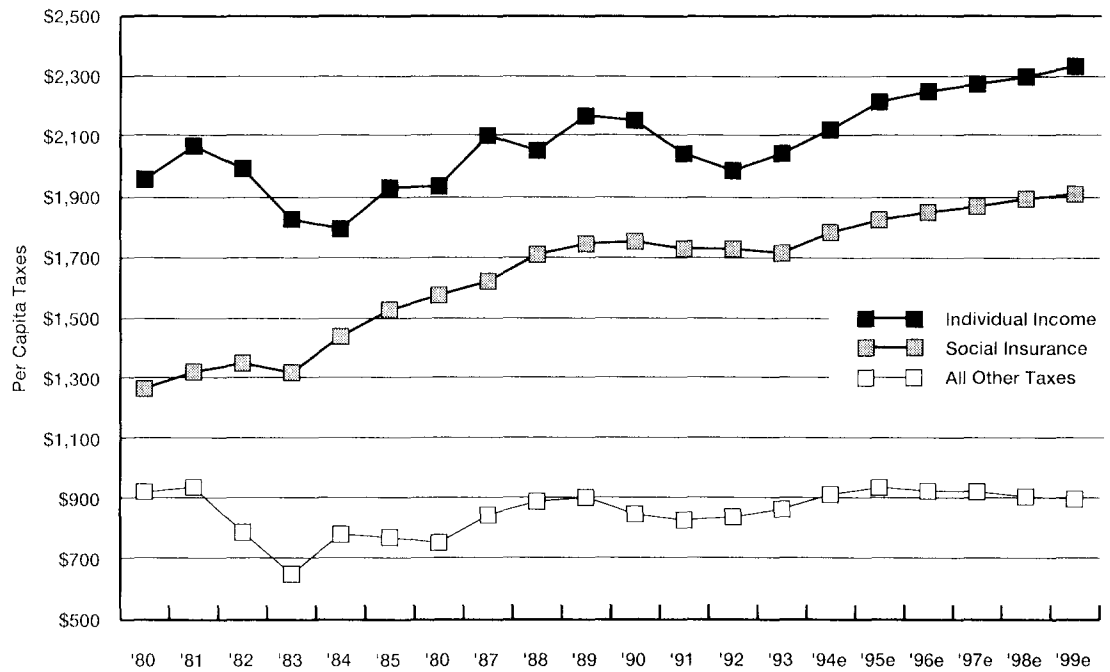
On the other hand, the administration's interest rate assumptions may be optimistic. Higher interest rates than projected would increase the deficit as borrowing costs for the federal government increase. The administration assumes that long-term interest rates (10-year Treasury notes) will stay at current 25-year lows of 5.8 percent until 1999, compared to CBO projections that show rates rising to 6.2 percent. According to the CBO, interest rates one percentage point higher than planned would add \$145 billion to the five-year deficit total.

Table 2
Per Capita Federal Taxes in Constant (1994) Dollars

Fiscal Year	Individual Income	Social Insurance	All Other	Total
1980	\$1,959	\$1,268	\$923	\$4,151
1981	2,069	1,324	940	4,333
1982	1,994	1,352	790	4,135
1983	1,827	1,321	651	3,799
1984	1,795	1,440	783	4,019
1985	1,932	1,528	773	4,233
1986	1,936	1,576	755	4,266
1987	2,103	1,622	846	4,570
1988	2,053	1,710	891	4,653
1989	2,168	1,745	904	4,817
1990	2,154	1,753	849	4,756
1991	2,043	1,729	829	4,601
1992	1,988	1,729	840	4,557
1993	2,045	1,716	866	4,627
1994e	2,124	1,784	915	4,824
1995e	2,216	1,826	939	4,981
1996e	2,250	1,851	927	5,028
1997e	2,274	1,870	925	5,068
1998e	2,299	1,895	908	5,102
1999e	2,334	1,911	900	5,146

Source: Tax Foundation, OMB.

Figure 2
Per Capita Federal Taxes in Constant (1994) Dollars



Source: Tax Foundation; OMB.

Table 3
Outlays by Major Budget Category (\$ Billions)

	Current Dollars				Constant 1994 Dollars			
	Mandatory*	Non-Defense Discretionary	Defense	Net Interest	Mandatory*	Non-Defense Discretionary	Defense	Net Interest
1980	\$26.2	\$14.2	\$1.55	\$53	\$476	\$258	\$245	\$96
1981	30.1	15.1	1.58	69	497	249	261	114
1982	33.5	14.0	1.86	85	517	216	287	131
1983	36.5	14.3	2.10	90	537	210	309	132
1984	36.1	15.2	2.28	111	511	215	323	157
1985	40.1	16.3	2.53	130	548	223	346	178
1986	41.5	16.6	2.74	136	551	220	363	180
1987	42.0	16.2	2.83	139	542	209	365	180
1988	44.7	17.4	2.91	152	557	217	363	189
1989	48.4	18.6	3.04	169	578	222	363	202
1990	56.7	20.2	3.00	184	649	231	343	211
1991	59.5	21.5	3.20	195	652	235	351	214
1992	64.6	23.3	3.03	199	684	247	321	211
1993	66.7	25.0	2.92	199	685	257	300	205
1994e	73.0	27.0	2.81	203	730	270	281	203
1995e	76.3	27.1	2.71	213	741	263	263	207
1996e	81.5	28.2	2.62	225	767	265	247	212
1997e	88.1	28.7	2.57	235	804	262	235	214
1998e	94.5	29.1	2.57	245	836	257	227	217
1999e	102.1	29.6	2.58	255	875	254	221	219

*Mandatory includes undistributed offsetting receipts.
Source: Tax Foundation; OMB.

Interestingly, the deficit could be eliminated in only three years if outlays were held to their FY'94 level of \$1,484 billion while receipts grew as expected until FY'97. (See *Table 1*.) Such a "hard freeze" on outlays seems unlikely, however, because "mandatory" spending—primarily entitlement programs like Social Security, Medicare, and Medicaid—grow automatically unless reform legislation is passed to curb program benefits and eligibility. (In contrast, "discretionary" spending includes those programs such as defense that go through an annual appropriation process.)

Mandatory Spending Continues Skyward

Mandatory spending is projected to increase 40 percent over the five-year budget plan, coming on top of a 51 percent increase in the past five years. (See *Table 3* and *Figure 4*.)

Leading the way is Medicaid spending, which grew 149 percent from FY'89 to FY'94

and is expected to grow a further 75 percent under the president's budget. (See *Figure 6*.) The program, which provides health care for lower income Americans, grows as eligibility is continually expanded and recipients maximize what is to them "free" service.

Spending on health care for older Americans under Medicare has also exploded, with 70 percent growth in the past five years and a projected 67 percent further growth under the president's budget.

Outlays for Social Security, now larger than defense outlays, will total \$335 billion in FY'95, and will rise 29 percent over the next five years. Outlays for the two main federal programs for the elderly, Social Security and Medicare, together will represent 32 percent of all federal spending in FY'95.

Another huge and rapidly growing "transfer" program operated by the federal government is servicing of the \$3.6 trillion (FY'95) public debt. The program, which transfers dollars from old bondholders to new bondholders, will consume \$213 billion in interest expenses in FY'95 representing 14 percent of all federal outlays.

Discretionary Spending Slowdown

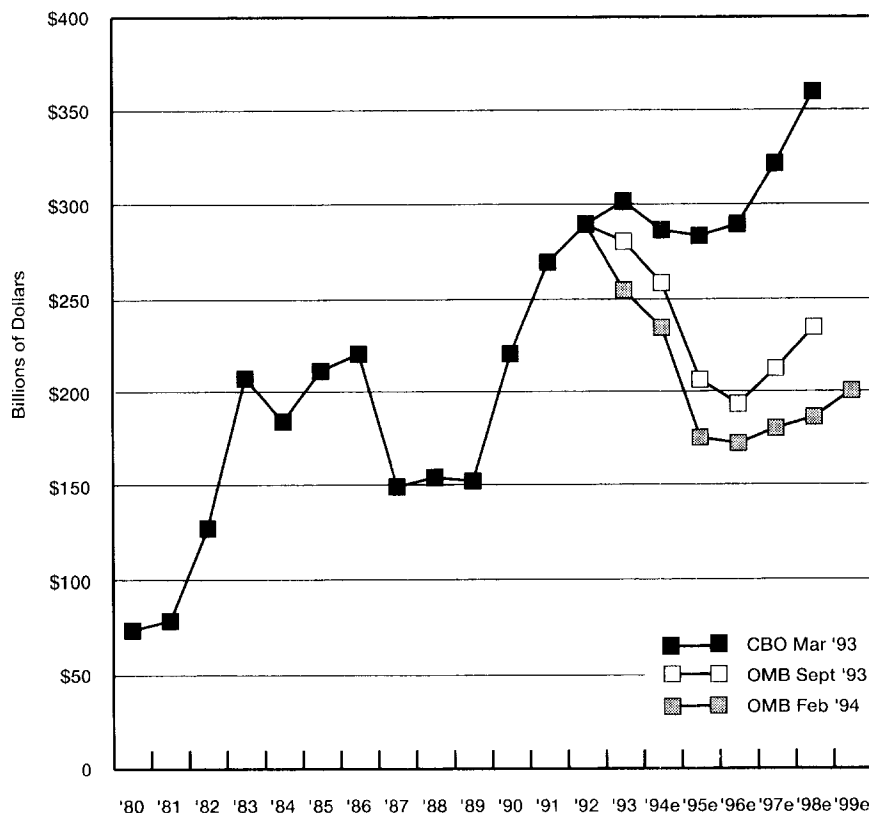
As entitlement and interest outlays climb, the share of federal spending going to discretionary programs shrinks. Discretionary outlays represented 49 percent of all federal outlays in FY'75, 36 percent of outlays in FY'95, and will fall to just 30 percent of outlays in FY'99.

The slow-growth projections for discretionary spending contained in the administration's budget are designed to fit within discretionary spending caps currently in place under the Budget Enforcement Act of 1990 (BEA) for FY'95, and caps under the Omnibus Budget Reconciliation Act of 1993 (OBRA93) for years FY'96 to FY'98. Discretionary spending in FY'95 of \$542 billion will actually be less than the FY'94 total of \$550 billion, reversing a growth trend that has not been broken since 1969.

The non-defense portion of discretionary spending will rise an average of 1.9 percent annually through FY'99. To make room for new "investment" spending, such as increased funding of homeless aid, job training, and Head Start, President Clinton has reshuffled priorities and proposed modest cuts in some agencies, including Agriculture, State, and Energy.

But room for new domestic spending initiatives largely comes from the continuing drop in defense spending, as seen in *Table 3*.

Figure 3
Changing Deficit Forecasts (March '93-February '94)



Source: OMB; CBO.

Defense outlays stood at \$304 billion in 1989, fell to \$281 billion in FY'94, and are projected to fall to \$258 billion in FY'99. In constant dollar figures, this is a dramatic 38 percent drop over the 10-year period.

Quiet on Tax Front Disturbed by Health Financing Measures

Any peace Americans might have enjoyed this year on the federal tax front may be short-lived as financing measures for a health care plan are debated by the administration and Congress. Aside from health care, President Clinton has not submitted any significant tax increases in his FY'95 budget after \$255 billion in tax increases in last year's budget. Last year's increases, however, help propel total receipts ahead a projected 5.5 percent annually from FY'94 to FY'99. (See *Table 4*). The budget does, however, contain a few billion dollars in fee increases and, more importantly, lets expire a number of important tax credits including the research and

experimentation tax credit, the orphan drug credit, and the targeted jobs tax credit.

However, proposed financing measures for the president's health care program, the Health Security Act (HSA), will radically change these projections. Revenues for the "health alliances" in the HSA, which would come primarily from employer/employee payroll taxes (also known as premiums), would total \$558 billion by 1999, according to the CBO. While the administration believes that this revenue should not be reflected in federal budget totals, the CBO determined February 8, 1994, that these revenues should be considered "off-budget," yet still reflected in overall or "unified" budget totals. Social Security payroll taxes provide a model since they are also compulsory payments that go into an "off-budget" trust fund, but are still part of unified budget totals.

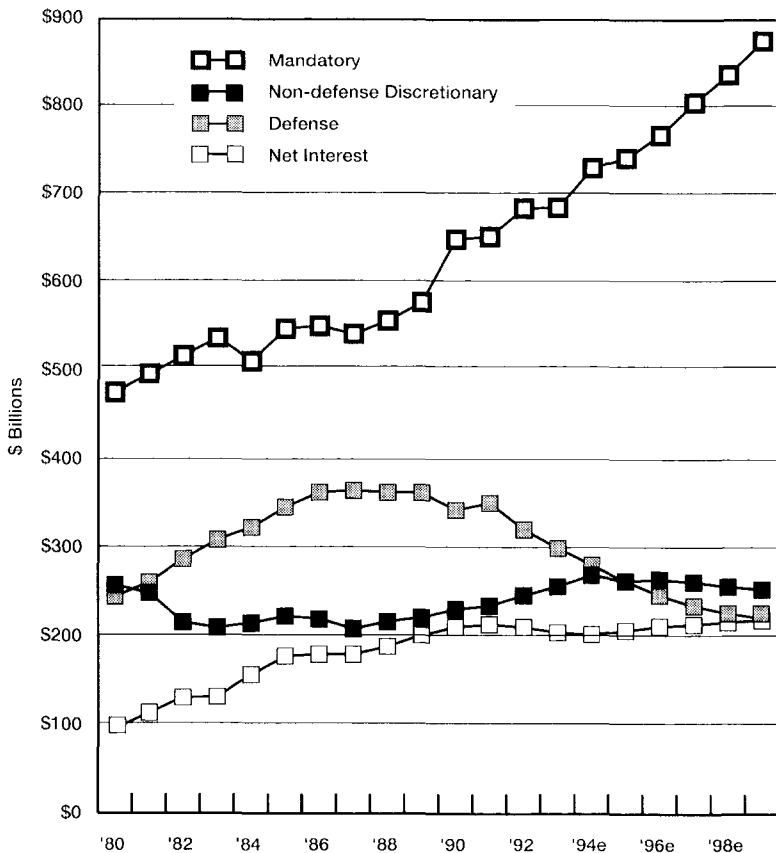
The CBO and the administration also differ on the amount of revenue required to fund the ambitious HSA. The CBO thinks that health care premiums would cost a two-parent family \$5,565 per year, whereas the administration believes the figure would be \$4,360 per year. In addition, while the administration believes the HSA would lower the federal deficit by \$59 billion over five years, the CBO predicts it would increase it by \$74 billion.

It is easy to see how estimates may differ when one considers the industry's large size. Slightly over \$1 trillion dollars will be spent on health care in the U.S. in 1995, about a third (\$346 billion) of which will be spent by the federal government under the current system. Clearly, a takeover of the industry by the government would be a massive undertaking and would radically alter the federal financial landscape. Director Reischauer of the CBO notes that the president's HSA, if enacted, would ultimately dwarf in size even Social Security and boost the size of the federal government by about one-fifth.

Conclusion and Outlook

While there will be other forces shaping federal finances this year, such as possible votes on a Balanced Budget Amendment, tax reform efforts, and various spending cut initiatives, health care reform will clearly dominate budget discussions. For the average taxpayer, the possible effects from the health care debate vary widely. Some tax relief might be realized if health care reform efforts concentrated on controlling the explosive growth in such existing federal health care programs as Medicare and Medicaid. However, if reform leads to a vast new government program, the tax burden would change significantly—with the taxpayer footing the bill for a huge new entitlement program, in the form of a growing drain from his or her paycheck.

Figure 4
Outlays by Major Category
(Constant 1994 Dollars)



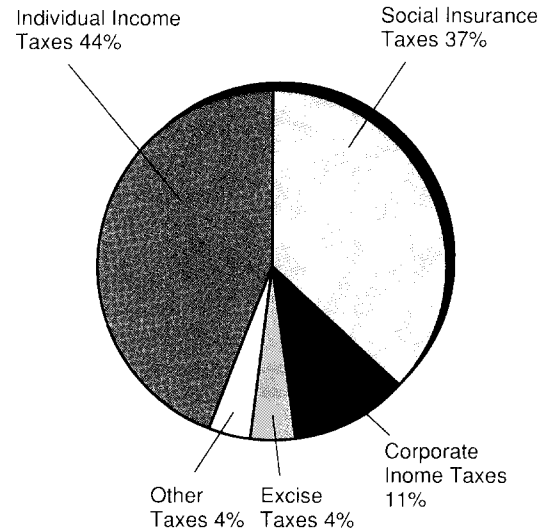
Source: OMB.

Table 4
Federal Receipts by Source

	FY'94	FY'95	FY'99	% Change FY'94-'99
Individual Income Taxes	\$550.0	\$597.2	\$739.4	34.4%
Social Insurance Taxes	461.9	492.1	604.7	30.9
Corporate Income Taxes	130.7	141.0	157.5	20.5
Excise Taxes	54.6	55.8	60.3	10.4
Other	52.0	56.0	67.2	29.2
Total Receipts	\$1,249.2	\$1,342.2	\$1,629.0	30.4%

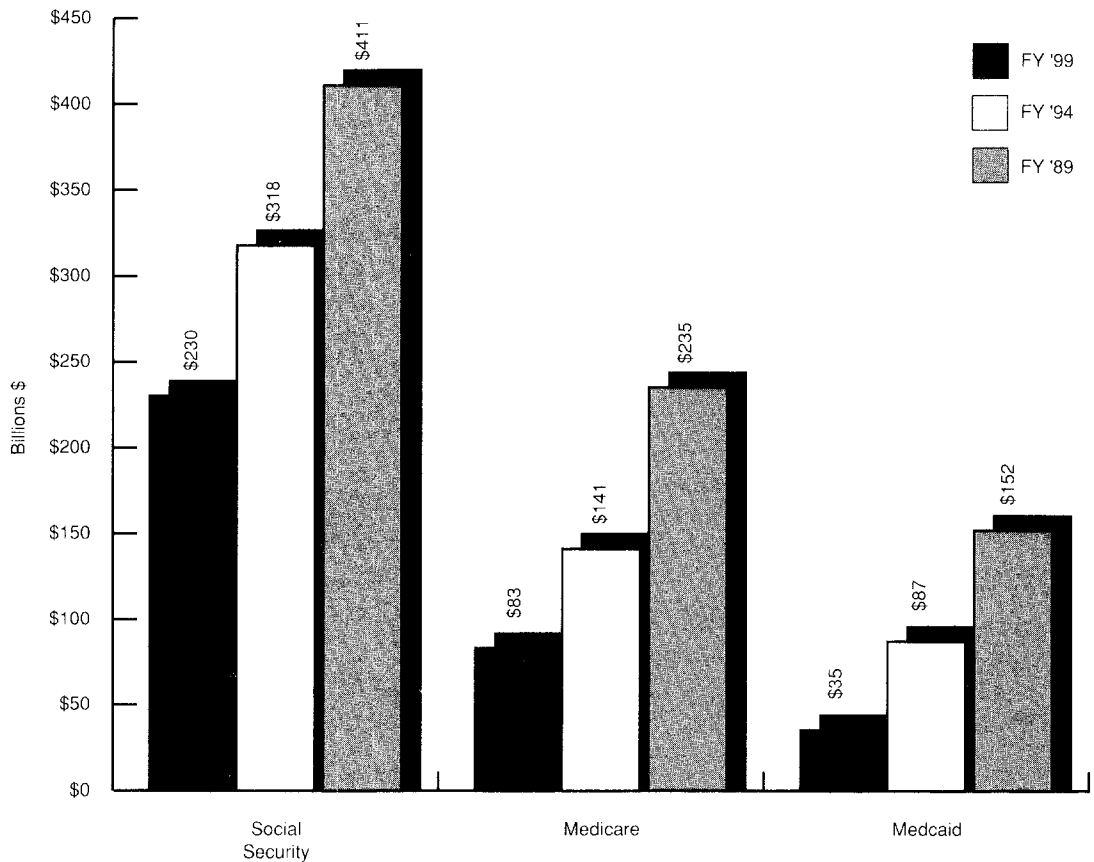
Source: Tax Foundation, OMB.

Figure 5
Federal Receipts by Source FY'95



Source: Tax Foundation, OMB.

Figure 6
Entitlement Outlays
Selected Years, FY 1989-FY 1999



Source: Tax Foundation, OMB.

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