Government: a year of change and surprise

Last year was one of change and surprise in federal government fiscal activity. The big change was the official introduction of the new Congressional budgeting procedure and the new fiscal year. The surprise was that the deficit was between $11 and $17 billion less than expected for the 15 months from July 1, 1975 to September 30, 1976. This lower deficit resulted primarily from lower spending, not larger receipts, during the first nine months of calendar 1976.

Congress implements change

The most obvious part of the change in government financial operations was the new starting date for the fiscal year. Federal government budgeting had been based on a July 1 to June 30 fiscal year since 1843. Beginning with 1976 (fiscal 1977), the budgeting year will run from October 1 through September 30. As a result, 1976's third quarter (July 1-September 30) was a sort of accounting limbo, part of no fiscal year, and referred to as the transition quarter.

Formal consideration of the budget begins nine months before the start of the new fiscal year when the President submits his budget to Congress. Congress may accept or modify his proposals and must establish its revenue and spending plans in a joint resolution by May 15. After all individual appropriations bills have been considered, Congress then must adopt a second joint resolution setting firm objectives for appropriations, outlays, and revenue. For fiscal 1977 this resolution set expenditures at $413.1 billion, revenue expectations at $362.5 billion, and an anticipated deficit of $50.6 billion. Although the budget process for fiscal 1977 is now complete, the new Congress can still accommodate programs proposed by the incoming administration if it so decides. This would require passage of a new joint budget resolution in addition to the appropriate authorization and appropriations bills.

It is clear that Congress has developed both the capability and the mechanisms for controlling the nation's purse, and can, as the actions of Congress on the 1977 budget show, evolve a budget that substantially modifies the proposals of the administration.

New tax legislation

The Congress also completed major tax legislation in 1976. For most taxpayers, whose incomes are primarily in the form of wages and salaries, this new legislation has little impact beyond continuing through 1977 the tax reductions that had been enacted for 1975. Taxpayers with large incomes from investments face higher taxes as a result of tightening of the "minimum tax" provisions and reducing tax preferences available from a variety of tax shelters. Corporations with major overseas operations lost some deductions available from foreign tax credits, while rule changes on the investment-tax credit benefited airlines, railroads, and shipbuilders. This credit was continued through 1980 at the 10 percent level.

One of the biggest changes in existing law was the treatment of taxes on estates and gifts. These two previously separate levies have been merged. The $60,000 exemption has been replaced by a tax credit that effectively removes the tax from most smaller estates. Extended payment schedules and favorable evaluation methods provide additional relief for estates where the major holding is a small business or farm. Taxes on larger estates were increased by stricter treatment of capital gains and by restrictions on generation-skipping trusts.

Spending shortfalls

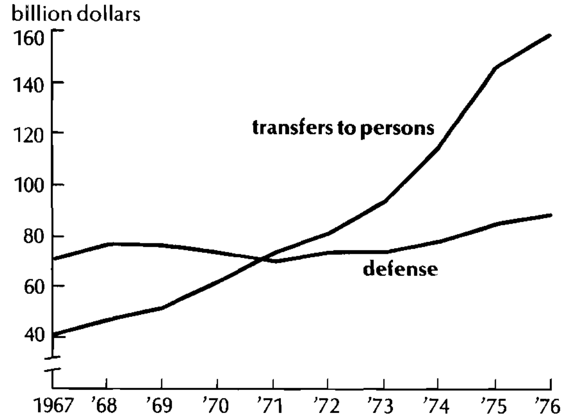
The lower than expected level of federal spending during the first nine months of 1976 first became obvious after final results for fiscal 1976 showed spending at least $5 billion lower than planned. At that time it was believed that since spending authorizations could be carried into the transition quarter the $5 billion shortfall would be made up by more rapid spending then. When this spending failed to materialize, various theories were put forward to explain the discrepancy: lower than expected price increases for government purchases, lower interest rates, unanticipated financial transactions, overly large contingency allowances, and overestimation of the speed with which new programs could be initiated by the Defense Department. All of these things probably contributed to lower spending, which was broadly spread through all facets of government. It is now believed that little of these unspent funds will add to spending in 1977. However, spending did accelerate in the fourth quarter of 1976 to a rate in line with the $413 billion planned for the new fiscal year.

Spending and revenue distribution

Federal revenue for calendar year 1976, measured on a National Income Accounts (NIA) basis, totaled about $330 billion, up 15 percent from 1975. Personal income tax payments of about $145 billion were 15 percent above the previous year, when large rebates were made for 1974 taxes in addition to lowering of withholding rates during 1975. Contributions for social insurance were about $106 billion, up 12 percent from 1975. Corporate income taxes furnished about $56 billion, up over 30 percent from last year. (In 1975 profits were below 1974 levels despite the rapid growth in the second half.) Expenditures (NIA) totaled about $385 billion, up 8 percent from the previous year. The deficit was nearly $60 billion, down substantially from the $71 billion level of 1975.

Social Security programs alone accounted for over $90 billion in 1976. Recipients received a 6.4 percent cost-of-living adjustment in July based on the increase in the Consumer Price Index over the previous year. Effective January 1, 1977, the

Personal transfers speed ahead of defense spending



ceiling income on which taxes will be collected was raised to $16,500 from the $15,300 effective in 1976. An increase in taxes for unemployment insurance was passed during 1976 to be implemented in two steps. In 1977 the rate goes from 0.5 to 0.7 percent, but the base remains $4,200. In 1978 the base on which the tax is collected goes from $4,200 to $6,000. Thus this tax on employers will be doubled over the next two years to replenish the unemployment trust fund, depleted by high claims levels of the past two years.

State and local problems continue

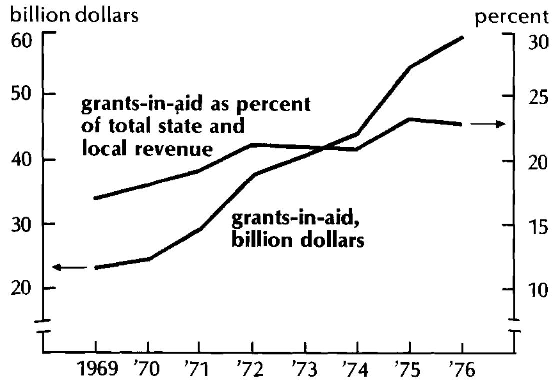
State and local governments in the aggregate spent over $245 billion (NIA) during 1976. This amount was about 8½ percent higher than in 1975, the slowest rate of year-to-year growth since 1964. The vast majority of these expenditures went for the purchase of goods and services, over $230 billion, and nearly 60 percent of that sum was spent on compensation of employees. Employment increased about 2½ percent, the slowest rate since 1954. Nevertheless, payroll costs climbed by 10 percent indicating that average wages paid by state and local governments increased 7-7½ percent over the level in 1975.

Revenues of state and local governments totaled about $260 billion in 1976, up about 10 percent from 1975. While these revenues were enough to provide an operating surplus of about $11 billion, this was not enough to cover the cost of social insurance funds. Overall, state and local governments had a deficit of about $2 billion. This represents a considerable improvement from the $5 billion deficit incurred in 1975.

The facts that state and local governments' revenues grew faster than expenditures and that the aggregate deficit was lower in 1976 than in 1975 suggest that state and local governments strengthened their positions during the past year. However, for most of these governmental units this improvement in apparent financial condition was achieved only by stringent restraints on services provided to their constituencies. In many cases there were sharp cutbacks both in services offered and in employment. New York City, because of the magnitude of its problems, received the largest amount of attention in the press. The city reduced fire, police, and teaching staffs, cut back on transportation services, imposed tuition for the first time on the city college system, and attempted to implement many other cost savings. Even these steps failed to provide the city with enough cash to meet its operating expenses while paying back its debt. The debt repayment problem was met by purchases of long-term debt by the city employees' pension funds. Holders of short-term paper were given the option of converting their claims to long-term debt or accepting a moratorium on principal payment and reduced interest rates. Thus it was expected the city could balance its budget and begin debt repayment over a three-year period. Late in the year New York State's highest court found the debt moratorium unconstitutional. At year-end a new plan for debt restructuring was yet to be agreed upon.

While New York City's problem involved the most money, many other local governments faced problems which were equally difficult for them considering their size. Detroit, despite taking many of the same steps New York had taken to reduce costs, remains in severe financial difficulty. Many school systems, of which Chicago's is the largest, closed early for the summer vacation or for the Christmas holiday because they had run out of money or because budgets could not get voter approval.

Total federal aid grew but its importance declined slightly during 1976



The outlook

The financial status of both the federal government and state and local governments for the coming year is going to be strongly affected by the steps taken by the new administration. It seems clear that some combination of tax reduction and increased spending will be proposed, increasing the federal deficit above the $50 billion level set by the Congressional budget resolution. Governors and mayors have been urging the federal government to provide more help, particularly for education and welfare. It seems likely that state and local governments will receive some additional help directly through federal funding for public service jobs. Indirect benefits from increased tax collections could result from federal stimulus of the general economy.