

Government: the federal government shifts gears

This time a year ago, the government was expecting a deficit for fiscal 1978 (October 1, 1977, to September 30, 1978) of \$62 billion. The Administration presented Congress with a budget proposal for fiscal 1979 that implied essentially no change in the deficit that year.

Nowhere in the President's Budget Message last January was the word *inflation* used. The focus was on the need for a fiscal policy that provided continuing economic recovery. Over the course of the year, however, the Administration shifted its attention from stimulating further growth of the economy to reducing inflation.

The change had little effect on fiscal 1978. But it was largely responsible for differences in the planning for fiscal 1979 and 1980.

Fiscal 1978—the outcome

Federal outlays totaled \$450.8 billion in fiscal 1978. With receipts at \$402 billion, the deficit was \$48.8 billion. The final figure for receipts is remarkably close to the January estimate of \$400.4 billion, particularly as that figure would have been about \$800 million higher if it had been estimated by the bookkeeping procedures used now. Outlays were almost \$11 billion less than expected in January and \$2 billion less than the forecast in July—mainly for a reason that has plagued budget authorities for years.

Government departments consistently overestimate their needs, during both preparation of the budget and later quarterly reviews. This year a substantial portion of the shortfall came from lower-than-expected defense spending and slowness in building the petroleum reserve. The Office of Management and Budget has tried to improve estimates of spending, but considering the large proportion of spending going to entitlement programs, errors in estimates of total outlays are apt to recur.

The tax cut—smaller, later, restyled

The budget proposal presented last January for fiscal 1979 included a tax cut over and above those previously passed but scheduled to expire at the end of calendar 1978. The cut, about two-thirds for individuals and a third for businesses, was planned to take effect October 1.

As proposed, the cut in personal income taxes was skewed toward low incomes. A tax credit would replace the personal exemption. Some deductions taken by individuals that itemize deductions would be eliminated or reduced, and use of other deductions would be restricted. Treatment of capital gains and some other tax preferences under the minimum tax would be tightened.

A similar approach was taken toward corporate income taxes. Rates would be reduced, but so would the allowable deductions. The investment tax credit would be made permanent and even liberalized. But the liberal treatment of domestic international sales corporations, income of foreign subsidiaries, and deductions for business meals, entertainment, and first-class air travel were items scheduled to be phased out, limited, or eliminated immediately.

About three and a half months after the President made his tax proposal, however, the Administration and Congress agreed that with inflation worsening, the tax cut would have to be smaller than originally proposed. The change was made primarily by shifting the effective date for most provisions forward to January 1979.

In addition to reducing the size of the tax cut, moreover, Congress drastically changed its form. Two concepts seem to have been underlying the thinking in Congress. One was that the combined effects of inflation and the progressiveness of the tax structure required that more relief be given to middle-income

groups than to low-income groups. The other was that taxes on capital gains, which had been raised in several recent tax bills, were discouraging the investment now needed to increase the potential growth of the economy.

The bill that finally passed raises personal exemptions from \$750 to \$1,000. It reduces the progressiveness of the personal income tax by reducing the rates and widening the tax brackets. Tax rates on capital gains are generally reduced, the maximum effective rate dropping from 49 percent to 28 percent. Taxpayers that itemize lose their deductions for state and local gasoline taxes.

Corporations get less reduction in income taxes than originally proposed. Broader use can be made of the investment tax credit, however, and like individuals, corporations pay lower taxes on capital gains. Some deductions for entertainment expenses are no longer allowed.

The bill, identified as the Revenue Act of 1978 (PL 95-600), is long and complicated. It changes the treatment of partnerships, some tax shelters, deferred income, and unemployment compensation. These are special changes, however, and while they may impact heavily on some taxpayers, they will have little effect on the size or shape of the tax reductions in the bill overall.

Fiscal 1979—the outlook

The budget picture for fiscal 1979 is now completely different from the way it was originally proposed last January, particularly for revenues. Expenditure estimates have been reduced from \$501 billion to about \$492 billion, but this lower estimate comes almost entirely from the lower-than-expected spending in fiscal 1978. Increases in spending in fiscal 1979 over those of 1978 are expected to be about the same as originally forecast. Revenues are now estimated at about \$453 billion, up sharply from the original estimate of \$441 billion, primarily because of the smaller tax cut.

As a result, instead of a deficit in excess of \$60 billion, as was originally forecast, the es-

timate is now down to \$39 billion. Receipts and expenditures during the first quarter of the fiscal year (last quarter of calendar 1978) were consistent with these forecasts.

This shift is a major change from the fiscal policy underlying the budget presented a year ago. There is clearly less fiscal stimulus. Moreover, the most recent budget statement for fiscal 1980, with a proposed deficit of \$29 billion, suggests that a policy of progressively lowered deficits is to continue at least another year. The deficit for fiscal 1980 could, however, grow substantially if the economy weakens as much as some private forecasters are suggesting. Lower incomes than the administration has estimated would reduce receipts, and higher unemployment would increase spending.

Holding the deficit to this figure, without raising taxes, will take a tight rein on spending. Social Security pensions, government retirement pay, veterans' pensions, and payments covered by similar programs go up automatically with the inflation rate. For budget objectives for 1980 to be met, spending on other programs—those legislated every year—will have to be constrained or even reduced from the levels of fiscal 1979.

A partial energy program

A year and a half after the President presented his proposals for a comprehensive energy program, Congress passed a bill that dealt primarily with the pricing and use of natural gas. Problems with the oil aspects of the energy program were left to the new Congress. Unless Congress acts, existing controls on oil will expire in May.

Legislation as passed has two main features: the gradual phasing out of price controls on new natural gas by 1985 (with some standby authority through 1988) and the imposing of controls on intrastate gas, which has been free of federal controls.

Price ceilings with escalator clauses tied to the inflation rate were established for various classifications of gas, depending on such factors as dates of discovery and terms of contract. The escalators seem generous

enough for market conditions to keep prices below legal ceilings until controls end.

Under certain circumstances, the Energy Department can order industrial boilers converted to coal and require use of coal on new facilities. Use of coal, however, is still constrained by environmental requirements.

Similarly, utilities burning natural gas in existing plants are expected to convert by 1990. New power plants cannot be built to use natural gas, nor can existing plants be converted to gas.

Other provisions of the program require state regulators to hold hearings over the next two years on the feasibility of introducing rate structures designed to encourage energy conservation.

A "gas-guzzler" tax was introduced, beginning with 1980 models. The tax gets progressively higher and the mileage rating to which it applies gets progressively lower every year through 1985. For 1980, performance better than 17 mpg is not taxed. But a tax as much as \$650 is imposed on cars (and light vans) getting no more than 13 mpg. By 1985, the levy begins at \$400 for performance less than 23.5 mpg and rises to \$3,850 for vehicles getting no more than 12.5 mpg. These penalties are, naturally, to be passed through to buyers.

State and local government

Last year has been called the year of the taxpayers' revolt. The rallying point of the revolt was California's Proposition 13, which sharply rolled back property taxes and limited the ability of the state legislature and local taxing authorities to raise other taxes. The proposition was originally thought to be another attempt at an issue that had been defeated in 1968 and 1972. This time, however, California voters surprised everybody by passing the proposition decisively. The California vote in June was a catalyst for discontent in other states. Some form of tax limitation issue was on the ballot in 16 states in November.

Issues were generally less restrictive than the proposition in California. Only Nevada

passed a constitutional amendment directly modeled on Proposition 13. And the law there requires that before the amendment can take effect, it must be voted on again in 1980. Voters in 11 other states took some kind of action bearing on taxes. Outcomes ranged from Illinois's advisory referendum that said taxes and spending were too high, and should be limited, to North Dakota's direct reduction of individual income tax rates. Several states put limits on spending by tying outlays to personal income.

The limit placed on California's property tax is believed to have reduced local tax receipts there by about \$7 billion. Much of that was made up by dividing the state's \$5 billion surplus with local governments. It is estimated that the federal government will collect about \$2 billion more in California than it would have. This is because both individuals and businesses will have smaller deductions for local taxes.

While the financial conditions of most state and local governments have improved with growth in the general economy, there are exceptions. Even with the federal government guaranteeing loans up to \$1.6 billion, New York City has still not convinced some observers that it can cut spending fast enough to bring its budget into balance in the near future. Detroit has been able to recover after substantial austerity, but Newark continues to experience financial problems.

The newest addition to the list of cities with severe problems is Cleveland. When it could not pay notes due December 15, Cleveland became the first city to default since the Great Depression.

Despite these problems, state and local governments have operated, on the whole, with a surplus, as measured in National Income Accounts. In the aggregate, the surplus declined quarter by quarter over the year. And given the sharp decline in revenue in California, the sudden limitations on taxing authority in other states, and outright reduction in federal assistance that can be expected in 1979, the number of total governments with financing problems could increase this year.