INFORMED BUDGETEER:

GOOD BUDGET NEWS: ITS OFFICIAL FOR FY 2000

• On October 24 the Treasury Department released its Monthly Treasury Statement for September 2000, which includes the final budget totals for FY2000. This is not a typo - the surplus for 2000 was $237 billion. This is about what it cost to operate all functions of the federal government as recently as 1973.

COMPARISON OF 1999 & 2000 ACTUALS
(Dollars in Billions)

	1999	2000	% Growth[a]
RECEIPTS:			
Individual income taxes	879.5	1004.5	14.2%
Corporation income taxes	184.7	207.3	12.2%
Social insurance taxes	611.8	652.9	6.7%
Excise taxes	70.4	68.9	-2.2%
Estate and gift taxes	27.8	29.0	4.4%
Customs	18.3	19.9	8.6%
Miscellaneous	34.8	42.6	22.6%
Total Receipts	**1827.3**	**2025.0**	**10.8%**
On-budget	1382.8	1544.5	11.7%
Off-budget	444.5	480.6	8.1%
OUTLAYS:			
National Defense	274.9	293.9	6.9%
International affairs	15.2	17.3	13.2%
Science, space& technology	18.1	19.7	8.7%
Energy	0.9	-1.0	-211.8%
Natrl resources & environment	24.0	23.3	-2.8%
Agriculture	23.0	38.5	67.2%
Commerce & housing credit	2.6	3.3	25.5%
Transportation	42.5	46.2	8.7%
Community & regional develop.	11.9	11.7	-1.5%
Education, training & soc. srvs.	56.4	58.4	3.5%
Health	140.9	154.2	9.4%
Medicare	190.4	197.1	3.5%
Income Security	237.7	247.4	4.1%
Social Security	390.0	409.4	5.0%
Veterans benefits & services	43.2	47.1	9.0%
Administration of Justice	25.9	27.7	6.9%
General Government	15.8	13.7	-13.1%
Net Interest	229.7	222.8	-3.0%
Undistributed offsetting receipts	-40.4	-42.6	5.3%
Total Outlays	**1702.9**	**1788.0**	**5.0%**
On-budget	1382.2	1457.3	5.4%
Off-budget	320.8	330.8	3.1%
SURPLUS	**124.4**	**237.0**	**90.6%**
On budget surplus	0.7	87.2	12911.2%
Off budget surplus	123.7	149.8	21.1%

[a]Nominal Growth; SOURCE: Financial Management Service, Department of the Treasury. Details may not add to totals due to rounding.

• Receipts rose by 10.8 percent last year, more than twice as fast as the 5.0 percent growth in outlays. The growth in receipts was spurred by a surge in individual income taxes, as well as strong corporate tax collections.

• Outlay growth was tempered by relatively slow growth in two large areas, Medicare and income security, and a decline in net interest payments. *Bulletin* readers should take care when interpreting percentage changes in the accompanying table. Very large percentage changes reflect the size of the base rather than large dollar changes, for the most part.

• Lower interest payments reflects a declining level of debt held by the public, which fell by $222.6 billion in 2000 to a level of $3,410.3 billion. Over the past three years, debt held by the public has been reduced by $362.5 billion.

• The President's February budget projected a 2000 surplus of $167 billion, and his Midsession Review projected a surplus of $211 billion, $26 billion less than the actual surplus. By contrast, CBO's corresponding summer update projected a 2000 surplus of $232 billion, only $5 billions off the final figure.

• Actual outlays were $14 billion below OMB's Midsession estimate. About half ($6.5 billion) of the under-estimate was due to lower-than-expected outlays for Medicare

• Actual revenues were $12 billion higher than OMB's Midsession estimate. Individual income taxes were $5.6 billion higher than the Midsession estimate; corporate income and social insurance tax collections were $4.6 billion and $4.2 billion higher, respectively, than the Midsession estimate. Excise and estate and gift tax collections came in under their respective estimates.

THE COST OF MILITARY RETIREE HEALTH CARE

• On October 12, the Senate considered the FY2001 Department of Defense Authorization Act. That Act included an amendment that offered the Defense Department's Tricare health insurance to military retirees now receiving Medicare.

• Because the Tricare provision involves moving costs currently classified as discretionary over to the mandatory side of the budget and establishing a new accrual account to help pay for future costs, CBO's scoring of the ten year costs of this program is complex. The President is expected to sign this legislation into law soon.

• One cost of the Tricare amendment is the mandatory (a.k.a direct spending) cost to the federal government. CBO estimates this to be nearly $59.9 billion over ten years.

• In addition, there are $1.9 billion in discretionary spending costs in FY2001 and FY2002. These costs are due to the fact that the health program will still be paid from discretionary funds in those years.

• When the spending for military retiree health becomes mandatory for the first time in FY2003, discretionary savings of more than $21.4 billion will be realized between 2003 and 2010. Over that period, discretionary money that once went to health care programs will no longer be needed, because military retiree health care is being funded from mandatory dollars. Next year, the baseline for the budget resolution will show a reduction in discretionary defense spending beginning in FY 2003 as a result of this provision.

• Therefore, the net cost of the Tricare amendment, including both the discretionary (-$21.4 billion and +$1.9 billion) and mandatory effects (+$59.9 billion), equals $40.4 billion.

• The Tricare amendment also includes more than $29 billion in Department of Defense (DoD) accrual payments that will be appropriated over a ten year period. Although these payments represent a cost to DoD, they have **no overall cost** to the federal government. Under the accrual mechanism, the Department of Treasury gets a corresponding $29 billion credit because the health care benefits are held in a trust fund account until they are needed to pay future beneficiaries at a later date.

ECONOMICS

CAPITAL GAINS AND THE BUDGET

• Given the stock market's gyrations this month, there has been increased interest in the role that capital gains have played in generating the present surpluses and how they may influence future years' surpluses. This is a very interesting and relevant topic; however, it has spawned some recent commentary which is overly negative and simply inaccurate, but has inexplicably taken on a life of its own.

• Extrapolating from tax returns received as of August 2000, SBC estimates that there were roughly $555 billion in capital gains realizations recorded in calendar year 1999. These realizations likely produced $110 billion in taxes. (The top statutory tax rate for capital gains is 20%). While the bulk of these realizations were probably linked to the stock market, it is important to realize that gains stemming from unincorporated businesses and investment real estate likely played a supporting role as well.

- In the last few weeks, some analysts have issued dire warnings that these realizations/receipts may soon vanish. Why? They argue that any one year's realizations are solely a reflection of that year's stock market performance. Thus, since the stock market is down in 2000, they believe the federal government will record in aggregate negative net realizations this year and thus negative tax receipts. Needless to say, such developments, if they occur, would have dire effects on the FY2001 surplus! However, we find their line of reasoning to be very puzzling - - dare we say "fuzzy math".

- We looked at data going back to 1962 and were not able to find a year when net losses exceeded net gains, even during 1987's capital gains tax rate increase/stock market fall, 1990/91's real estate market crash, or 1998's Asian crisis. In fact, in most years since 1962, the capital losses in Adjusted Gross Income (AGI) have been 10% or less of net capital gains. There are three main factors that explain this phenomenon:

  1) For a long time, the law has limited the amount of losses that can be claimed in annual tax filings. At present, only $3,000 in losses in excess of any gains can be taken in one year. (Additional losses may be carried over, however, they must be spread over a number of years so that the annual limit is not breached.)

  2) The economy has generally grown, thereby generating more gains than losses. This has led to steadily rising household net wealth.

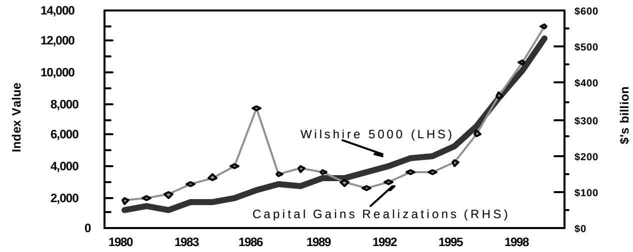
  3) Over time, inflation has converted many real losses into nominal gains.

- So if it is extremely unlikely that we will record net negative capital gains realizations in a given year, why do some analysts believe otherwise? Their error comes in how they model capital gains realizations - - i.e. by assuming that one year's capital gains realizations are the result of that year's stock market price action.

- It is more common to model the amount of capital gains as a function of the level of stock prices and the size of the economy and not as a function of one year's ups and downs.

- The linkage between stock market level and capital gains realizations can be seen in the following chart. It suggests that even with a minor stock market correction this year, realizations would certainly be expected to remain positive and indeed, could still be fairly sizeable. With the Wilshire 5000 roughly twice as high as it was in 1995 (even with recent losses), there are still large unrealized gains outstanding which are likely to be realized incrementally in coming years. Furthermore, it is interesting to note that even though the stock market was largely flat in 1994, realizations that year remained at their 1993 level and did not fall to zero as would be predicted if realizations were solely a function of one year's change in stock prices.

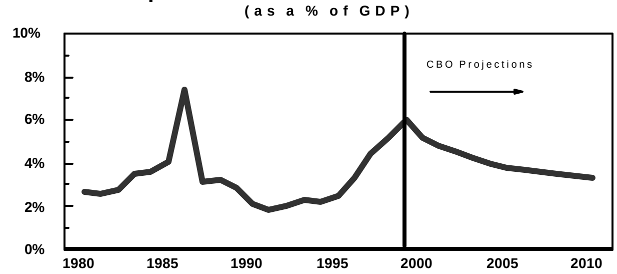
Capital Gains v. Wilshire 5000



Source: Treasury Dept., SBC (1999 Forecast), Haver
Note: Capital gains tax rate increased in 1987, generating considerable volatility between 1986/1987

- Of course, with the stock market down for the year-to-date, it does seem reasonable to expect that 2000's realizations may fall short of 1999's record level. Indeed, CBO's July baseline assumes that capital gains realizations/receipts will be slightly below 1999's level in each of the next 10 years. (For those analysts who think CBO's revenue forecasts are optimistic, it should be noted that a decade of stagnant capital gains realizations is rare).

Capital Gains Realizations
(as a % of GDP)



Source: Treasury Dept., BEA, SBC (1999 Forecast), CBO (2000-2010 Projections)
Note: Capital gains tax rate increased in 1987, generating considerable volatility between 1986/1987

- Thus, as a share of GDP, CBO assumes capital gains realizations will fall from roughly 6 percent of GDP today to near 3 percent by 2010 (which is the historical ratio, adjusted for the 1997 capital gains tax rate reduction). This does not strike us as overly optimistic, but instead shows that CBO has made a serious effort <u>not</u> to be carried away with the euphoria of the moment.

- As such, while revenue forecasts are always vulnerable to shifts in economic fortunes, the fall-out from a limited stock market correction should not be as devastating to capital gains receipts as some have recently suggested. Indeed, CBO already assumes a declining role for capital gains going forward.

- It should be noted that capital gains receipts are not the only way that the stock market influences our revenue projections – stock options, bonuses, retirement account withdrawals, and corporate taxes are also affected. However, these will need to be the topic of a future *Bulletin!*

BUDGET QUIZ

<u>Question:</u> What do budgeteers do after Congress adjourns sine die?

<u>Answer:</u> Once Congress adjourns sine die, sections 251, 252 and 254 of the Balanced Budget and Emergency Deficit Control Act of 1985 require our friends over at the Congressional Budget Office and the Office of Management and Budget to kick into high gear. Section 254 directs CBO to issue its final sequestration report within 10 days of adjournment. Sections 251 and 252 require OMB to complete its final sequestration reports and, if necessary, issue any sequestration orders (of either discretionary or mandatory accounts) no later than 15 *calendar* days after the Congress adjourns sine die.

- If Congress had adjourned today (Monday October 23rd) this would have meant that the OMB reports would have been due on November 7th – Election Day. In the interim, congressional budgeteers will be anxiously awaiting the results of the November 7th elections and hoping that their legislative suggestions were included in the final enacted bill ensuring there are no sequesters this year.

Bonus question: For all you legal eagles: what happens (*ugh*) if Congress never adjourns sine die?