

Appreciation of Capital

A surge in capital gains led the way to federal budget surpluses

By Thomas G. Donlan

Presidents and congressmen must marvel at how appropriate it is that deficits are written in red ink and surpluses in black ink. For in fiscal politics, surpluses and deficits both present chancy propositions, filled with peril as powerful as the rush of adrenaline that hits a gambler when he puts the rent money on the roulette table.

Red or black? Deficit or surplus? As on the roulette table, it doesn't really matter. The odds are just about even, but a little bit unfair. As on the roulette table, where zero and double-zero give an edge to the house, Murphy's Law dictates that every political gamble offers a little more peril than payoff.

The Bush Administration put its money on red last week. President George W. Bush submitted a budget for the 2003 fiscal year that proposed a \$106 billion deficit. It would be the first deficit since fiscal 1997. And the President's budget document predicts more deficits for the next two years.

Welcome to Credibility Gap. At this time five years ago, when President Clinton was submitting his federal budget for fiscal 1998, he projected a \$121 billion deficit, with more deficits stretching out through fiscal 2001. Only for the fiscal year of 2002 did his budget project a surplus. We know now, of course, that every one of those presumptive deficit years actually recorded a surplus. Only now, in fiscal 2002, is the United States again running a deficit -- which of course was completely unexpected at this time last year.

Surplus source

Delving into the differences between the fiscal outlook seen by Clinton in February 1997 and the real experience of the last five years turns out to be very educational. We never really understood where the surpluses came from any more than Clinton's budget prognosticators expected them.

We had imagined that gridlock between the Democratic White House and the Republican Congress held expenditures in check. That's true for certain expenditures, notably Medicare and welfare, but other accounts, particularly defense and agricultural support payments, ate up the savings. Aggregate federal spending proceeded close to 1997's projected path.

On the revenue side, the comparison produces one astounding deviation: For fiscal 1997, the budget projected individual income tax receipts of \$672 billion, followed by modest growth, to \$691 billion in fiscal 1998, \$721 billion in fiscal 1999, \$755 billion in fiscal 2000, \$795 billion in fiscal 2001 and \$839 billion in fiscal 2002. The real figures were much higher: \$737 billion in 1997, \$828 billion in 1998, \$879 billion in 1999, \$1 trillion in 2000, \$994 billion in 2001 and an estimated \$949 billion in 2002, despite the recession.

Whatever caused this leap in revenues wasn't just the robust economy creating new jobs and raising incomes. Corporate income-tax receipts were pretty much on target, with one exception. Payroll taxes, mostly for Social Security and Medicare, ran above the 1997 predictions, but not by anything like the enormous variances of individual income-tax receipts. Excise taxes, largely on alcohol, cigarettes and highway fuels, also were just a little higher than expected.

Only one other major category of tax receipts ran so much higher than the 1997 forecast: Estate and gift tax receipts were 30% to 50% higher than projected. The estate and gift tax is relatively minor, bringing in \$29 billion in the biggest year, fiscal 2000, which was less than 1.5% of total revenues. But a clue to the unexpected surpluses is buried here. During the years of surplus, more people were dying with taxable estates, and the estates were bigger, paying more taxes.

Capital returns

These were years when capital investments, especially stock-market investments, appreciated rapidly. Could it be that taxes on capital gains accounted for a large chunk of the unexpected surplus, even though the capital-gains tax rate was cut just before the surpluses started to accumulate?

The budget documents never break down the sources of individual income-tax receipts, but it stands to reason that if the Office of Management and Budget could do a reasonable job predicting payroll taxes, its projections for income derived from salaries and wages were also pretty near the mark. Which leaves income from the employment of capital.

Across town at the Internal Revenue Service, economic analysis proceeds slowly, and with little relationship to budget analysis. The most recent tax figures available at the IRS are "preliminary" data based on a sample of 1999 returns. The most recent thorough analysis of capital-gains income uses data from 1997 returns. Both reports were published last fall.

In 1999, the number of tax returns increased 1.9% over 1998, and the amount of adjusted gross income reported on those 127 million returns increased 8.6%, to \$5.8 trillion. The number of returns reporting salaries and wages increased 1.7% and the amount of such income increased 7.2%, to \$4.1 trillion. Among more than a dozen other types of income one stands out with the greatest increase in returns and reported income.

The number of returns reporting capital gains in 1999 increased 8% and the amount of capital gains reported by those 22.5 million taxpayers increased 21.8%, to \$516 billion. The only other source of income that came close to that kind of growth was dividend income, with a 6.2% increase in returns reporting it and a 12.9% increase in the amount reported.

The IRS does not tell us how much of those 1999 gains were earned in the stock market. On that, the newest public information is for 1997. What's worse, the 1997 law that reduced the tax rate on gains also created an exclusion of up to \$500,000 in gains for a couple selling a primary residence after May 6 of that year, so 1997 isn't entirely comparable to later years. Here's what the IRS does tell us:

Net capital gains in 1997 totaled \$360 billion on asset sales of \$2 trillion, of which \$136 billion came from direct sales of corporate stock, \$94.7 billion from gains passed through to taxpayers by partnerships, certain corporations, estates and trusts, \$44.9 billion from gains distributed to taxpayers by mutual funds and similar investments, and \$12.1 billion from direct sale of mutual funds. In 1997, residential real-estate transactions accounted for \$5.1 billion in gains, a smidgen of the gains derived from financial transactions.

Those gains from financial transactions, moreover, do not include one type that has become famous for its production of gains. Employees pay ordinary income-tax rates when they make a profit exercising stock options. Which reminds us of the year when corporate income taxes mysteriously dipped below projected receipts, which was 2000. One reason for the dip in receipts could have been the peak in the stock market: When employees cash in stock options and pay tax on the gains, they create a tax deduction for their employers. We will have to wait years for IRS reports that might confirm this surmise, but it appears that stock-option exercise may have been so widespread in 2000 that taxes on exercises replaced corporate income-tax payments by as much as \$50 billion.

Protection of capital

Acutely aware of its vulnerabilities on the political right, the Clinton Administration was extremely sensitive to financial markets, perhaps more than any other administration in living memory. The Bush Administration is full of business executives and others who have been checking the stock pages since they learned the meaning of the term trust fund. And Congress has more than its share of wealthy people, whether they earned their dough before seeking office or afterward.

But the Clinton and Bush administrations and their admirers in Congress have never forthrightly acknowledged how much the United States government's four fat years of surplus owed to the bull market on Wall Street. They have attributed the black ink to their wise policies, when in fact the surplus was a much simpler matter.

High taxes happened to be in place when the people of the United States produced one of their periodic bursts of creativity. Their investments in communications and information technology produced big profits, which were capitalized in stock-market valuations. The normal ebb and flow of investment and investors produced a sudden surge in taxable gains from transactions. The government, a bystander in the creative process, reaped some of the profits.

Fortunately, the Bush Administration last year convinced Congress to forego some of the government's windfall. Nothing could be a greater incentive to new bursts of creativity than the resolve of the government to take less of creativity's rewards. Keeping the tax cut is more important than guessing whether 2003 turns up red or black.