

The Big Squeeze

Impacts of Federal Budget and Tax Policy

By Gary Bass, John Irons and Ellen Taylor

For the nonprofit and philanthropic sectors, paying attention to the federal budget and proposed tax cuts has never been more critical. As government revenues and outlays continue to decrease, the impact is already being felt by nonprofits that rely on public dollars for their survival. More than ever, being silent on tax and budget issues is not an option for those who care about the individuals and communities that the government and nonprofits serve.

Current Federal and State Budget Picture

Over the past few years, federal and state budget situations have deteriorated at unprecedented rates because of huge federal tax cuts, poor economic performance, and rapidly growing outlays for defense and domestic security.

At the federal level, record surpluses have turned into massive deficits. The latest Congressional Budget Office report predicted a record \$477 billion deficit for fiscal year 2004, and the president's fiscal year 2005 budget is predicting a deficit of \$521 billion. Without counting the Social Security surplus, the deficit forecasted in the current budget is \$675 billion,

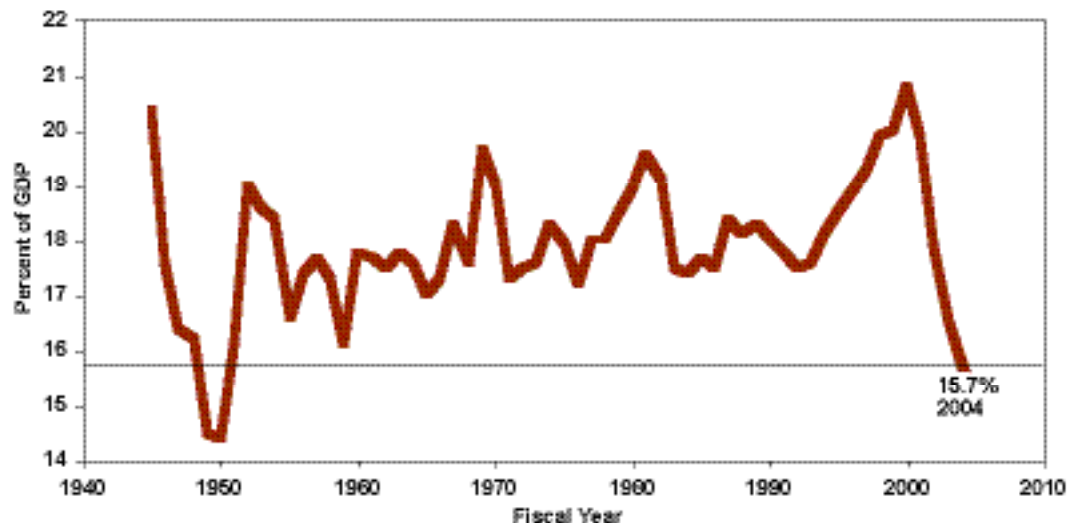
or approximately 5.9 percent of GDP—and the second largest since World War II.

State governments last year faced their worst budget crises since World War II, with the worst yet to come for many states. Both directly and indirectly, federal tax and budget policies cascade down to the states, most of which are already struggling with their own structural deficits, further reducing state revenue and funding for state services.

An economic slowdown, and increased spending for national defense and national security, are important contributors to these deficits, but tax policy over the last few years has played a role as well.

Federal revenue for fiscal year 2004—at just 15.7 percent of gross domestic product—is projected to be at its lowest level since 1950 (see Figure 1), and federal income tax receipts for fiscal year 2004, at 8 percent, will be at their lowest level since 1942, even without full implementation of the Bush administration's tax cuts or other expected changes in tax law. The reduction in federal revenue as a result of tax cuts creates a long-term structural problem at the feder-

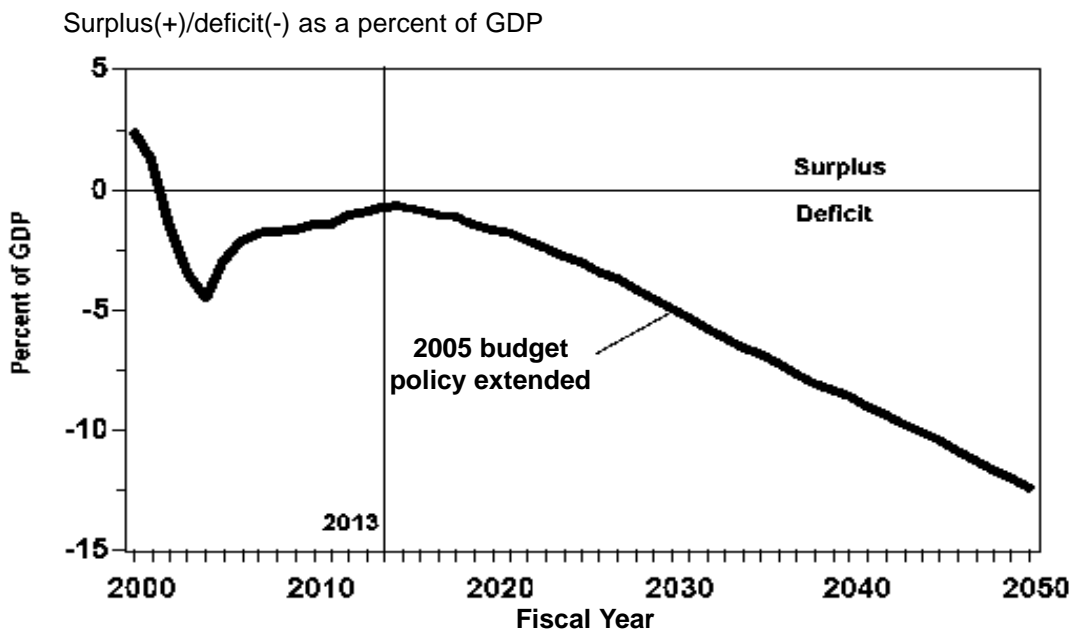
FIGURE I—Federal Receipts, 1945–2004



Revenue is at its lowest level since 1950.

Source: Office of Management and Budget (OMB), 2005 budget, Historical Tables, p. 24.

FIGURE 2—Surplus/Deficit, 2000–2050



Source: Office of Management and Budget, 2005 budget, Analytical Perspectives, p. 194, derived from chart 12-5.

As baby boomer
come of age
deficits explode

al budget level since spending levels have not been adjusted. Total revenues from all levels of government—federal, state and local—haven't represented such a small share of the economy since 1968.

This fiscal situation has massive implications over the long term for the role of government and the role of nonprofit organizations. The combined federal and state crisis is already affecting programs and services that many Americans take for granted, from higher education and basic social services to the arts and the environment. For example:

- Gov. Mark Sanford of South Carolina proposed slashing more than \$2 million from the state Forestry Commission's budget, which could eliminate one-tenth of the agency's jobs and reduce recreational activities, including biking and hiking, at state forests.
- Last year, 11 states cut K-12 school funding, including the elimination of reading specialists, all-day kindergarten and preschool programs, summer school for 9th, 10th and 11th grades, and transportation to and from school.
- State arts-agency legislative appropriations decreased for the second year in a row following a decade of steady growth, dropping 13.1 percent between 2002 and 2003.

The budget situation at the federal and state

levels leaves little hope for the expansion of investments—in basic human needs, arts, public education, research and infrastructure. It leaves states and localities—often facing unfunded mandates from new homeland security responsibilities and education initiatives—holding the bag. For example:

- This year, through the network of 16 food pantries it operates in Mecklenburg County, North Carolina, Loaves and Fishes has distributed one week's worth of food each to more than 70,000 poor people, nearly double the total in 2000.
- After Catholic Charities of the Diocese of Cleveland started receiving \$5 million less from the state of Ohio this year, the organization had to lay off 130 of its 1,750 employees, eliminate three programs and shutter office space it occupied in buildings it didn't own.

Long-Term Fiscal Situation

The immediate crisis illustrated above pales in comparison with the long-term picture.

While low interest rates and tax rebates may help the economy grow in the short run, current fiscal policy has created a long-term imbalance. The current period thus represents the "calm before the storm"—the prelude to a deepening and unsustainable deficit, lower national savings, a probable increase in interest rates and a

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slowing of the economy down the road, all in addition to painful cuts in vital government programs and investments.

With the increased demand on Social Security and medical care presaged by the upcoming retirement of baby boomers, there will be even more pressure to cut spending in other areas. After 2013, when the baby-boom retirement begins to accelerate, the deficit will soar to levels not seen since the height of World War II.

Figure 2 shows a 50-year projection by the Bush administration of the federal deficit if current budget policies are extended. According to the projection, by 2050 the deficit would be more than 13 percent of GDP—which many believe is well beyond sustainable levels. The deficit will soar even higher than this scenario indicates if Congress passes additional tax cuts, if Congress approves necessary fixes to the Alternative Minimum Tax, if spending grows at current levels, if there are various unexpected expenses, or if the economy doesn't do as well as projected.

Even with this dismal forecast, there will be significant pressure to extend tax-cut legislation (currently slated to "sunset" in 2011 or earlier); if enacted, such legislation would reduce revenue even more than currently projected. The Tax Policy Center, a joint project of the Urban Institute and the Brookings Institution, estimates that the cost of extending current tax legislation would be in excess of \$2 trillion, including the increased interest payments on the national debt, through 2014. This is in addition to the \$1.9 trillion deficit over the next 10 years predicted by the Congressional Budget Office in its January 2004 projections.

The Federal-State-Nonprofit Connection

States and localities depend on federal support. According to a recent study by Woods Bowman, direct federal aid is 20 percent of local and state revenues. In addition, various "tax expenditures"—income and property taxes that are deductible from federal income tax and bond interest that is exempt from federal taxation—generated approximately \$62 billion to states and localities in 1999. This amounts to federal financial support that is equivalent to one-fourth of the revenue of state and local governments.

According to Bowman, state and local revenues for 2003 were \$27 billion below the

amount required to maintain the 2001 spending level after adjusting for inflation and population growth. The shortfall could have been much worse, had not the federal government appropriated one-time fiscal relief to the states of \$20 billion, of which half was earmarked for Medicaid. The \$20 billion grant expires at the beginning of fiscal year 2005, and it is unlikely, given the state of the federal budget and calls to cut spending, to be extended.

Tax cuts at the federal level thus have a direct effect on the states. For example, the phasing out of the federal estate tax over nine years included a provision eliminating the state "pick up" tax (equal to the maximum state estate tax credit allowed under federal law) in four years, or by January 2005. In 2001, states collected \$7.5 billion in estate, inheritance and gift taxes, representing 1.3 percent of state tax revenue. This would have grown to more than \$9 billion by 2010, the year the federal estate tax will be fully repealed. Other federal tax cuts will cause states to lose \$3 billion per year.

State tax collections have fallen dramatically in 2001-2002. State and local government revenues have dropped to their lowest level, as a share of the economy, since 1988. With their reserve and special funds depleted, with all the easy "fixes" and gimmicks to address budget shortfall already used, and with rapidly growing Medicaid obligations, state and local governments are facing much harder decisions during the next few years.

The Government-Nonprofit Connection

Government funding is vital to the nonprofit sector. Of the total federal outlays of \$315 billion (adjusted for inflation) going to state and local governments in fiscal year 2002, \$266 billion was spent in areas where nonprofit organizations are active, including \$125 billion for Medicaid, according to Bowman.

In addition, the same report says government contracts and grants account for at least 31 percent of the income of the nonprofit sector. This percentage is likely quite a bit higher than official statistics indicate, because nonprofits often report income from government as service-related fee income. Respondents to the most recent Listening Post Project survey, conducted by the Johns Hopkins Center for Civil Society Studies, indicated that 43 percent of their revenue came from government sources.

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demands for services as the government is less able to afford programs, and also through less revenue from the government to nonprofits to address societies' challenges.

Nonprofits are struggling with cuts in state and local government funding, and the situation is expected to worsen. As both direct government assistance shrinks, and government grants to nonprofits doing the work of government decrease, the minimal safety net becomes full of holes. Even beyond the provision of basic human needs, a number of other important nonprofit programs suffer, from the arts and culture to the environment.

According to the latest Listening Post Project survey of nonprofits across the country, while more than 40 percent of surveyed nonprofit organizations expect growth in revenue, only 17 percent expect growth in revenue from government sources and 52 percent expect declines in their government revenue. This is especially significant because these organizations receive 43 percent of their total revenue from government sources.

What Can Be Done?

Over the past several years, the public interest community has primarily engaged in short-term defensive battles on federal tax and budget issues. The conservative movement, on the other hand, has continued to press its tax and budget agenda through well-funded, multiyear and multilevel campaigns. Our community must seize the initiative on tax and budget issues if we are ever to succeed in promoting what we stand for—a fair, simple and equitable tax system that generates adequate resources to implement the government programs and services that Americans want.

One of the strengths of the progressive network is the large number of nonprofit organizations at the federal, state and local levels. By engaging those groups—including some that have never participated in tax and budget issues, but are now seeing the need to do so—we can make progress in promoting a progressive, fair, sensible tax system and a sustainable framework for support of needed and valuable social investment.

To take advantage of this opportunity, the public interest community must do more than advocate against conservative budget and tax policies. Rather, it is imperative that we begin to formulate and support an affirmative alternative vision—one that demonstrates the variety of

ways in which government services and actions have proved efficient and effective. The long-term vision must contain the elements of a fair, efficient and simple tax plan, in part to counter the broad plans advocated by proponents of smaller government.

This will require a long-term effort that includes national, state and local voices. It will require reaching out to new constituencies. It will require all groups to work beyond specific issue areas and pursue a common long-range vision and strategy.

Reaction by Nonprofits

Such reactions have already begun. An OMB Watch Internet survey completed this past February reveals that nonprofits are clearly making the connection between state and local conditions and federal budget and tax policy. More than 700 respondents completed the lengthy survey, with 74 percent identifying themselves as regional, state or local/community groups. An analysis shows overwhelmingly positive support for moving forward with a long-term proactive effort around federal tax and budget issues. The most important issues (and their average rating on a 1-4 scale, with 1 the least important and 4 the most important) were:

- Build a fair, simple, progressive federal tax system that can raise adequate revenue to fund the programs and services that government should be implementing. (3.7)
- Identify and elevate domestic needs and priorities. (3.5)
- Encourage government resources and policies that strengthen long-term economic growth, including through creation of good jobs. (3.5)
- Cut regressive taxes that especially hurt low- and middle-income Americans. (3.5)
- Ensure that the federal government provides adequate funding to states and localities for federal mandates. (3.5)

Respondents identified the largest barriers to accomplishing these efforts to be a lack of leadership and organizational structure, lack of a common message, and lack of coordination between groups that work on tax/budget issues and issue-based organizations. Strikingly, groups place these issues as even more important than receiving more money to help implement such a campaign.

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For a host of reasons—mission related, financial self-interest, and many others—the nonprofit community including philanthropy, has an enormous stake in the future of tax policy.

Why Should the Philanthropic Community Care?

On the OMB Watch Internet survey, nearly one in four respondents added a comment to the question about important roles that foundations should play with respect to tax and budget issues. The vast majority felt that the philanthropic community must become involved and play a leadership role. Many pointed out that in order to get foundations more engaged, it would first be necessary for foundation executives and trustees to understand the extent of the problem and better reflect on why involvement is central to their philanthropic mission.

One respondent, reflecting the views of many, noted that it is essential to “bust the myth that nonprofit charities can replace government services.” It would be impossible to replace the role of government, with regard to not only service delivery but also regulatory protections, enforcement of laws, and many other critical functions.

Total foundation giving in 2001, according to the Foundation Center, was \$30.5 billion. In comparison, federal government funding of programs in which nonprofits play an active role was in the neighborhood of \$200 billion to \$225 billion—dwarfing the amount provided by foundations. As one respondent noted, “Do the math on the foundations’ funding of social services. It’s impossible [for foundations to pick up the cost].”

Consistent with these comments, survey respondents ranked educating foundation trustees about the importance of tax and budget issues as the most important task for foundations to do. Eighty-one percent considered this an important issue, with 42.1 percent identifying it as a very important task. However, even among some who ranked this task as very important, there was skepticism about whether this task could be accomplished.

A number of respondents felt that foundations could play a very important role in building the advocacy capacity of nonprofits to engage in a long-term tax and budget campaign. Three out of four respondents felt this was important, with 47.3 percent identifying it as very important. As one respondent noted, “It is hard to get [foundations] to fund ongoing public policy advocacy work that can change state laws to provide better services for families. Funding public policy advocacy, as well as budget analysis and advocacy, must be increased to make progress on the state level.” Some respondents echoed the need to “cultivate more organized citizen activism by concentrating more on supporting social change

work rather than social services.”

There were several common themes among respondents about the manner in which foundations fund organizations. The need for foundations to provide ongoing, steady support was one theme. “Foundations think things can change significantly in a short amount of time, and they do not fund adequately the advocacy work needed to ... bring in the government through an education/persuasion campaign,” said one respondent. Other respondents felt that more foundations need to provide general operating support to allow them to become engaged in tax and budget issues.

There were repeated calls for foundations to support smaller, grassroots groups. A few specifically mentioned that community organizing groups need foundation support in order for a longer-term tax and budget campaign to be successful. A few respondents were skeptical that foundations would ever, in fact, consistently fund smaller, grassroots groups. They suggested that national organizations should create a system for regranteeing funds to such groups in order to effectively organize a campaign.

Roughly nine percent of respondents identified themselves as private foundations. They were a little more divided than nonprofits overall on the highest ranked items, but had the same overall ranking as the larger pool of respondents, with one exception. They felt it was more important to fund advocacy capacity than public education projects on tax and budget issues. Foundations were less supportive of funding social services directly to take the place of government funding than nonprofits generally were.

In addition to the impact that a shrinking government will have on the mission of foundations, there are other reasons foundations, along with the broader nonprofit sector, should be concerned about tax policy. There is little question that tax policy generates incentives for charitable giving. Yet there has been little active involvement of institutional philanthropy in these debates. A good example is repeal of the estate tax. The Tax Policy Center estimated that the repeal of the estate tax would reduce charitable giving roughly \$10 billion per year. While this would have a broad impact on the entire nonprofit sector, foundations would be especially hard hit since they receive nearly the largest dollar share of giving through bequests.

Thus, for a host of reasons—mission related, financial self-interest, and many others—the nonprofit community, including philanthropy, has an

enormous stake in the future of tax policy. Together, nonprofits and foundations must work to:

- Educate nonprofit leaders, especially foundation executives and trustees, on the importance of engaging in tax and budget issues. Increased foundation funding is necessary to address these issues, which means it is essential to educate foundation decision makers. But it is not solely about more money; it is also about leadership. Foundation trustees and executives are often influential in their communities. They can play a powerful role in educating other community leaders as well as policymakers.
- Build the advocacy capacity of nonprofits to more effectively work on tax and budget issues. This requires increased funding from foundations, along with strategic approaches by nonprofit leaders, to get more nonprofits engaged in advocacy, especially on budget and tax issues.
- Support efforts to improve the language nonprofits use to describe tax and budget issues. Poll after poll shows that the public supports

a responsive government, but the way we talk about it turns off many people. The sector needs values-based language that talks about building a fair, simple, progressive federal tax system that can raise adequate revenue to fund the programs and services that are central to communities.

- Operate in new ways. Foundations and nonprofits tend not to focus on long-term problems; in fact, current problems and crises seductively sap almost all of our energy. We must find ways to work on immediate issues while at the same time building for the future—developing a longer-term vision of what we do want and mapping a plan for moving toward that vision.

Now is the time to take action to address the crucial future impacts of tax and budget policy. ☹

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TABLE I—The Role of Foundations on Tax and Budget Issues

	Not Important	Somewhat Unimportant	Somewhat Important	Very Important	Don't Know	Difference between Important and Not Important	
						All Respondents	Foundations Only
Educate trustees about the importance of tax and budget issues	4.5%	13.0%	34.0%	47.1%	1.3%	+63.6	+63.4
Fund public education projects that support a fair and simple tax system that provides the necessary revenue to support a strong, responsive federal government	5.8%	17.2%	27.9%	47.3%	1.8%	+52.2	+56.6
Fund the advocacy capacity of nonprofits to engage in a long-term tax and budget campaign	5.5%	16.0%	33.2%	43.1%	2.0%	+54.8	+52.4
Fund pilot projects to solve social problems on a small scale, which government (with its greater resources) could then replicate on a larger scale	6.1%	18.9%	37.9%	35.7%	1.5%	+48.6	+42.6
Fund social services directly to take the place of the shrinking role of the federal/state government	13.8%	28.5%	28.5%	27.2%	2.0%	+13.4	+8.2

Source: OMB Watch Internet survey that concluded Feb. 4, 2004.