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Revised August 16, 2005

REVENUE COLLECTIONS IN 2005
WHAT DOES THE RECENT INCREASE IN REVENUES SIGNIFY?

by Richard Kogan and Isaac Shapiro

Recent strong tax collections have led the Congressional Budget Office to reduce its deficit estimate for 2005 to about $331 billion and the Office of Management and Budget to reduce its deficit estimate to $333 billion.[1]

The trimming of the deficit is a positive development for the U.S. Treasury. But this development does not lead to the conclusion that "the tax cuts are working," as some now are claiming. Furthermore, the reduction in this year's deficit from a *very large* one to a *large* one has little bearing on the nation's shaky long-term fiscal foundation.

CBO: The Outlook Has Not Improved

The first paragraph of CBO's new "Budget Update" reads as follows:

> The fiscal outlook for the coming decade has not changed much since the Congressional Budget Office (CBO) issued its previous baseline projections of the federal budget in March. Although the deficit for 2005 will be notably lower than CBO estimated then, *the underlying projections of revenues and outlays for future years are similar to those presented five months ago.* (emphasis added)

- *A surge in economic growth is not behind the unexpected increase in 2005 revenues.* Real economic growth in 2005 has not been unusually rapid, nor has it been stronger than was projected earlier this year by CBO or OMB.[2] Thus, the unexpected gain in revenues does not reflect faster-than-anticipated economic growth. In May, CBO said that one possible reason that revenues are coming in faster than it forecast earlier this year is that increases in income may be more concentrated among high-income taxpayers than it anticipated. High-income taxpayers pay taxes at higher rates, so an increasing concentration of income results in a higher level of revenue. In its August report, CBO stresses that much of the recent growth of revenues has occurred because of a boom in corporate tax receipts rather than in taxes on wages and salaries. This is consistent with the notion of increased income inequality, and is consistent with revenues exceeding expectations at the same time that overall economic growth has not.

- *The recent revenue rebound has not made up for the large revenue shortfalls that have developed since 2000.* The recent increase in revenues follows three consecutive years (2001-2003) in which revenues declined in nominal terms, an extremely rare occurrence, and a year (2004) in which revenues were lower as a share of the economy than in any year since 1959. Even with the recent increase, revenues in 2005 will remain well below the levels at which they were projected to be when the 2001 tax cut was enacted.

- *Many of the factors behind the increase in revenues in 2005 are temporary.* The expiration of a business tax cut at the end of 2004 is leading to an increase in tax collections of about $50 billion this year, according to past estimates by the Joint Committee on Taxation. In this case, the increase in revenue stems from the *termination* of a tax cut, not from a tax cut's effect in spurring the economy. The recent revenue increase also apparently reflects a rise in the stock market in 2004 that resulted in increased capital gains tax payments when tax returns for 2004 were filed earlier this year. This increase in the market, however, has not continued in 2005. Additionally, the corporate tax legislation enacted last October contained a provision (relating to profits that U.S. companies have earned abroad and kept overseas) that was designed to produce a one-time gain in revenues this year. The one-time gain will be followed by revenue losses in subsequent years. Another contributing factor is higher-than-expected inflation, which generates higher revenues. To the extent that 2005 and future revenues are higher because of higher inflation, this growth would be largely offset in later years by higher expenditures, most of which also respond to inflation. In fact, CBO's new report projects faster growth of Social Security and other entitlement programs over the next ten years because it now expects faster inflation than it did in January.

- *Federal revenues remain low as a share of the economy, and the long-term fiscal outlook remains grim.* CBO's new report reveals that revenues will *fall* as a percent of the economy after 2006, assuming that the tax cuts enacted since 2001 and current AMT relief are extended. Under those circumstances, revenues over the next ten years would average 17.1 percent of GDP, lower than the average in the 1950s, 1960s, 1970s, 1980s, or 1990s.

- *The increase in revenues does not confirm the "Laffer Curve;" tax cuts do not pay for themselves.* Some tax-cut proponents have begun claiming that the recent rise in tax revenues proves that the tax cuts of recent years are increasing revenues and that the "Laffer Curve" is working.[3] According to this argument, revenues could be *higher* than they would have been in the absence of the tax cuts. However, the consensus among economists and financial analysts, and the empirical data, are strongly consistent with the basic, common-sense notion that tax cuts do not pay for themselves. They result in less, not more, government revenue. Not only do the several recent years of revenue declines suggest this, but the experience of the 1980s and the 1990s does as well. The average economic growth rates for those two decades were virtually identical. But the rates of revenue growth diverged sharply. Revenue collections grew much more robustly in the 1990s — when taxes were increased — than in the 1980s, when taxes were cut sharply. Not coincidentally, the nation's fiscal position improved substantially in the 1990s, after deteriorating in the 1980s.

  Most of these findings are discussed in more detail below.

Have the Tax Cuts Boosted Revenues?

In 2001, conservative anti-tax activist Stephen Moore declared that "…the Bush tax cut will not lose $1.6 trillion as forecasters have predicted…the Joint Tax Committee always overestimates the revenue gains from tax rate increases and always overestimates the revenue losses from tax rate cuts."[4] In retrospect, it is apparent that the Joint Tax Committee estimates were indeed off, but not in the direction that Moore and many other proponents of the tax cut predicted. Revenues have come in lower, not higher, than the Congressional Budget Office and the Joint Tax Committee forecast.

If CBO's new revenue estimate of $2.14 trillion proves correct, total revenues in 2005 will still be considerably *lower* than CBO and OMB predicted in early 2002. Note that these 2002 revenue projections were made after the large 2001 tax cut had been enacted, the September 11, 2001, terrorist attacks had occurred, and the economy had hit bottom. (The trough of the recession occurred in November 2001.) If CBO's 2005 revenue estimate is correct and revenues run $85 billion higher than CBO predicted this March, revenues this year will still be *$89 billion lower* than the level of 2005 revenues that CBO projected in January 2002. See Table 1. (In making this comparison, we have adjusted CBO's January 2002 projection downward to reflect the Joint Tax Committee estimates of the cost of all tax cuts enacted since then.) Not only have the tax cuts failed to pay for themselves, but revenues continue to come in well below prior expectations.

TABLE 1: Revenue Projections and Shortfall

		2005 revenues (billions)
(1)	CBO's January 2002 Projection	$2,342
(2)	JTC Estimate of Cost of Tax Cuts Enacted 2002-2004	111
(3)	Adjusted CBO Projection [(1) – (2)]	2,231
(4)	CBO's New Estimate of 2005 Revenues	2,142
(5)	Remaining Unexplained Shortfall [(3)-(4)]	89

Indeed, far from confirming the view that cutting taxes increases tax receipts, the tax cuts enacted in 2001 were followed by three years in which the level of revenues fell short of official estimates. The recent growth in revenues simply means that the large revenue shortfall is not quite as severe as previously thought. While revenues in 2005 will be significantly higher than revenues in 2004, a point that proponents of the tax cuts have begun to trumpet, revenues in 2004 were at a stunningly low level — the lowest level as a share of the economy since 1959.[5] As a result, revenues will remain at a relatively low level as a share of the economy this year, 17.5 percent of GDP. And CBO's new estimates show that if the recent tax cuts and current AMT relief are extended, after 2006 revenues will drop below their current 17.5 percent level and average only 17.1 percent of GDP over the ten-year period from 2006 through 2015. This would be lower than the average level of revenues in the 1950s, 1960s, 1970s, 1980s, or 1990s.

Temporary Factors Related to the Revenue Increase

Much of the recent upsurge in revenues appears to stem from temporary developments, not from tax-cut-fueled economic expansion. In fact, one of the causes of the sizeable increases in tax receipts between 2004 and 2005 is the *expiration* of a large tax cut.

- A large business tax cut enacted in 2002 — the accelerated depreciation tax cut — expired at the end of 2004. This is producing a significant increase in business tax payments in 2005 — an increase estimated at $51 billion by the Joint Committee on Taxation when the provision was enacted. Revenues are rising in this case because a tax cut is no longer in effect. The expiration of the accelerated depreciation tax cut causes tax revenue from businesses to jump significantly from 2004 to 2005, and then jump again from 2005 to 2006. But the unusual increase in revenues cannot be repeated thereafter because the provision can expire only once. The future growth rate of business tax revenues will revert to normal, all other things being equal.[6]

Reasons to Doubt that Tax Cuts Caused the Revenue Surge
Excerpted from: "Daily Financial Market Comment," Goldman Sachs Daily,
June 30, 2005.

- "Withheld taxes have been sturdy but not inexplicably strong. Unusually strong growth in withheld taxes would be the most logical way to verify the Laffer Curve… As most observers are aware, neither employment levels nor work weeks have shown the kind of strength (relative to GDP growth in the case of employment) that would suggest a significant increase in work effort. Although withholdings have been unquestionably sturdy over much of the past year, the strength is far from what would be required to provide such evidence or to make up the loss in personal income tax revenue…

- "The bonanza has been concentrated in nonwithheld taxes… This surge was mainly a reflection of the prior year's strength in economic growth and the stock market… The fact is that both growth and stock market momentum have cooled in 2005. Thus the strength in nonwithheld taxes is apt to fade as well.

- "The rest is in corporate tax receipts. In fact, in percentage terms, corporate receipts have exhibited the strongest growth… We discount strength in corporate receipts as a demonstration of the Laffer Curve for two reasons. First, at its core, the Laffer Curve is an argument that lower marginal tax rates will induce greater individual work effort; corporate receipts may benefit, but only indirectly as economic activity strengthens. Second, the increase in corporate receipts is easily explained as the combined result of last year's strength in economic activity and a return to more normal tax levels following the expiration of the depreciation bonus [i.e., the business tax cut that expired at the end of 2004]."

- Tax returns for 2004, which are filed in fiscal year 2005, appear to have included a substantial increase in capital gains tax payments, reflecting the increase in the stock market in 2004. The stock market now appears to have stopped rising; it has been flat in recent months. Capital gains revenues cannot be expected to continue increasing at the rate they did between 2004 and 2005. (See the box above, which cites an analysis of this issue by the investment firm Goldman-Sachs.)

- An additional one-time boost in 2005 revenues is occurring because last fall's corporate tax legislation allows businesses with foreign profits being held abroad to bring the profits back to the United States *in 2005 only* and pay taxes at a modest 5.25 percent rate, rather than at the normal corporate tax rate of 35 percent. This will increase revenues by several billion dollars (or more) in 2005, as corporations rush to take advantage of this windfall, but according to the Joint Tax Committee's estimates, it will result in modest revenue *losses* in 2006 and thereafter.

To be sure, 2005 tax receipts are running higher this year than CBO and OMB projected earlier this year. But the greater-than-anticipated revenue growth comes mostly from increases in corporate income taxes and non-withheld individual income taxes, as CBO repeatedly stresses, not from increases in taxes on wages and salaries. If the tax cuts had been sparking a "supply-side miracle" by inducing people to work more or encouraging businesses to expand employment, then real economic growth, job growth, and withheld taxes would have significantly surpassed expectations, as well. Instead, economic growth and job growth have been modest, and CBO's current estimates for 2005 economic and job growth are now very slightly lower than CBO's January forecast. In addition, withheld tax receipts appear to be similar to CBO's expectations.[7] [8]

No Evidence of Accelerated Long-Term Growth

TABLE 2

Average Annual Growth in GDP for 3½ Years Since Recovery Began in Nov '01	3.3%
Average Annual Growth in GDP for First 3½ Years of Other Recoveries Since World War II	4.7%

For tax cuts to lead to long-run revenue increases, they must raise long-run economic growth rates significantly. Both the Joint Committee on Taxation and the Congressional Budget Office have concluded, however, that the changes in the tax code enacted since the start of 2001 are likely to have only small effects on long-term economic growth and that these effects could as easily be negative as positive.[9] CBO and the Joint Tax Committee project that the tax cuts will generate little, if any, additional revenues through stronger economic growth and that the overall budgetary effect of the tax cuts thus will be one of large revenue losses.

Moreover, since the recession hit bottom in November 2001, real economic growth (economic growth adjusted for inflation) has averaged 3.3 percent per year. This is significantly below the 4.7 percent average growth rate for other post-World War II economic recoveries.[10]

With respect to employment, it took nearly four years for the number of jobs to rise back to the level they were at before the recession started. In no other business cycle since World War II has it taken so long for employment to return to pre-recession levels. Even this year, job growth has continued to lag well behind that in prior recoveries. When the recovery period as a whole is examined, the pace of job creation still falls well behind the pace of job creation in every other recovery since World War II. Among non-supervisory workers, moreover, average real wages have actually fallen since 2003 and in the second quarter of 2005 were at their lowest level since the close of 2001.

In fact, in another recent analysis we found that the current recovery has been less robust than average not only in terms of economic growth and job growth, but also consumption, investment, net worth, and wages. Only corporate profits have rebounded faster than usual.[11] Thus, there is little evidence that the tax cuts are significantly boosting economic performance.

Economists agree that cutting taxes reduces revenue

No reputable economist, liberal or conservative, has ever shown that tax cuts pay for themselves, and economists are virtually unanimous in concluding that tax cuts reduce revenue. This consensus holds even among economists who have served at high levels in the Bush Administration.

For example, N. Gregory Mankiw, chairman of the President's Council of Economic Advisers during the President Bush's first term, wrote in his popular introductory economics textbook that there is "no credible evidence" that tax cuts pay for themselves, and that an economist who makes such a claim is a "snake oil salesman who is trying to sell a miracle cure." [12]

Supply-Side Theory Has Failed Before

In 1981, Congress approved major supply-side tax cuts that featured large reductions in marginal income-tax rates. In 1990 and 1993, by contrast, Congress raised marginal income-tax rates on the well off. Analysts thus can compare two decades with sharply contrasting tax policies.

TABLE 3: Comparing the 1980s and 1990s

	Avg. real per capita economic growth	Avg. real per capita income-tax growth
1979-1990	2.0%	0.2%
1990-2000	2.0%	4.2%

Sources: Bureau of Economic Analysis, OMB Historical Tables

- There was no discernable difference in average economic growth rates between the two decades.
- Even though rates of economic growth were virtually identical during these two decades, the growth in real income-tax revenue and total revenue was far higher in the 1990s (when taxes were increased) than in the 1980s (when taxes were sharply reduced).

The international evidence supports a similar conclusion. Based on a review of that evidence, Brookings Institution economists William Gale and Peter Orszag have concluded that "cross-country studies find very small long-term effects of taxes on growth in developed countries."[13] Many studies find no effect whatever.

These results confirm common sense: large tax cuts result in reductions in revenue, tax increases result in increases in revenue, and the general effect of tax cuts on economic growth (beyond the temporary stimulus effects during an economic slump) tends to be slight, especially if the tax cuts are deficit-financed.

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[1] For an analysis of CBO's August 15th "Budget Update" report, see James Horney and Richard Kogan, "What the New CBO Report Shows: Budget and Economic Outlook Has Not Improved," Center on Budget and Policy Priorities, August 16, 2005.

[2] In January, CBO forecast that real GDP for fiscal year 2005 would be $11,148 billion (in 2000 dollars), and has now revised that estimate downwards to $11, 143 billion. In February, OMB forecast real GDP for calendar year 2005 of $11,233 billion, and did not change that figure in its July Mid-Session Review..

[3] See for example Stephen Moore "Real Tax Cuts Have Curves," *The Wall Street Journal*, June 13, 2005, p. A13, and Donald Lambro "Deficit Tide Ebbing," *Washington Times*, July 7, 2005, p. A18.

[4] Stephen Moore, Testimony before Senate Budget Committee, February 8, 2001.

[5] Calculations based on CBO Estimates.

[6] The following table shows, in billions of dollars, the growth or shrinkage of corporate tax revenues in one year, relative to revenues in the prior year, caused by the enactment and later expiration of the accelerated depreciation provisions of the 2002 and 2003 tax cuts. (Source: Joint Committee on Taxation, JCX-13-02 and JCX-55-03.) For example, the Joint Tax Committee cost estimates show that the accelerated depreciation tax cut would lose $62 billion in revenues in 2004 but lose only $11 billion in revenues in 2005. Therefore, 2005 revenues will be $51 billion higher than 2004 revenues because of this provision, as shown in the table below ($62 billion minus $11 billion equals $51 billion). In other words, the size of the revenue *loss* under accelerated depreciation shrinks by $51 billion from 2004 to 2005, producing a surge in

revenue collections in 2005 relative to 2004's collections. There will be another, smaller surge in 2006, but after that, the expiration of this provision will slightly retard year-to-year revenue growth (although the expiration will generate higher revenues).

2002	-35	2008	-4
2003	-7	2009	-5
2004	-20	2010	-5
2005	51	2011	-4
2006	40	2012	-3
2007	-1		

[7] See Ed McKelvey, "Daily Financial Market Comment," Goldman Sachs Daily, June 30, 2005.

[8] Payroll tax revenues are higher than OMB had projected in February. But OMB's February projection of payroll tax revenues was noticeably lower than CBO's earlier estimate; in this case, OMB appears to be catching up to CBO.

[9] In its August 2003 *Budget and Economic Outlook*, CBO finds that the revenue measures enacted since 2001 could "…boost the level of potential GDP by as much as 0.3 percent or reduce it by as much as 0.1 percent over the years 2004 to 2008. From 2009 to 2013, it could reduce the level of potential GDP by about 0.4 percent." In regard to the macroeconomic effect of the 2003 tax bill, the Joint Committee on Taxation reached similar conclusions. See: CBO, *The Budget and Economic Outlook: An Update*, August 2003, p. 45; JCT, "Macroeconomic Analysis of H.R. 2: The Jobs and Growth Reconciliation Tax Act of 2003," *Congressional Record — House of Representatives*, May 8, 2003, pp. H3829-H3832. CBO and JCT focused on the long-term or permanent increase in growth that might occur as a supply-side effect of broad-based tax cuts, and the offsetting reduction in growth that might occur because of increased deficits.

[10] Calculations based on Bureau of Economic Analysis data. Economists agree that when the economy is running below capacity, both tax cuts and spending increases can boost economic growth on a short-term basis for demand-side reasons (i.e., by giving consumers more cash to spend). Economists generally agree, however, that these demand-side effects cannot increase long-term economic growth. They also generally concur that tax cuts and spending increases do not pay for themselves even during recessions. Finally, a number of analyses, such as an array of analyses by Brookings Institution economists, have concluded that the recent tax cuts were not well designed to produce immediate economic stimulus.

[11] Isaac Shapiro, Richard Kogan, and Aviva Aron-Dine, "How Does This Recover Measure Up?" Center on Budget and Policy Priorities, August 9, 2005.

[12] N. Gregory Mankiw, *Principles of Economics* (Fort Worth, TX: Dryden, 1998), p. 29-30.

[13] See William Gale and Peter Orszag, "Bush Administration Tax Policy: Effects on Long-Term Growth," Tax Notes, October 18, 2004.