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DROP IN DEFICIT IN 2005 DOES NOT MEAN TAX CUTS ARE SPURRING ECONOMIC AND REVENUE GROWTH; NEW IRS DATA CONFIRM TAX CUTS LOSE REVENUE

by Richard Kogan, Isaac Shapiro, and Aviva Aron-Dine

According to final Treasury Department figures, the deficit for fiscal year 2005 was $319 billion, down significantly both from last year's level and from projections made at the beginning of this year. This progress is due to an increase in tax collections from last year (and from what had been projected earlier this year). Some are using this fact to argue that the tax cuts "are working" and are responsible for stronger economic growth and a large increase in revenues.

But this interpretation is misguided. The recent increase in revenue collections does *not* reflect unexpectedly fast growth in the economy. Revenue levels remain quite *low* by historical standards, and without the tax cuts, revenues would be substantially higher, and deficits substantially smaller.

Recently published Internal Revenue Service data provide additional evidence that tax cuts do not pay for themselves. The IRS data are for tax year 2003, the year in which the Jobs and Growth Tax Relief Reconciliation Act took effect. That legislation enacted tax breaks for capital gains and dividends, as well as reductions in marginal tax rates and other tax cuts. Based on a detailed analysis of individual tax returns for 2003, the IRS concludes, "Because of this law [JGTRRA], even with [an] increase in taxable income, the lower tax rates resulted in a 6.1-percent decrease in total income tax [relative to the previous year]."[1]

There are many reasons to doubt that tax cuts are behind the more recent tax revenue increase.

- *A surge in economic growth is <u>not</u> behind the greater-than-expected increase in 2005 revenues.* While economic growth in 2005 has been somewhat more rapid than CBO projected, it has not been nearly strong enough to account for the unexpected revenue growth. GDP growth in fiscal year 2005 was less than 1 percentage point above what CBO predicted in January, 2005, while revenue growth was more than 6 percentage points higher.

- *The recent revenue rebound does not make 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 one year (2004) in which revenues

[1] Michael Parisi and Scott Hollenbeck, "Individual Income Tax Returns, 2003," IRS Statistics of Income Bulletin, Fall 2005, http://www.irs.gov/pub/irs-soi/03indtr.pdf.

were lower as a share of the economy than in any year *since 1959*. After a year of such a depressed level of revenue, a large increase in revenue should not be surprising. The critical point is that even with the recent increase, *revenues in 2005 will remain well below the levels at which they were projected to be after the 2001 tax cut was enacted* (after adjusting for the additional revenue losses from the 2003 tax cuts and other tax cuts).

- *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 $51 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 being made when tax returns for 2004 were filed earlier this year. The strong growth in stock values in 2004 did not continue in 2005. Another contributing factor is somewhat higher-than-expected inflation, which generates higher revenues. To the extent that revenues in 2005 are stronger because of higher inflation, however, this revenue growth will largely be offset in later years by higher expenditures as a result of cost-of-living adjustments and other such mechanisms.

- *According to outgoing CBO Director Douglas Holz-Eakin, the increase in revenues may stem in part from tougher tax enforcement.* In a recent interview, Holtz-Eakin speculated that one possible reason for the unexpected upsurge in corporate tax receipts in 2005 may have been stricter tax enforcement and increased attention to accounting by public companies.[2] Improved tax enforcement is welcome but does not reflect stronger economic growth.

- *Federal revenues remain low as a share of the economy, and the long-term fiscal outlook remains grim.* In CBO's most recent report on the 10-year fiscal outlook (issued in August 2005), CBO projected that revenues will *fall* as a share of the economy after 2006 (assuming that the tax cuts enacted since 2001 and AMT relief are extended). Revenues are projected to average 17.1 percent of the Gross Domestic Product over the next ten years, a lower level than the average for the 1950s, 1960s, 1970s, 1980s, and 1990s.

- *Without the recent tax cuts, the deficit in 2005 would have been much smaller.* The cost of the tax cuts enacted since 2001 amounts to $248 billion in 2005, based on estimates from the Joint Committee on Taxation on the costs of the tax cuts and including the higher interest payments on the debt to which they have led. This suggests that in the absence of the tax cuts, the deficit would have been less than $100 billion in 2005.[3]

New Data Confirm that Tax Breaks Lose Revenue

Both aggregate and more fine-grained analyses show that tax cuts, including those targeted at investment, lose revenue. In 2003 Congress substantially reduced the tax rate on income from capital gains and dividends and accelerated reductions in income tax rates. The following table shows the effect of these tax cuts by comparing the *actual* level of revenues in 2003, 2004, and 2005 with the *predicted* level of revenues. (In the table below, the "predicted level of revenues" equals

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[2] Bureau of National Affairs Daily Tax Report, January 3, 2006.

[3] Even if one were to assume that the tax cuts had some positive effects on the economy, the cost of the tax cuts would still account for the majority of the current deficit.

OMB's 2003 revenue projections not including any tax cuts, reduced by the Joint Tax Committee's estimate of the cost of the tax cuts that Congress subsequently enacted.)

The Joint Tax Committee's estimates (and therefore the predicted level of revenues) do not assume any revenue "feedback" — that is, the Joint Tax Committee estimates do not assume that the economy will grow faster as a result of the tax cuts and thereby produce more revenues to offset some or all of the revenue losses from lowering tax rates. The table shows that the actual levels of revenue have been very similar to the predicted levels, which verifies that there has *not* been much or any revenue feedback — the predictions have largely been proven correct. In fact, in two of the three years — and for the three years on average — actual revenues have been *below* the predicted levels. Even in 2005, revenues are only $23 billion, or one percent, higher than predicted. If tax cuts had generated large revenue feedback, revenues would have been well above the predicted levels, instead of at or below them.

Comparing projected revenues to actual revenues
in billions of dollars

	2003	2004	2005	3-yr total
OMB estimate of revenue without tax cuts, made in February 2003	1,867	2,031	2,235	6,133
Cost of enacted tax cuts in & since 2003 (without any feedback), JTC	-53	-132	-104	-289
Predicted revenue (result if OMB and JTC estimates were exactly right)	1,814	1,899	2,131	5,844
Actual level of revenues	1,782	1,881	2,154	5,817
Revenues below (-) or above (+) predicted levels	-32	-18	+23	-27

Based on a more detailed analysis of individual income tax returns, IRS researchers reached the same conclusion: that tax breaks for capital gains and dividends, as well as other tax breaks enacted in 2003, substantially reduced tax revenues. IRS notes, "taxable income, which is the result of AGI less exemptions and deductions, rose 2.5 percent to $4.1 trillion [in 2003]. However, total income tax fell 6.1 percent… for 2003. This was the third successive year that total income tax declined. The decline in total income tax for 2003 reflects the reduction in tax rates, under JGTTRA."[4]

Conclusion

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. According to this argument, revenues may be *higher* than they would have been in the absence of the tax cuts. The consensus among economists and financial analysts and the empirical data, however, are strongly consistent with the basic, common-sense notion that tax cuts do *not* pay for themselves. A recent CBO study, for instance, found that, even given very generous assumptions about tax cuts' impact on growth, they recoup only a fraction of lost revenue.[5]

Not only do the several recent years of revenue declines confirm this, but the experience of the 1980s and the 1990s does as well. The average economic growth rates for those two decades were

[4] Michael Parisi and Scott Hollenbeck, "Individual Income Tax Returns, 2003," IRS Statistics of Income, Fall 2005.

[5] Congressional Budget Office, "Analyzing the Economic and Budgetary Effects of a 10 Percent Cut in Income Tax Rates," December 1, 2005, http://cbo.gov/ftpdocs/69xx/doc6908/12-01-10PercentTaxCut.pdf.

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.[6]

[6] Richard Kogan, "The Simple Story: Tax Cuts Lose Revenues," Center on Budget and Policy Priorities, January 25, 2005, http://www.cbpp.org/1-25-05bud2.htm.