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January 27, 2006

INCREASES IN CBO'S REVENUE PROJECTIONS DO NOT SHOW TAX CUTS ARE HELPING THE ECONOMY

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New forecasts issued by the Congressional Budget Office confirm that if the tax cuts and Alternative Minimum Tax relief are extended, the nation faces large and growing deficits over the next ten years, with total deficits of between $3.5 and $4 trillion over that period.[1]

While still quite high, CBO's current deficit projections are somewhat lower than those issued last January and August. A key reason for the lower deficit estimates is that CBO has revised its revenue projections upwards.

Some proponents of the 2001 and 2003 tax cuts may try to seize on CBO's new budget forecasts to argue that "tax cuts are working." They may claim that tax cuts have led to stronger economic growth and that this growth is the source of the higher revenue estimates.

In fact, however, CBO's report makes clear that stronger growth of real economic activity is *not* the reason for the revised revenue projections. While CBO has revised its revenue projections upward since last January, it has revised its estimates of real economic output slightly *downward*. Moreover:

- The CBO report states explicitly that CBO's expectations for real GDP growth are essentially unchanged since August and that higher inflation, not higher economic growth, is the reason for higher revenue forecasts. CBO writes that "increases [in the revenue projections] occur mainly because of a rise in projected GDP, which derives from higher prices in the economy, not real economic activity."[2]

- CBO projects real economic growth averaging 3.38 percent per year between 2006 and 2010, as compared with its January 2005 projection of 3.43 percent average annual growth over the same five-year period. In contrast, as noted, CBO expects somewhat higher revenues between 2006 and 2010 than it projected last January. Since CBO's revenue and real economic output forecasts have moved in opposite directions, expectations of stronger growth cannot be the reason for CBO's expectation of higher revenues.

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[1] Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2007-2016," January, 2006.

[2] CBO, "Budget and Economic Outlook," p. 83.

Furthermore, comparing CBO's projections for real GDP and employment growth over the next five years with actual real GDP and employment growth over the equivalent 5-year period of the 1990s economic expansion shows that growth during the 1990s expansion — which occurred following significant tax increases — was notably stronger. Real GDP growth during the equivalent period of the 1990s business cycle averaged 4.0 percent per year, in contrast to the 3.4 percent CBO projects for the next 5 years. Employment growth averaged 2.4 percent per year in the 1990s, as opposed to a projected 1.1 percent for the next 5 years.[3]

One possible source of confusion regarding CBO's new revenue forecasts is that CBO labels the factors explaining its changes to the projections "economic." The economic changes referred to, however, are not changes to real GDP growth projections, but, as discussed above, primarily higher-than-expected inflation in 2005. In addition, CBO writes that its revenue estimates are influenced by expectations of higher near-term corporate profits due to "downward reestimates of contributions to defined-benefit plans."[4]

There may also be other explanations for higher-than-expected levels of revenue. For example, former CBO director Douglas Holtz-Eakin recently speculated that one explanation for the unexpected surge in corporate tax receipts in 2005 may have been stricter tax enforcement and increased attention to accounting by public companies.[5] Improved tax enforcement is very welcome, but it does not reflect stronger economic growth.

CBO's increase in projected revenues since last January and August should also be considered in the context of the path of revenues over the past few years. As revenues declined in nominal terms for three straight years in 2001, 2002, and 2003 (the first time this happened in the U.S. since the 1920s) and in 2004 reached their lowest level as a share of the Gross Domestic Product since 1959, CBO found itself consistently overestimating revenues. This may have led CBO to be especially cautious in raising its projections as revenues began to rebound somewhat in 2005 (especially since, as a share of GDP, actual revenues in 2005 are still well below the average of 18.3 percent of GDP for the last 30 years). It would not be surprising, therefore, if at least some of CBO's increase in projected revenues since last August were the result of a natural tendency to become somewhat less cautious after another year of revenue growth.

Even with the unexpected gains, projected revenues remain low by historical standards. CBO's estimates show that, if the tax cuts and AMT relief are extended, revenues as a share of the economy over the next decade (2007-2016) will be lower than they were in the 1960s, 1970s, 1980s, or 1990s.

CBO's new study consequently underscores the need to address deficits and low revenue levels. It does not support the view that tax cuts constitute a 'free lunch.'

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[3] Employment growth and, to a lesser extent, real GDP growth to date during the current economic expansion also have been lower than during the equivalent period of the 1990s business cycle. This means that in order for average growth rates in this cycle to catch up with those in the 1990s cycle, the economy and employment would have to grow *more* rapidly in the next five years than during the equivalent 1990s period. Instead, CBO projects slower economic and employment growth over the next five years than over the comparable period of the 1990s. For more detailed comparisons of growth rates during this and other economic recoveries, see Isaac Shapiro, Richard Kogan, and Aviva Aron-Dine, "How Does This Recovery Measure Up?" Center on Budget and Policy Priorities, Revised January 9, 2006.

[4] CBO, "Budget and Economic Outlook," p. 83.

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