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POLICY POINTS

October 27, 2006

# THE PHANTOM FEDERAL REVENUE "EXPLOSION"

The final budget figures announced by the President on October 11 forecast higher revenues and a lower deficit for fiscal year 2006 than OMB and CBO had projected earlier in the year. The Administration has greeted this news as evidence that its tax cuts are "working," by generating strong economic and revenue growth. The President even suggested that the tax cuts are paying for themselves — i.e., that they have not reduced revenues at all. The reality, however, is quite different.

- After adjusting for inflation and population growth, revenues have not even returned to the level they reached more than five years ago. Real per-capita revenue growth since the current business cycle started in March 2001 has been *negative*. In previous post-World War II business cycles, in contrast, real per-capita revenues grew an average of about 10 percent during the business cycle's first five and a half years.

| Total Real Per-Capita Revenue Growth in 22 Quarters after the Last Business Cycle Peak | |
|---|---|
| Current Business Cycle | -0.4% |
| Average for All Previous Post-World War II Business Cycles | 9.8% |
| 1990s Business Cycle | 10.7% |

  While revenue growth has picked up in 2005 and 2006, these revenue "surprises" followed *negative* revenue "surprises" in 2001, 2002, and 2003, years in which revenues came in well *below* the levels OMB and CBO had projected earlier in the year (even after adjusting for the cost of enacted tax cuts).

  In 2001-2003, revenues fell in nominal terms for three straight years for the first time since before World War II. By 2004, revenues were at their lowest level since 1959 as a share of the economy. The recent so-called "surge" in revenues is essentially a rebound from unusual revenue declines.

  In fact, even with this year's revenue increase, the nation's budgetary position has deteriorated more in the past six years than in all but one other six-year period since World War II, going from a surplus of 2.4 percent of GDP in 2000 to a deficit of 1.9 percent of GDP in 2006. (The worst six-year deterioration occurred from 1998-2004.)

- Rather than booming, the economy actually remains *weaker* than in the average post-World War II business cycle, especially with respect to employment and wage and salary growth. Economic growth during the current business cycle has been somewhat below — and investment growth has been considerably below — the average for previous postwar

business cycles. Further, wage and salary growth has been exceptionally weak in this business cycle, and employment growth has been weaker than in *any* previous postwar business cycle.

The only key economic indicator in which the current business cycle has significantly outperformed the postwar average is corporate profits. This combination of strong corporate profits and weak wages and salaries is consistent with other evidence that the lion's share of the gains of the current recovery has gone to those at the top of the income spectrum. As the Congressional Budget Office suggested in May, increased income concentration may also help explain this year's stronger-than-expected revenues, since high-income taxpayers pay taxes at higher rates than less-affluent ones.

- **The President's claim that his tax cuts have paid for themselves is refuted by the Administration's own analysis.** In remarks on October 11 touting the revised deficit figure, President Bush stated, "[some] said that we had to choose between cutting the deficit and keeping taxes low... I strongly disagree with those choices. Those are false choices. Tax relief fuels economic growth, and growth -- when the economy grows, more tax revenues come to Washington. And that's what's happened."

  These remarks mirror previous statements by the President, the Vice President, and key congressional leaders that the increases in revenues in 2005 and 2006 prove that recent tax cuts are paying for themselves — that the economy expands so much as a result of tax cuts that it produces at least as much revenue as it would have without the tax cuts.

  But a Treasury Department analysis presented in OMB's Mid-Session Review now confirms what outside experts have consistently said: tax cuts do not come anywhere close to paying for themselves. According to the Mid-Session Review, extending the President's tax cuts could have positive long-term economic effects that might raise national income by "as much as" 0.7 percent over the long term. Under other assumptions, the tax cuts would actually *reduce* long-run national income. But even if the more optimistic estimate is accepted, the projected increase in national income would pay for *less than 10 percent* of the cost of the tax cuts.

  For example, in 2016 the tax cuts will cost $314 billion, according to the Joint Committee on Taxation. In that year, a 0.7 percent increase in national income would be equivalent to $146 billion, of which no more than 20 percent would be paid in taxes. The additional economic growth would offset at most about $29 billion (20 percent of $146 billion) of the tax cuts' $314 billion cost, or less than 10 percent of it. The tax cuts would still add substantially to the deficit.

  Estimates from non-Administration sources are even more sobering. The Congressional Budget Office, the Joint Committee on Taxation, and academic economists have all found that deficit-financed tax cuts, such as those enacted since 2001, are as (or more) likely to *reduce* national income over the long run as to increase it, because of the corrosive effects over time of persistently high deficits. If the tax cuts' long-run economic impact is negative, their long-run cost would be even higher than anticipated, rather than lower.

  Moreover, the projected cost of the tax cuts in 2006 is slightly larger than the 2006 budget deficit. This implies that, while the Administration is celebrating the final deficit figure of $248 billion, the 2006 budget would be essentially balanced were it not for the tax cuts.

**A $248 Billion Deficit in the Fifth Year of an Economic Recovery Isn't Good News**

The bottom of the most recent recession is now nearly five years behind us. With the economic recovery in a mature phase, the government should be running small deficits or even surpluses in order to increase national saving (which is at historic lows) and help prepare the nation for the baby boomers' impending retirement, which will place new pressures on Medicare, Medicaid, and Social Security.

Instead, the Administration is now celebrating a 2006 deficit of about $248 billion.
Moreover, deficits inevitably will rise when the current expansion ends and the next recession starts, or even sooner; the Administration itself projects that the deficit will rise in 2007. And the new projections do not materially alter the grim long-term budget picture. When asked whether the lower 2006 budget deficit indicates that deficits will be lower in future years, former Congressional Budget Director Douglas Holtz-Eakin answered: "No."

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