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OMB'S MID-SESSION REVIEW
Does an Increase in Revenues this Year Really Mean Future Deficits are Under Control?

by James Horney and Richard Kogan

The *Mid-Session Review* released July 13 by the Office of Management and Budget is consistent with a recent report from the Congressional Budget Office that shows revenues for fiscal year 2005 will be significantly higher than estimated earlier this year and that the deficit for 2005 consequently will be lower than was projected. According to OMB, the deficit for the current year will be $333 billion, or $94 billion lower than the deficit level that it projected when it released the President's budget in February.

KEY FINDINGS

- The Administration is overly optimistic in assuming that the recent increase in revenues signifies that revenues in future years, as well, will be substantially higher than earlier projections indicated.
- An examination of factors behind the recent increase in revenues does not support the notion that the President's tax cuts are substantially boosting the economy and increasing tax collections.
- OMB's estimates of deficit levels for the coming five years appear unrealistically low.
- The troubling long-term budget outlook has not significantly changed.

The increase in federal revenues for the current fiscal year (OMB now estimates that revenues will be $87 billion higher than it projected in February), and the resulting reduction in the projected deficit for 2005, are good news. But the Administration's reaction to this news is troubling. Based on the greater-than-expected level of revenues in recent months, the Office of Management and Budget now is assuming that revenues also will be substantially higher than earlier projected for each of the next five years. Over the five years (2006-2010), the increase in projected revenues totals $409 billion. As a result, OMB has reduced its projections of deficits under the President's policies for the 2006-2010 period. The Administration also is claiming that these reductions in projected deficits prove that the President's 2001 and 2003 tax cuts are working and that deficits can be brought under control even if the additional tax-cut measures the President is proposing, including making the 2001 and 2003 cuts permanent, are adopted.

The Administration almost certainly is being overly optimistic about the significance of this year's increase in revenues. There are good reasons to doubt:

- That the tax cuts enacted in 2001 and 2003 contributed significantly to the unanticipated increase in revenues this year;

- That the increase in revenues in 2005 signifies that revenues in future years will exceed earlier projections by as much as the Administration is now assuming;

- That deficits will be as low as OMB is projecting for the next five years; and

- That the longer-term budget outlook has significantly improved.

A More Realistic Assessment of the Budget Situation

Despite the Administration's claims, the budget outlook for future years has not been substantially improved by the increase in revenues for 2005. A more realistic assessment of the budget situation finds the following.

- *Many of the factors behind the substantial 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. In addition, the recent revenue increases evidently reflect the rise in the stock market in 2004, which resulted in increased capital gains and estimated tax payments when tax returns for 2004 were filed earlier this year. This increase in the market, however, has not continued in 2005. Finally, corporate tax legislation enacted last October contained a provision (relating to profits that U.S. companies have earned abroad and kept overseas) that was specifically designed to produce a one-time gain in revenues this year. The Joint Committee on Taxation has estimated that this one-time gain will be followed by revenue losses in subsequent years. (For a more in depth discussion of 2005 revenue trends, see Richard Kogan and Isaac Shapiro, "Revenue Collections in 2005: What Does the Recent Increase in Revenues Signify?," Center on Budget and Policy Priorities, revised July 13, 2005.)

  Commenting on the increase in revenues earlier this month, Congressional Budget Office Director Douglas Holtz-Eakin warned against assuming that the recent increase in revenues significantly changes the budget outlook. "I do hope people are taking this with a grain of salt and not thinking this is 1998 all over again," Holtz-Eakin said. "There's simply no question if you take yourself to 2008, 2009, or 2010, that vision is the same today as it was two months ago."[1]

  Similarly, while agreeing with OMB's increased estimate of revenues *for 2005*, the investment firm of Goldman Sachs, in an analysis issued on July 13 after release of the Mid-Session Review, expressed skepticism about OMB's assumptions regarding increased revenue levels in subsequent years: "More controversially in our view, the OMB also lowered its estimates for

[1] Jonathan Weisman, "Economic Growth, Tax Receipts Combine to Reduce Deficits," The Washington Post, July 2, 2005, p. D1.

budget deficit in 2006-2010 by an average of $65 billion per year. We differ on the longer-outlook…."[2]

- *The increase in revenues in 2005 does not indicate that the President's tax cuts are boosting economic growth and thereby raising revenues.* Economic growth in 2005 has not been unusually rapid. Nor has it been stronger than was projected earlier this year. The Mid-Session Review itself makes that clear in acknowledging that "The projections for the main macroeconomic variables — real GDP, inflation, unemployment, and interest rates — have not changed materially since the 2006 Budget."[3] In fact, the Administration's estimate of real growth in the economy in 2005 is exactly the same now as it was in the February budget — 3.6 percent. Thus, the unexpected gain in revenues does not reflect faster-than-anticipated economic growth.

  Furthermore, 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 in revenues as estimated by OMB, revenues in 2005 still will be *$91 billion below* the level at which they were projected to be in 2005, under the projections that CBO made in January 2002, following enactment of the 2001 tax cuts. (In making this comparison, the January 2002 CBO projections have been adjusted downward to reflect the cost of tax cuts enacted since then.) The consensus among economists and financial analysts, as well as the empirical data, reflect the basic, common-sense notion that tax cuts do not pay for themselves.[1] (See the box below, which cites a recent analysis by the investment firm Goldman Sachs that debunks the "Laffer Curve" theory that tax cuts increase revenues.)

- *Deficits in the next five years are likely to be substantially higher than OMB is projecting.* If revenues do not increase in future years at the rate that OMB is assuming, deficits will be significantly higher over the next five years than the deficits estimated in the Mid-Session Review. Even in the unlikely event that revenues are as high as OMB assumes, deficits still will be considerably higher than OMB is projecting, because of costs that the Administration has not included in its deficit estimates.

  - The Mid-Session Review includes no funding after 2006 for operations in Iraq and Afghanistan or for the broader war on terrorism. Even if the number of troops in Iraq can be drawn down gradually after next year, the additional funding that CBO has estimated would be needed would add $216 billion to the deficit over the next five years (above what the Mid-Session Review shows), including the increased interest payments on the debt.

  - The Mid-Session Review also assumes no costs for continuing relief from the Alternative Minimum Tax or otherwise reforming it. The Administration has indicated that changes in the AMT should be revenue neutral. This is a laudable goal, but the Administration has not suggested how such changes should be paid for, and it seems unlikely that Congress will offset the large costs of extending AMT relief (or repealing the AMT altogether). According to the Congressional Budget Office, simply extending the AMT policy that is slated to expire at the end of 2005 would add about $200 billion to the deficit over the next five years.

[2] "Daily Financial Market Comment," Goldman Sachs Daily, July 13, 2005.

[3] Office of Management and Budget, *Mid-Session Review: Fiscal Year 2006*, p. 12.

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]."

Repealing the AMT without offsets, as provided for in legislation introduced by a bipartisan group of Senators in May, would add more than $350 billion to the deficit over five years — and nearly $1.2 trillion over 10 years, assuming that the President's tax cuts are made permanent.[4]

- *The longer-term budget outlook has not improved significantly.* Because the Mid-Session Review, like the President's budget in February, covers only the years through 2010, it does not show what happens to deficits in the longer run. CBO's March 2005 reestimate of the President's budget, which estimated the effects of the President's budget policies through 2015, showed that deficits would decline gradually through 2010 but then begin swelling. Moreover, CBO's estimate itself likely underestimated the problem, because it did not include the costs of those policies the President left out of his budget, such as funding for operations in Iraq, Afghanistan, and the war on terrorism after 2006.

As noted above, the left-out costs almost certainly will increase deficits over the next five years above what OMB has projected. The added costs will be greatest after 2010, the last year that the Mid-Session Review covers. For example, the funds omitted from the budget for overseas operations related to the war on terror would add more than $210 billion to deficits in 2011 through 2015. (This reflects CBO's estimate of these costs and includes the additional interest payments that

[4] See, James Horney, "Repealing the Alternative Minimum Tax Without Offsetting the Cost Would Add $1.2 Trillion to the Federal Debt Over the Next Decade," Center on Budget and Policy Priorities, June 9, 2005.

would result from this spending.) Simply extending current AMT relief would add more than $550 billion to deficits in 2011 through 2015 (assuming the expiring tax cuts are extended). In addition, the Mid-Session Review includes the cost of only two years of the President's Social Security proposal, because the plan would not take effect until 2009. In 2011 through 2015, the proposal would add $681 billion to deficits (including interest costs), based on estimates issued by the Social Security actuaries.

When these costs are taken into account, it is clear that the budget outlook for the next 10 years under the President's proposed policies remains rather bleak, even if OMB's optimistic assumptions regarding future revenue growth are borne out. Deficits would still begin to grow at the beginning of the next decade and mount to quite high levels by 2015. The budget situation then would deteriorate further in the years after 2015 as increasing numbers of baby-boomers retire and per-person health care costs continue to grow faster than the economy.

Conclusion

The unanticipated revenues in 2005, and the resulting reduction in the deficit for this year, represent good news. But the good news is limited and should not lead to complacency. In fact, the recent increase in revenues collections could even have the unfortunate effect of making the longer-term budget outlook worse if a misreading of the new data and their implications leads policymakers to ignore the plain reality that current budget policies are unsustainable.