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ARE CBO BUDGET PROJECTIONS STILL UNDERSTATED?

Confronted with a torrent of tax dollars, the Congressional Budget Office (CBO) has revised its surplus projections upward several times in 1998. In January, the CBO had projected a $5 billion deficit for 1998 but surpluses of $127 billion for 1998-2003 and $655 billion for 1998-2008. In March, the CBO changed its 1998 forecast to an $8 billion surplus but added only $11 billion to projected surpluses for all subsequent years. In May, as tax revenues continued to pour into Washington, the CBO upped its 1998 forecast to a $43-$63 billion surplus, raised its 1999 forecast to a $30-$40 billion surplus, but said it expected the changes for years beyond then to be "smaller amounts." In its July budget update, the CBO projects a $63 billion surplus for 1998, an $80 billion surplus for 1999, a $583 billion surplus for 1998-2003, and a $1,611 billion surplus for 1998-2008. These are enormous numbers, but they may still be too low.

If the CBO projected that revenue growth would merely match nominal GDP growth, the 1998-2003 surplus would be $167 billion greater than it currently projects and the 1998-2008 surplus would be $570 billion greater, boosting the 11-year total [surplus] to more than $2.1 trillion.

For several years, federal revenues have climbed substantially more rapidly than nominal gross domestic product (GDP). Between fiscal years 1995 and 1998, for example, nominal GDP growth averaged 5.3% annually while revenue growth topped that by 3 percentage points yearly, averaging 8.3% annually; for fiscal year 1998 alone, nominal GDP is expected to increase 5.2% while revenues jump 8.7%. The CBO's projections, however, assume that this pattern is suddenly about to reverse itself. According to the CBO, revenues will increase only slightly more rapidly than nominal GDP in 1999, considerably more slowly than nominal GDP in fiscal years 2000, 2001, 2002, and 2003, and generally no faster than nominal GDP in subsequent years.

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The surpluses currently being projected indicate that policymakers now have a major opportunity to reform the troubled U.S. tax system in ways that would substantially reduce both its inefficiencies and its complexity. If the actual surpluses prove to be higher, the opportunity to make positive tax changes would be even greater. Unfortunately, unreasonably low CBO projections may deter policymakers from acting on this opportunity.

Another consideration for policymakers is that, except for a brief period during World War II, federal revenues have never commandeered a larger share of GDP than they are now (20.5%). It is only by postulating that revenues will suddenly grow more slowly than GDP that the CBO can project a reduction in the revenue-GDP ratio without the need for a tax cut. If the historical relationship holds and taxes are not reduced, the government will be setting new records every year in the share of

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people's productive output it is taking away in taxes.

Despite the CBO's projection, two lines of reasoning suggest that, unless there is tax relief, revenues are likely to continue growing faster than nominal GDP. First, part of the increase in nominal GDP is attributable to inflation, and inflation would push up taxes and nominal GDP at equal rates even if the tax code were fully indexed for inflation. In actuality, because many tax provisions lack inflation protection (some examples are the alternative minimum tax's exempt amount, the income threshold for taxing social security benefits, the computation of capital gains, and the corporate income tax's progressive rate schedule), the government reaps an inflation dividend from taxpayers (albeit a much smaller inflation dividend that before the Reagan Administration introduced inflation indexing in the 1980s.) Thus, to the extent nominal GDP increases because of inflation, federal revenues would be expected to increase as rapidly or more rapidly than nominal GDP.

As [budget] surpluses mount, there is less and less reason to endure tax inefficiencies and complexities that could be corrected through well designed relief.

In addition, nominal GDP increases because of real growth in the economy. Some real growth occurs simply because population is increasing. Real growth from this source tends to increase federal revenues at the same rate as GDP. Real growth also occurs, though, because people are becoming more productive over time, resulting in rising wages and incomes. Because the tax system is progressive, real growth per capita pushes people into higher tax brackets, which causes the government to take a larger share of their incomes. (Tax indexing does not cover real wage growth. In fact, even if the CPI slightly overstated inflation, tax indexing does not fully offset the combined effects on real tax collections of productivity-related wage hikes and inflation.) Thus, the portion of real growth attributable to higher population will tend to raise federal revenues in line with GDP increases and the portion attributable to higher productivity will tend to boost revenues relative to GDP. Either way, there is no explanation for revenues growing more slowly than GDP.

The Taxpayer Relief Act of 1997 (TRA-97) included some tax reductions phased in over several years. Could the phased-in tax cuts of TRA-97 explain why the CBO is projecting such slow relative growth in federal revenues? No, even if TRA-97's changes are added back to revenues, the CBO is still projecting that revenues will grow more slowly than nominal GDP.

Another possible explanation for revenues suddenly growing more slowly than GDP would be a redistribution of GDP from taxpayers subject to high tax rates to taxpayers subject to low tax rates. Among those taxed at higher rates are corporations, and the CBO does project that corporate profits as a share of GDP will decline somewhat over the next five years. But this does not explain the revenue slowdown. The CBO's projection for revenue growth, excluding corporate income taxes, is not quite as slow as the CBO's projected growth rate for all revenues, but it still trails GDP growth for several years starting in 2000 and then in later years grows no more rapidly.

Tax collections have been running much higher than the CBO had previously forecast mainly in the area of personal income not subject to withholding. Due to the government's slowness in analyzing tax return data, the sources of that taxable income are not yet known with certainty. Two often-mentioned possibilities are non-corporate business income and capital gains realizations. Business income has been strong and capital gains realizations have been bolstered by lower tax rates and a strong stock market. If business income and capital gains realizations are the sources of the robust revenue growth, there is no reason to expect them to evaporate, barring undesirable policy changes such as higher taxes, more government regulations, or higher inflation.

The CBO argues, however, that because the sources of the higher-than-it-expected taxable income are not yet entirely clear, the income from those sources should be assumed to be atypically high in 1998, and the CBO arbitrarily excludes part of it in projecting future taxable income and tax collections. This arbitrary exclusion is a key reason the CBO projects that revenues will increase more slowly than GDP for several years and then increase no more rapidly. As explained, this result is peculiar because, unless taxes are cut from time to time, revenues tend to increase relative to GDP due to inflation and real growth.

The uncertainty about the source of higher-than-anticipated current revenues could be resolved very quickly if the Internal Revenue Service immediately analyzed a sample of recently received tax returns. With literally billions of dollars of tax relief perhaps hanging in the balance, such a sample should be examined at once.

In the discussion thus far, it has been assumed that the CBO's assumptions about GDP growth are accurate. In reality, they may be too pessimistic—especially if pro-productivity tax relief is enacted to invigorate the U.S. economy. The CBO assumes that real GDP will grow less than 2.2% annually over the next decade and that for most of the period the unemployment rate will be more than a percentage point higher than it is presently. The CBO is apparently still wedded to the idea of the Phillips curve and cannot believe that unemployment much under 6% can coexist for very long with low inflation. If the CBO did not assume the economy would expand so little in the future, its revenue projection would be much higher (the size of the economy is one of the most powerful determinants of tax revenues), leading to far larger surpluses.

The strong possibility that the CBO is still underestimating budget surpluses underscores the desirability of tax relief. As surpluses mount, there is less and less reason to endure tax inefficiencies and complexities that could be corrected through well designed relief.

Changes that ease anti-production tax biases will tend to strengthen the economy and sustain the economic expansion, leading to further benefits for everyone, and recouping much of the static revenue loss in the process. In contrast, if tax relief is not forthcoming, the American people may be condemned to paying a steadily mounting share of their incomes and output to the government, weakening the economy and income growth in the process. Further, while some claim that Washington will use the projected surpluses to pay off the federal debt, a more realistic appraisal is that Washington will soon channel into increased government spending whatever it does not relinquish through tax cuts, notwithstanding the waste, inefficiency, and perverse incentives of many government spending programs.

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