Quick Study

A Policy Report Summary by the Institute for Policy Innovation

The Case For A $Trillion+ Tax Cut

A Summary of IPI Policy Report #147

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Last year, Congress forfeited a golden opportunity to cut tax rates and begin overhauling the federal tax system because Congressional Budget Office (CBO) projections misled Congress and the public. In 1997, just as it had in every year since 1993, CBO greatly underrated the economy's performance and vastly underestimated revenues.

This year, it appears that CBO is continuing to low-ball economic assumptions and revenue projections for the sixth year in a row. The trillion-dollar question is, "Will Congress fall for it again?"

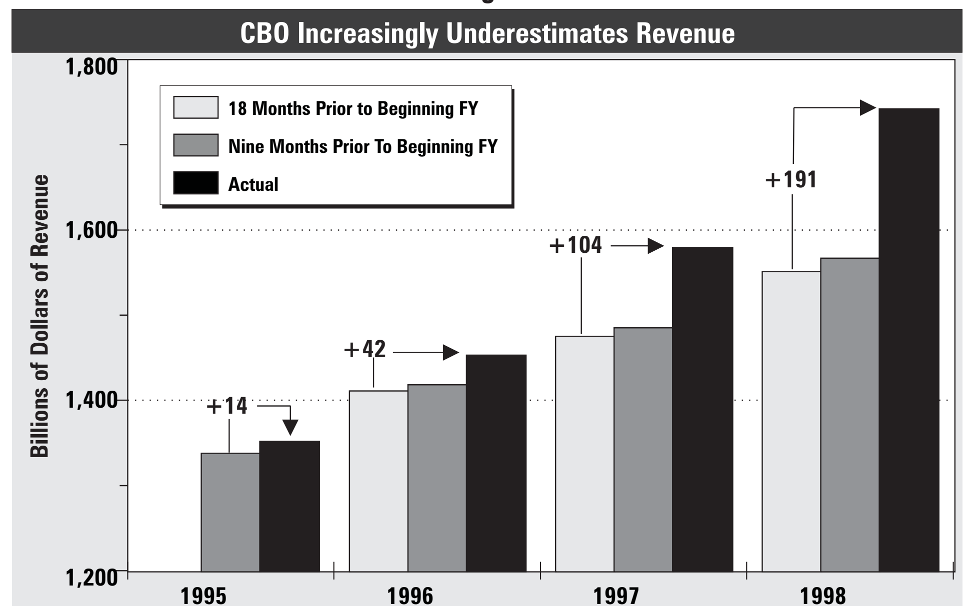
"April Surprise"—1997. By the time April rolled around in 1997, the Clinton White House and the Republican Congress had agreed in principle to slow the growth of federal spending sufficiently to balance the budget by 2003. Congress also was promising to cut taxes by $85 billion over five years, about $17 billion a year, and the President was proposing a number of new spending programs.

At the height of the negotiations between Congress and the White House, the Congressional Budget Office discovered that it had underestimated 5-year revenue projections by $185 billion due to so-called "technical revisions." "April Surprise!" Suddenly, it became possible to increase the size of the tax cuts from $85 billion up to as much as $270 billion, or $54 billion a year, and still balance the budget on schedule. Remarkably, Congress refused to devote any part of the April revenue surprise to increasing the size of the tax cuts and instead dedicated the "found" revenue to funding several of President Clinton's new spending proposals and to somewhat larger annual deficit reduction between 1998 and 2003.

The Overselling of the Balanced Budget Amendment (BBA). After enactment of the BBA in September 1997, when CBO did finally revise its economic assumptions and update its budget projections, the estimated revenue loss due to the tax cut was factored in, depressing projected revenues and partially obscuring the powerful effect higher economic growth was having on revenues. More than half (59 percent) of the $391 billion projected deficit reduction recorded between CBO's last pre-BBA projection (May, 1997) and its first post-BBA projection (September, 1997) was due to revised economic assumptions.

The Scramble To Spend Surpluses. A projected federal budget surplus is a self-negating proposition. The very act of projecting sur-

Figure 1



pluses sets in motion irresistible political forces that will invariably claim and then consume most if not all of the surpluses before they ever materialize in reality. Thus, it goes without saying that unless surpluses are returned to taxpayers in tax cuts, they will be spent by politicians.

While brazenly taking credit for balancing the budget, for which they held only secondary responsibility, Congress and the President were also beginning to concentrate on how they would use the rising tide of revenue for political advantage.

President Clinton devised a two-pronged strategy to ward off tax cuts. First, he sought to soak up some of the surpluses by proposing a virtual cornucopia (some $45 billion worth over five years) of new entitlement spending targeted to benefit constituencies viewed with great sympathy by the public. Second, if surpluses do materialize, Mr. Clinton says he wants to "put Social Security first" by reserving every dollar of any surplus for Social Security.

But it is a practical impossibility for the federal government to reserve, save, or set aside a surplus. The federal government by law, and wisely so, is not permitted to save or invest surplus revenues in the sovereign debt of foreign nations nor may it invest them in private equities or debt instruments.

Since it is really impossible to "save" surpluses, the President must argue that debt retirement indirectly strengthens Social Security by improving the economy. But the problem with this theory—call it "austerity economics"—is that it has precious little empirical evidence to back it up.

Therefore, the best and highest use of the federal surplus is to leave it in the private economy to begin with where the money will do the most good.

"April Surprise"—1998. As Figure 1 illustrates, CBO's estimating errors in 1997 were simply the continuation of a trend and a harbinger of more mistakes to come in 1998.

As April 1998 approached, Wall Street analysts and Washington economists were warning of another "April Surprise." The author and Lawrence Kudlow, Chief Economist at American Scandia Life Assurance Co., independently stated publicly that the 1998 surplus could go as high as $70 billion.

Finally, on May 5, 1998 CBO conceded that another April revenue surprise had occurred. According to CBO's new estimate, revenues in fiscal year 1998 would be at least $1,710 billion, $131 billion higher than CBO had projected in its initial post-BBA projections last September. CBO acknowledged that the 1998 budget surplus would be at least $43 billion.

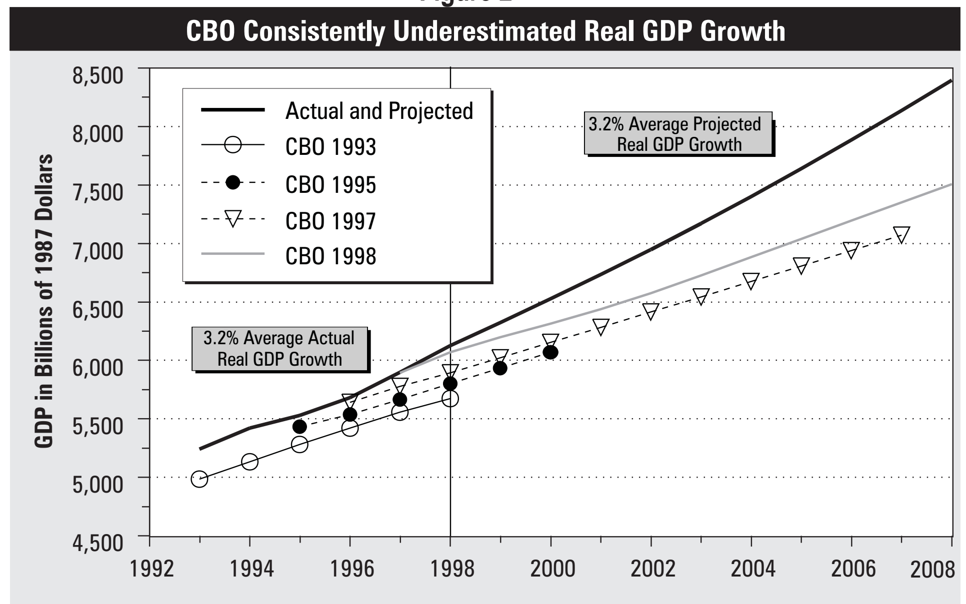
One Source Of CBO's Estimation Errors. Consistent with long-standing practice, CBO Director June O'Neill refused to change CBO's pessimistic long-run outlook for the economy, which in the past exaggerated projections of future deficits and now dampens projections of future budget surpluses.

No matter what near-term adjustments must be made in CBO's forecasts to bring them into line with reality, the long-run assumptions are sacrosanct CBO's tenacity in the face of reality is documented nicely in Figure 2.

The reason CBO seldom can find data that "indicate any long-term improvement in the economy" is that the Keynesian macroeconomic model used at CBO posits a theoretical speed limit on the economy of about 2.3 percent a year. Since the American economy seldom grows this slowly for more than a couple of years at a time, there is hardly a time CBO can see any upward potential for the economy. In fact, the better the economy is doing when CBO is in the process of raising its near-term economic outlook to comport with reality, the worse the future looks to CBO. Thus, CBO's assumptions are usually biased against the idea of cutting taxes.

Figure 2

CBO Consistently Underestimated Real GDP Growth



CBO is like the proverbial farmer for whom the weather is always too wet or too dry. In CBO's Keynesian world, the economy is either growing too fast or too slow. In either case, tax cuts are considered ill-advised.

Looking Forward Into An Era Of Surpluses

The Bias In CBO's Revenue Estimates. Taking the tax code as a given, revenue growth is largely a function of **nominal** GDP growth (unadjusted for inflation). CBO projects average nominal GDP growth of 4.7 percent during the next five years, little less than average annual nominal GDP growth of 5.3 percent during the preceding five years when real growth averaged 3.2 percent. Clearly, either CBO is intentionally low-balling the revenue estimates or something is afoot to alter the relationship between GDP growth and revenue growth.

Figure 3 illustrates what is going on. In the entire period 1960-1998, revenues grew annually by about 1.1 percent on average for each one percentage point increase in GDP. Since 1992, revenues have grown slightly less than 1.4 percent for each one percent that nominal GDP has grown. The longest time frame during which revenue elasticity remained below its long-run mean was the four years 1990-1993. Yet, CBO projects that revenue elasticity will remain depressed below the long-run mean for the next ten years.

Even more difficult to comprehend is the fact that beyond 1998, CBO projects revenue consistently growing **slower** than nominal GDP, i.e., elasticity remaining below 1.0, in seven years out of ten.

CBO Ignores Real Bracket Creep. Short of a deep and lingering recession, the only way CBO's revenue projections can come to fruition is if its presumed abrupt change in the relationship between revenue growth and GDP growth comes about. CBO has been expecting this reversal for some time now, hence its consistently low revenue forecasts.

However, it is not unreasonable to hypothesize, contrary to CBO, that there has been a permanent upward shift in mean revenue elasticity. In a rapid-growth, sound-money environment, markedly higher tax rates superimposed on top of shallow income brackets create significant real bracket creep. Although the bracket thresholds are indexed for inflation, they are not also indexed for real growth in income. Therefore, each year the economy grows, large numbers of taxpayers are propelled into higher tax brackets as a result of normal real increases in income, e.g., receiving a routine raise or taking a second job.

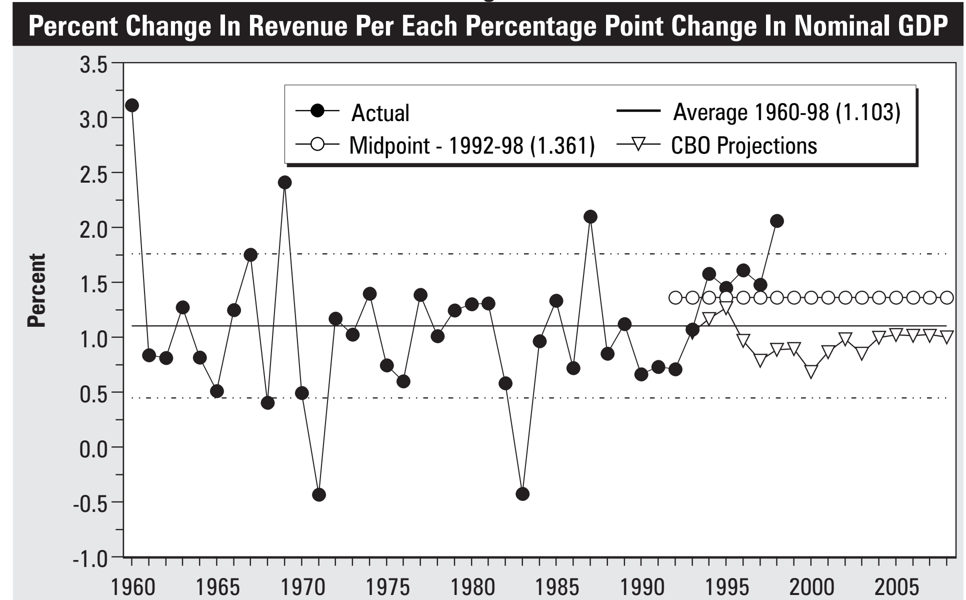
Unlike the 1970s, when rapid inflation, an unindexed tax code and very high tax rates drove people into tax shelters, today inflation is virtually nonexistent and the tax code has been stripped of most shelters so that even with tax rates higher than optimal for economic performance, federal revenue growth does not suffer. And, with the introduction of Roth IRAs, in spite of higher marginal tax rates, individuals still have a greater incentive to earn and declare taxable income and save it for future withdrawal at retirement tax free on principle and on capital gains and interest buildup.

Another factor that has led to a permanent increase in and generated continuous upward pressure on revenue elasticity was the 1994 elimination of the maximum on the amount of wages, salaries and self-employment income that is subject to the 2.9% Medicare-payroll tax. On top of income-tax and payroll-tax real bracket creep, more taxpayers also fall into the Alternative Minimum Tax (AMT) each year because it is not even indexed for inflation.

As a result of pervasive real-bracket creep over time, a growing proportion of taxpayers each year will find themselves paying a larger share of their income in federal taxes. It is not surprising, therefore, that federal revenues have risen from 17.7 percent of GDP in 1992 to the 20.8 percent expected this year.

Figure 3

Percent Change In Revenue Per Each Percentage Point Change In Nominal GDP



Conclusion

Since Republicans took control of the Congress in 1994, the White House has agreed to abide by Congressional Budget Office economic and budget projections for purposes of negotiating annual budget agreements. This report concluded that CBO's projections are usually biased against tax cuts, in part, because the economic model from which they derive is biased against economic growth above about 2.3 percent a year. Secondly, CBO's apparently *ac hoc* revenue-elasticity assumptions are so out of sync with past and current reality that they cannot be taken seriously.

In addition to criticizing CBO's overall forecasting track record, this report also has been critical of CBO's now routine *ad hoc* "revenue surprises," unaccompanied by revised economic assumptions to explain why the revisions were necessary and what they imply for the future.

The tax burden is at an all time high save for one year at the height of World War II. If economic growth remains high, surpluses will swell to enormous proportions and revenues will continue to gobble up a larger share of GDP. Therefore, *every* taxpayer deserves a tax cut.

At the same time, there is a reasonable possibility that the economy may stumble under this growing tax burden. Therefore, the economy does indeed "need" dramatic tax rate reductions if only to innoculate it against the President's very pessimistic economic forecast. Giving surpluses back to the people who created them in the first place, therefore, is desirable on a number of grounds but none more important than keeping the economic expansion rolling.

Allowing the economic expansion to falter now would be not only harmful but senseless. We have at our fingertips the means to avert a slowdown. And, with the tax burden at a peacetime high, if real growth slows only to 2.5 percent, large budget surpluses remain in the offing. As Jack Kemp said recently, "There is absolutely no downside to enacting broad-based, across-the-board, pro-growth, pro-family tax cuts now— Reaganesque in character, a tax cut for everyone, not just politically favored groups."

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