Executive Summary

Since Republicans took control of the Congress in 1994, the White House has agreed to abide by Congressional Budget Office (CBO) economic and budget projections for annual budget agreements. This report is an examination of CBO's economic and revenue forecasting records throughout the 1990s. The author, Empower America Chief Economist Larry Hunter, concludes 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.

"CBO's projections are usually biased against tax cuts."

The report is also critical of Congress for its delay last year in receiving CBO's mid-year economic and budget revisions until after it passed the Balanced Budget Act (BBA). This delay obscured the true fiscal health of the United States at the time the BBA was under negotiations and misled both politicians and taxpayers as to the true effects of the balanced budget agreement. Without timely and accurate revenue and surplus projections, Congress falsely assumed that the long-run fiscal environment was still one of deficits, not surpluses, even though in retrospect it is clear that *budget surpluses were baked in the cake before the BBA was even enacted into law.*

Both Congress and the President seem to be ignoring the larger economic picture as they go about business as usual. The current economic expansion is now within a half-year of the length of the 92-month Reagan expansion, the longest peace-time economic expansion on record. In addition, the Clinton Council of Economic Advisers forecasts that economic growth will plummet from its current robust annual rate of about 3.9 percent a year to 2.0 percent during each of the next two years, and that it will rise thereafter to no more than 2.4 percent.

"The fastest way imaginable to turn President Clinton's pessimistic economic forecast into a dismal economic reality is to maintain high tax rates on saving, working and investing."

If the President is correct and the economy does slow dramatically, revenue growth is certain to fall along with it. Hence, the argument being used by the President and many Members of Congress against tax cuts—that budget surpluses may be only transitory—will become a self-fulfilling prophecy. ***The fastest way imaginable to turn President Clinton's pessimistic economic forecast into a dismal economic reality is to maintain high tax rates on saving, working and investing just in order to hoard budget surpluses in Washington.***

The tax burden is at an all time high save for one year at the height of World War II. 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.

We have at our fingertips the means to avert a slowdown. As Jack Kemp said in a letter to House Budget Committee Chairman John Kasich, "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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The Case For A $Trillion+ Tax Cut

By: Lawrence A. Hunter
Chief Economist, Empower America

Introduction

Last year, Congress forfeited a golden opportunity to cut tax rates across the board and begin the process of overhauling the federal tax system. Why? Because erroneous Congressional Budget Office (CBO) projections misled members of Congress and the public into believing that significant tax cuts would be inconsistent with balancing the budget. 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?"

Jack Kemp was among a very small group of people last year who recognized that the United States had entered an era of budget surpluses.[1] He repeatedly brought the fact of impending budget surpluses to the attention of the congressional leadership and to the President. Kemp went so far as to meet privately with President Clinton in an effort to convince him to support using the looming surpluses for broad-based tax cuts.

"Under current circumstances, Reaganesque tax cuts are the order of the day."

Congress and the President turned a deaf ear to Kemp's admonitions last year on the grounds that projected surpluses were uncertain. Therefore, in early 1998 Mr. Kemp assembled a group of economists and budget experts to analyze CBO's projections and help him prepare a more realistic alternative economic and budget outlook.[2] Mr. Kemp transmitted his conclusions in a memorandum to Speaker of the House Newt Gingrich and Senate Majority Leader Trent Lott on May 6, 1998. In that memorandum, Kemp placed current proposals to reduce taxes and spending by $150 billion over five years into the context of today's new fiscal reality:

> "Budget surpluses are not random events and they do not simply 'dissipate' into thin air. Unless we go on a spending binge or make a policy mistake and send the economy reeling, budget surpluses are baked in the cake as far as the eye can see.…with all due respect, a $150 billion tax cut is minuscule in light of the $1.3 trillion tidal wave of revenue rolling toward the Treasury. Under current circumstances, Reaganesque tax cuts are the order of the day."[3]

Estimating Errors and Publication Procrastinations

"April Surprise"—1997.

By the time April rolled around last year, 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 over the tax cuts and the President's new spending proposals, the Congressional Budget Office discovered that it had underestimated 5-year revenue projections by $185 billion due to so-called "technical revisions." "April Surprise!"

"Congress refused to devote any part of the April [1997] 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."

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.[4] The stated rationale for not devoting any part of the "April Surprise" to tax cuts was that CBO's revenue adjustment was a one-time, technical correction that did not promise permanently higher revenue flows into the Treasury.

Belying this explanation is the fact that Congress not only refused to devote any part of the "April Surprise" to larger tax cuts but also purposely delayed receiving official mid-year economic and budget revisions from CBO until after it passed the Balanced Budget Act of 1997 (BBA) and companion legislation (The Tax Payer Relief Act of 1997) in late July which contained the $85-billion tax cut.[5] By doing so, Congress managed to avoid having to confront even higher revenue projections that would have resulted if CBO had revised its economic assumptions to comport with reality prior to passage of the BBA.

The Overselling of the BBA.

In September after enactment of the BBA, 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. Moreover, because CBO had never revised its pre-BBA deficit baseline using more realistic economic assumptions, the post-BBA budget projections, which *were* based on updated economic assumptions, gave an wholly misleading impression of the BBA's contribution to balancing the budget. 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. See Table 1.

Table 1
Congressional Budget Office (Deficit) and Surplus Estimates Pre & Post Balanced Budget Act of 1997

Source: U.S. Senate Budget Committee and Author's calculations.

[1] Author's simulation of what CBO's deficit projections pre-BBA would have been had CBO revised its economic assumptions in July 1997 before passage of the BBA rather than waiting until September 1997 after the BBA was enacted into law.

Congressional Budget Office (Deficit) and Surplus Estimates Pre & Post Balanced Budget Act of 1997
(Billions of Dollars)

Date of Estimate	Fiscal Year						
	1997	1998	1999	2000	2001	2002	Total
March 1997	(115)	(122)	(149)	(172)	(167)	(188)	(913)
May 1997	(67)	(89)	(109)	(121)	(95)	(105)	(586)
Simulated July 1997 [1]	(22)	(49)	(66)	(77)	(66)	(77)	(357)
Pre-BBA Estimation Error 3/97 -7/97	93	73	83	95	101	111	556
Sept. 1997	(34)	(57)	(52)	(48)	(36)	32	(195)
March/May 1998	(22)	43	30	1	13	67	176
Post-BBA Estimation Error To Date (9/97 - 5/98)	44	92	96	78	79	144	533

CBO shows cumulative six-year deficits between 1997 and 2002 falling from $586 billion in its May projection to $195 billion in its September projection, leaving the false impression that the BBA was responsible for the entire $391 billion decline. Not so. As Table 1 demonstrates, had CBO revised its economic assumptions and produced revised deficit baselines in July, prior to enactment of BBA, it would have shown cumulative deficits $229 billion lower than CBO projected in May due to changing economic assumptions alone.

The total change in projected deficits/surpluses since a year ago March amounts to a staggering $1,089 billion, only $162 billion of which, or 15 percent, is attributable to the BBA. The other 85 percent ($927 billion) is the result of faster economic growth.

"The total change in projected deficits/surpluses since a year ago March amounts to a staggering $1,089 billion, only $162 billion of which, or 15 percent, is attributable to the BBA."

There is another irony in this confusing maze of budget projections and revisions that seems to have been totally lost on members of Congress. CBO's revenue projections actually went up after enactment of the tax cuts. In its post-BBA revenue baseline (September 1997), which fully incorporates the "static revenue loss" from the tax cuts, CBO projected that revenues would be $119 billion higher between 1997 and 2002 than it had projected in May 1997 *before* the tax cuts.

In retrospect, it is perfectly clear why all of the procrastination on publishing an economic update until after the BBA passed. Denying taxpayers the $185 billion April revenue windfall was, perhaps, explainable to voters. Explaining why another $120 billion windfall two months later also had to be withheld from taxpayers might well have exposed the entire BBA as a charade.

In January 1998, CBO once again revised its revenue projections upward to account for the effect of the booming economy. By then, however, the "April Surprise" was history, the potential "July Surprise" was suppressed and never materialized, and CBO was now projecting a negligible deficit of only $5 billion for 1998 and small surpluses beginning in 2001. Congress and the President both were claiming credit for balancing the budget and patting themselves on the back for impending surpluses.[6]

From Deficits To Surpluses

The Scramble To Spend Surpluses.

A projected federal budget surplus is a self-negating proposition. The very act of projecting surpluses 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. But in Washington, DC, what normally goes without saying, is better said, repeatedly.

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. Suddenly, politicians in both political parties, in both the legislative and the executive branches, from both ends of the ideological spectrum, all found themselves with a common interest in preventing the American public from learning the truth about the fiscal circumstances of the federal government in 1998: *There is a tidal wave of revenue flowing right at the United States Treasury.* Whether the revenue swell is eyed for increased spending by Liberals and pork-barrel Conservatives or for debt retirement by congressional debt hawks and an opportunist President in the name of "saving Social Security," anyone proposing that the revenue wave be channeled into tax cuts looms as a common threat who might touch off a taxpayer revolt and thwart the best laid spending plans.

The Plot to Thwart Tax Cuts

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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, he concocted a clever preemptive strategy to prevent surpluses that are not consumed in new spending from being returned to taxpayers in tax cuts. The President says projected surpluses are uncertain, and therefore it would be imprudent to cut taxes before it is certain the surpluses are real and here to stay. In the meantime, if surpluses do materialize, Mr. Clinton says he wants to "put Social Security first" by reserving every dollar of any surplus for Social Security.

Republicans devised their own strategy that paralleled that of the President. One GOP tactic for claiming part of the surpluses for additional spending was to claim all of the gasoline tax for more highway spending. In 1990, the Democrat Congress and President Bush agreed to raise the gasoline tax a nickel a gallon and siphon it off for non-highway spending to keep from having to cut other spending to reduce the deficit. In 1993, President Clinton convinced Congress to put 4.3 cents of the gasoline tax directly into the general fund so that less of the highway trust fund revenues siphoned off had to be replaced with federal bonds. The fiscal reality, however, did not change. Congress continued to authorize less highway spending than there was fuel tax revenue available, and the revenue not spent on highways was spent on other federal programs.

Now that surpluses loom, continuing to take in more motor fuel tax revenue than is spent on highways can no longer be justified. The justification for raising the gas tax and then siphoning it off into the general fund—the deficit—is gone.

"…it is a practical impossibility for the federal government to reserve, save, or set aside a surplus."

The highway spenders, however, profess now to be in high dudgeon because the highway trust fund is being raided and gasoline revenue is going for other than highway spending. The easiest solution to this misuse of the gasoline tax, of course, is to cut the tax. Repeal the gasoline surtax that was originally justified solely on deficit reductions grounds. But, to paraphrase Ronald Reagan, the closest thing to immortality in this life is a federal tax. So, in the name of "reclaiming" the highway trust fund for its rightful purpose, the GOP has latched onto a clever means to justify spending part of the budget surpluses. The highway spenders now claim the right to keep the deficit-reduction gasoline tax in place and to spend it for highways.

The second Republican gimmick to avoid having to cut taxes is to don the Hooveresque mantle of debt retirement. If deficit reduction is good, debt retirement must be even better. Many Republicans even picked up on the President's line that retiring the national debt is the same as "reserving surpluses for Social Security."

Unfortunately for the President and his Republican co-conspirators, 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.

If the federal government collects tax revenue, it must spend it on government programs or use it to retire outstanding debt that was used to finance public spending at an earlier time. Therefore, although he disguises his true intentions behind rhetorical obfuscation about "reserving surpluses for Social Security," what the President really means is he intends to keep taxes higher than they otherwise need to be so the federal government can generate surpluses that can be devoted to retiring debt held by the public.

"…practical experience and economic theory suggest that "austerity economics" is counter-productive and ultimately self-defeating."

"Austerity Economics."

Surplus politics surely does make for odd bedfellows since the President's insistence on "reserving surpluses for Social Security" reduces to nothing more than a Hooveresque preference for debt retirement over tax cuts. Mr. Clinton, meet Mr. Hoover.

Since it is really impossible to "save" surpluses, the President must argue that debt retirement indirectly strengthens Social Security by improving the economy. But this argument reduces to the same case that Hooveresque Republicans must prove in order to convince voters that debt retirement is generally preferable to tax cuts—a heavy burden of proof.

In order to prove their case, President Clinton and his GOP compatriots must demonstrate that the current level of federal debt imposes such a burden that it prevents the economy from achieving its full potential; that if debt held by the public were retired, the rate of return to capital would increase, investment would rise, and the economy would grow faster generating more revenue to support Social Security.

"the best and highest use of the federal surplus is to leave it in the private economy where the money will do the most good and the government will not impose dead-weight loss on the economy by extracting excess revenues through a destructive and inefficient tax system."

The problem with this theory—call it "austerity economics"— is that it has precious little empirical evidence to back it up. In fact, practical experience and economic theory suggest that "austerity economics" is counter-productive and ultimately self-defeating. The fallacy of "austerity economics" is that fails to take account of more productive alternative uses of the excess revenue and ignores the high cost of extracting tax revenue from the private economy.

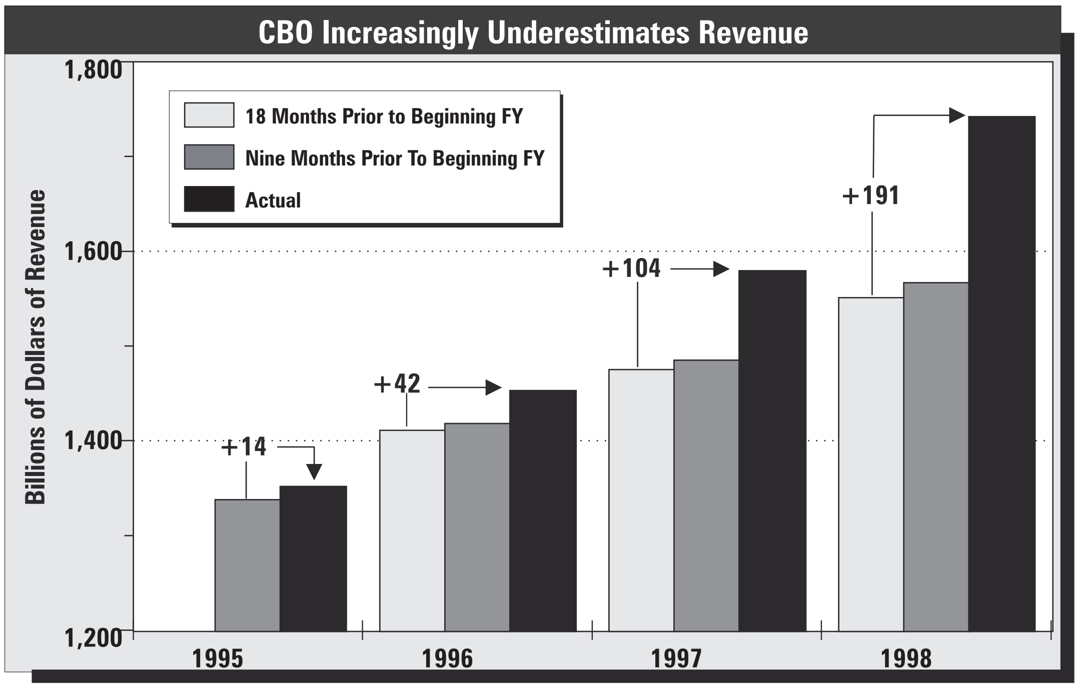
Empirical studies reveal that the current federal tax system is so burdensome and inefficient that the process of extracting each additional dollar in tax revenue from individuals and firms retards economic growth by a total of about $1.50. Even in the extreme, if each additional dollar of public debt retired would produce a dollar increase in GDP—which no one seriously believes—it still would make no sense to keep taxes higher than they need to be just to retire debt. It's like taking two steps forward and three steps back.

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 and the government will not impose dead-weight loss on the economy by extracting excess revenues through a destructive and inefficient tax system. Since the rate of return on those monies if left in the private sector is certain to be higher than the interest on the national debt (now around six percent) saved by retiring it, the most cost beneficial "use" of excess tax revenue is never to raise it in the first place.

"April Surprise"—1998.

Few outside observers have bothered to examine the premises behind the political credit taking for balancing the budget and the posturing over surpluses. Consequently, few people have made an effort to reflect on the huge estimating errors CBO made in the course of a single year. Anyone who does bother to look will notice, as Figure 1 illustrates, that CBO's estimating errors in 1997 were simply the continuation of a trend and a harbinger of more mistakes to come in 1998. Last year's estimating errors and procrastinations over publishing revisions provided a fig leaf for politicians indisposed to tax cuts. But this year as revenues rise, more than a fig leaf will be required to hide the surpluses and save politicians from fiscal embarrassment.

Figure 1
CBO Increasingly Underestimates Revenue



As April approached this year, Wall Street analysts and Washington economists were warning of another "April Surprise." The Federal Reserve Board staff leaked a surplus estimate of at least $50 billion in 1998 and said the surplus easily could go higher. 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. In March, CBO finally nudged its January projection of a $5 billion deficit into the surplus category but insisted the surplus in 1998 would not exceed $8 billion. Throughout the month of April, CBO remained in denial about the full extent of the surplus.

"In a rerun of last Spring, CBO again did not update its economic assumptions."

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.

In a rerun of last Spring, CBO again did not update its economic assumptions. In a letter to House Budget Committee Chairman John Kasich reporting on the revised 1998 surplus figure, CBO Director June O'Neill continued the practice of the past several years of adjusting near-term budget numbers to bring them into alignment with reality while attributing the revisions to episodic events such as "unexpected revenue increases," which is merely a description, not an explanation.

One Source Of CBO's Estimation Errors.

Consistent with long-standing practice, Ms. 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. As a result, CBO's economic assumptions and revenue projections consistently have been and continue to be systematically biased against tax cuts.

"CBO's economic assumptions and revenue projections consistently have been and continue to be systematically biased against tax cuts."

Ms. O'Neill revealed the source of this bias in her letter to Chairman Kasich: "In the absence of an unexpectedly severe downturn in the economy, it seems likely that the surplus will also be larger in 1999 and succeeding years than CBO projected in March. However, *because current data do not consistently indicate any long-term improvement in the economy* relative to our winter forecast, the likely increase in the surplus for 1999 ($20 billion to $30 billion above the March projection) is smaller than the increase in 1998, and the probable increase declines further in subsequent years."[7] (Emphasis added.)

In other words, 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. Consequently, any short-run deviations from CBO's long-run projection trends quickly converge back to trend. It's CBO's story, and CBO is stickin' to it. CBO's tenacity in the face of reality is documented in Figure 2.

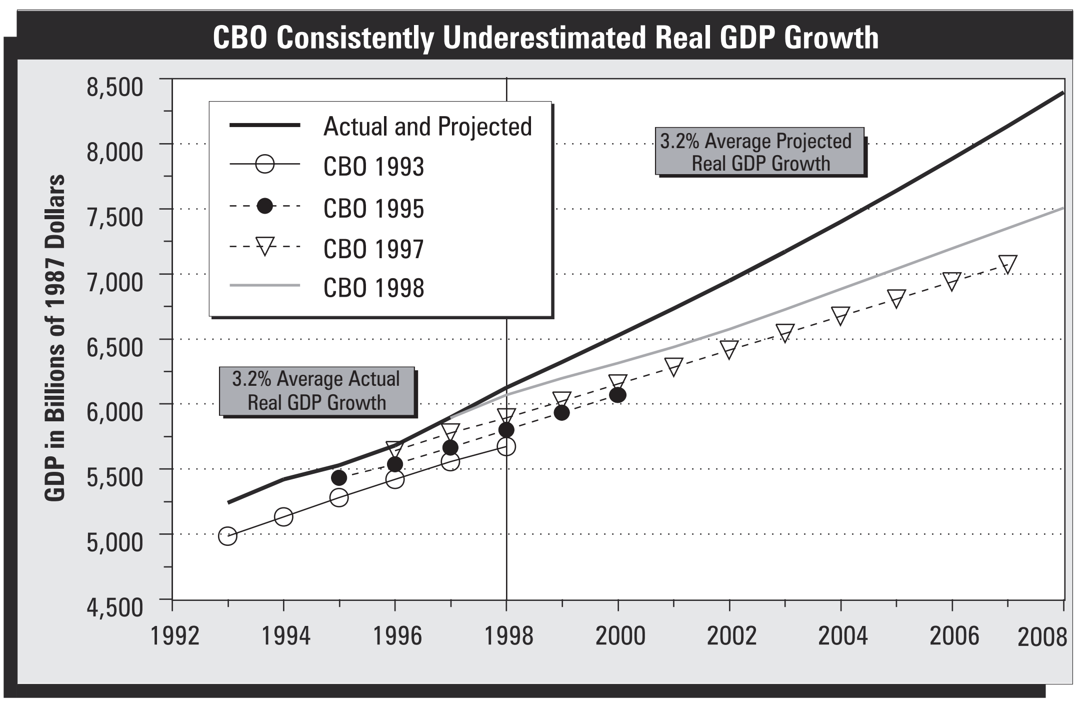


Figure 2
CBO Estimates Underestimate Real GDP Growth

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, usually going into or coming out of a recession, 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. Under its model of the economy, economic growth above 2.3 percent cannot persist for long, so any rapid revenue flows currently being generated by brisk economic growth must of necessity "dissipate" in the near future. Tax cuts would be "risky and imprudent" under these circumstances. On the other hand, if the economy happens to be growing below 2.3 percent when CBO is making its revenue projections, revenue flows will naturally be depressed, and rising deficits or declining surpluses will threaten in the near term. Under the official static revenue-estimating methodology employed by the Congress—which fails to take into account economic improvements that may result from a tax rate reduction—a tax cut under these circumstances would only depress future revenues more and threaten to throw the budget "out of fiscal balance" over the long run. Again, tax cuts are portrayed as risky and imprudent.

"In CBO's Keynesian world, the economy is either growing too fast or too slow. In either case, tax cuts are considered ill-advised."

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.

Reality Contradicts CBO's Economic Model.

The fact is, by the end of 1998 (assuming the economy continues to perform throughout the second half of the year as it has during the first half), the average annual real GDP growth rate since 1993 will equal 3.2 percent, almost exactly the long-run average growth rate since the end of World-War II. Yet, in the face of this robust economic performance, CBO continues to cling, as it has for the past five years, to a long-run outlook for the economy that each year falls further below three percent a year, now projected at 2.1 percent real growth a year through 2008. [See Figure 2.]

The trillion-dollar question remains: Before acting on tax cuts this year, will Congress insist that CBO provide it with alternative economic forecasts and budget projections based on a model other than its tired and discredited Keynesian macroeconomic model, which places a 2.3 percent speed limit on non-inflationary economic growth? Or, will Congress replay last year's game of "don't ask/don't tell" the truth about the optimistic outlook for the American economy and the federal budget?

Looking Forward Into An Era Of Surpluses

The Revenue Outlook.

Based upon monthly Treasury reports, it is virtually certain that revenues will grow between 10 and 11 percent in 1998 over 1997. They grew 8.7 percent last year over 1996, and they grew 7.5 percent in 1996 over 1995—for average annual revenue growth of at least 8.8 percent in the period 1996-1998. Revenues have grown 6.3 percent a year on average since 1981.

Before making its *ad hoc* revenue adjustment in May 1998, CBO was projecting revenues to grow 6.4 percent this year but then fall off thereafter with average annual revenue growth of 3.8 percent in the period 1999-2003. Why are CBO's revenue projections so low?

Part of the explanation for such slow revenue-growth projections has to do with CBO's very pessimistic economic outlook. As observed above, CBO projects average real GDP growth of only 2.1 percent during the next five years.

In response to CBO's persistently unwarranted pessimism, Jack Kemp has called for a trillion-dollar, across-the-board tax cut to return surpluses to taxpayers to fuel the economic expansion and to prevent it from floundering. Kemp reasons that if CBO is correct that real GDP growth is destined to decline to 2.3 percent a year, then Reaganesque tax cuts are the order of the day to raise the return on capital and send the economy back toward its historic expansion path of between 3.0 percent and 3.5 percent real GDP growth a year.

In light of CBO's uninspired economic forecasting record, a number of commentators, including the author, have questioned CBO's revenue and surplus projections on their face because in order to be true they require such a dramatic decline in year-over-year revenue growth, which CBO does not explain. The *prima facie* case against CBO's revenue projections is simply that revenue growth could decline well below its torrid pace of the past five years (about 8.6 percent a year) and still generate considerably larger budget surpluses than CBO currently is projecting. For example, as the author and his colleagues noted in the previously mentioned memorandum to Jack Kemp, if federal revenues were to grow during the next five years at only 6.3 percent a year, the average rate at which revenues grew in the 17 years between 1981 and 1998—as opposed to CBO's January 1998 assumption of a meager 3.8 percent a year—the federal government would take in an additional $1.3 trillion in revenue between 1999 and 2003.[8]

"…revenue growth could decline well below its torrid pace of the past five years (about 8.6 percent a year) and still generate considerably larger budget surpluses than CBO currently is projecting."

While this critique of CBO's surplus projections is compelling, it is preferable to base the argument for a trillion-dollar tax cut on more than a case of first impression. It is especially important to test the alternative hypothesis that the collapse of inflation will mean slower nominal GDP growth and thus lower revenue growth in the future. Moreover, CBO's long-run real growth assumption of 2.3 percent, as low as it may be, is insufficient taken alone to account for a revenue growth rate as low as 3.8 percent a year. In other words, in CBO's world even if it's the real-growth assumptions are raised, the revenue-projecting methodology in use still would predict revenues growing considerably slower than six percent a year. Something else, therefore, must be at play to depress CBO's revenue outlook so dramatically.

The Bias In CBO's Revenue Estimates.

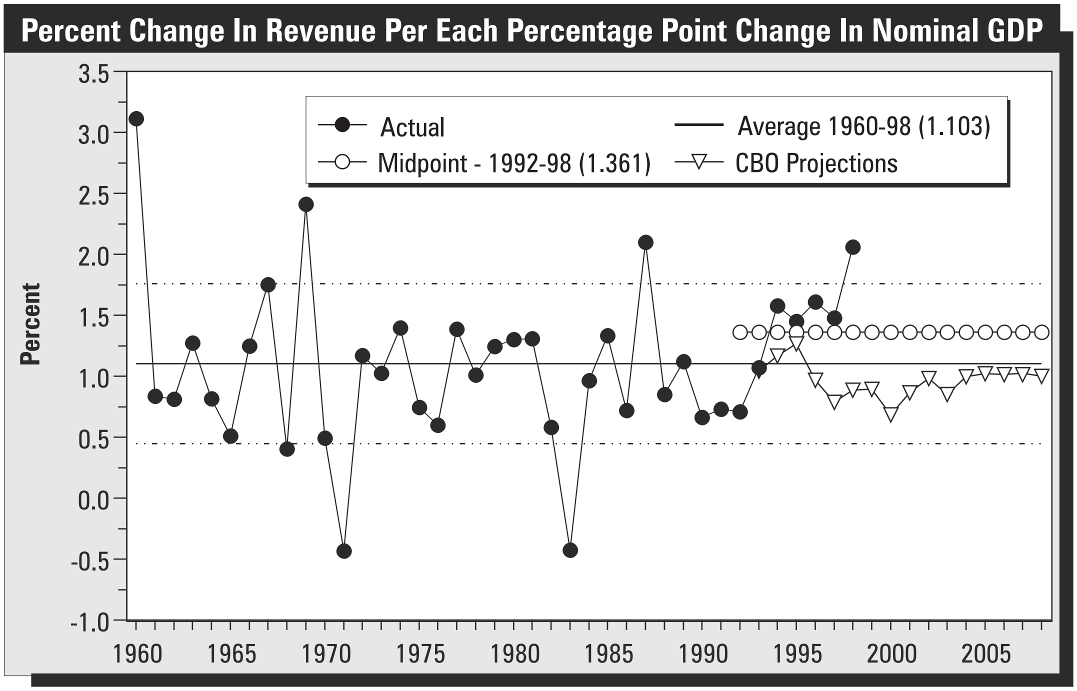
Taking the tax code as a given, revenue growth is largely a function of **nominal** GDP growth (unadjusted for inflation).[9] CBO projects average nominal GDP growth of 4.7 percent during the next five years, little less than average annual nominal GDP growth of 5.3 percent during the preceding five years when real growth averaged 3.2 percent. How can an 11 percent decline in the growth of nominal GDP (5.3 percent to 4.7 percent) translate in CBO's model into a 40 percent decline (6.3 percent to 3.8 percent) in revenue growth? Clearly, either CBO is intentionally low-balling the revenue estimates or something is afoot to dramatically alter the relationship between GDP growth and revenue growth.

Figure 3 illustrates what is going on. The vertical axis measures the annual percentage increase in revenues that has occurred historically for each one percentage point increase in nominal GDP since 1960. This ratio provides a measure of federal revenue elasticity with respect to nominal GDP. The

"…either CBO is intentionally low-balling the revenue estimates or something is afoot"

bold horizontal line at 1.103 is the mean revenue elasticity in the period 1960-1998. The dashed horizontal lines above and below it mark one standard deviation above and below the mean. The horizontal line traced out by open ovals at 1.361 is the mean revenue elasticity during the period 1992-1998. In other words, 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.

Figure 3
Percent Change In Revenue Per Each Percentage Point Change In Nominal GDP



The open triangles superimposed on this historical record plot the same revenue-elasticity measure derived from past CBO revenue and GDP growth forecasts and from CBO's current projections out to 2008.[10] The most striking feature of this picture is how abnormal CBO's projections appear in historic context. Not only did CBO's elasticity assumptions of the recent past turn out to be much too low, its elasticity assumptions beyond 1998 are unprecedentedly low by historical standards. 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. Why? Looking back to 1993, CBO has projected revenue elasticity above (barely) its long-run mean only twice in 16 years.

"The most striking feature of this picture is how abnormal CBO's projections appear in historic context."

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. Never during the entire 1960-1998 period did revenue elasticity remain below 1.0 for more than three years in a row. Before revenue projections based on these weird assumptions can be taken seriously, it is incumbent upon CBO to explain them. And, the burden of proof is doubly heavy in light of the indication in Figure 3 that long-run, mean revenue elasticity may actually have risen since 1992.

Revenue Elasticity in Historic Perspective.

The Reagan tax rate reductions became fully effective in 1983 after a lengthy phase-in period, and revenue flows finally stabilized a year later. Inflation indexing of tax brackets, the standard deduction and personal exemptions took effect in 1985. Then in 1986, Congress passed another major income-tax rate reduction accompanied this time with major base-broadening—some of which was ill-advised and increased the tax burden on capital by increasing multiple taxation of the income from capital.[11] In 1991, a recession year, the Bush administration convinced Congress to increase tax rates again in the name of deficit reduction. Nevertheless, between 1984 and 1991, the elasticity of revenue with respect to nominal GDP deviated about a mean of 1.115 (with a standard deviation of 0.359). For three straight years thereafter, revenue growth remained depressed at or below 0.75 percent for each percentage point increase in GDP growth, matching the longest string of consecutive years in which revenue elasticity remained stuck below 1.0.

Beginning in 1993, the year of the Clinton tax increases, revenue elasticity began to rebound dramatically. For six straight years now, the elasticity measure depicted in Figure 3 has risen almost continuously above 1.0, crossing over 2.0 in 1998. In other words, by 1998, annual revenue growth was proceeding twice as fast as growth in nominal GDP. During this same period, however, CBO's revenue projections would manifest only a slight upward blip in assumed revenue elasticity. By 1996, CBO believed the elasticity of revenue with respect to GDP would fall significantly below 1.0 and stay there for a considerable period of time.

As Figure 3 reveals, CBO has yet to adjust its future expectations to the dramatic change that appears to have occurred in the relationship between revenue growth and GDP growth. Even if CBO believes the 1992-1998 period is an aberration, it is not clear why CBO has failed to bring its projections of the future at least back into line with previously established trends. Between 1999 and 2008, CBO assumes a revenue elasticity of 0.856. In other words, for the next ten years, CBO's revenue projections are based on an assumption that for every one-percent growth in nominal GDP, federal revenues will increase on average by less than nine-tenths of a percent.

"CBO has yet to adjust its future expectations to the dramatic change that appears to have occurred in the relationship between revenue growth and GDP growth."

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. Based upon CBO's most recent revenue projections, it still believes a reversal in revenue elasticity is in the cards. However, CBO offers no explanation for its belief.

There is, however, very good reason to believe that CBO yet again will be mistaken in this belief because its implicit revenue elasticity assumptions are inconsistent with events occurring in the real economy and the interaction of those economic events with changes in the tax code since 1992. Productivity increases and a drop in inflation since 1992 have created enormous forward momentum in the economy. Last year's capital gains tax rate reduction adds an additional boost to economic growth. Even President Clinton's tax rate increases in 1993 could not for long overcome the powerful thrust of high tech and low inflation.

Consequently, 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.[12]

"Even President Clinton's tax rate increases in 1993 could not for long overcome the powerful thrust of high tech and low inflation."

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. In 1997, the Medicare tax base was 8.7 percent larger than it would have been if the cap had remained in place, which in that year alone increased revenues as a share of GDP by 0.1 percentage points beyond what it would have been under pre-1994 tax law. Each year that real incomes grow, therefore, a larger share of wage, salary, and self-employment income is taken by Medicare payroll taxes compared to under the pre-1994 tax code, which also contributes to a higher post-1994 revenue elasticity.

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. The growing proportion of taxpayers falling prey to the AMT is expected to accelerated rapidly in the near future.[13]

"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."

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. In a low-inflation environment, a larger share of nominal GDP growth is real and thus a smaller share of taxable income is sheltered against bracket creep by inflation indexing. For example, with inflation running at about 1.5 percent and real growth at 3.0, only one-third of increases in nominal GDP are shielded against bracket creep. The economy-wide effect is to claim an increasing share of national output for higher federal taxes, which creates continuous upward drift in the elasticity of revenue with respect to GDP toward a new long-run equilibrium.

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. In fact, assuming CBO's current nominal GDP projections, even if revenue elasticity fell suddenly from 2.0 to its midpoint between 1992 and 1998 (1.36), revenues as a share of GDP would rise from 20.8 percent this year (already a peacetime high) to 23.5 percent by 2006 and 24.4 percent by 2008. Even if revenue elasticity fell as low as 1.115 (its average value from 1984 to 1991— just after the effective date of the Reagan tax cuts to just prior to the Clinton tax increases), revenues as a share of GDP would still rise to 21.2 percent of GDP by 2002 and 21.9 percent by 2008.

Clearly then, even if revenue elasticity reverses its upward trend, there is every reason to believe that the structural changes to the tax code since 1992 would leave average revenue elasticity at or above where it was then.

Certainly, there is little reason to expect revenue elasticity to fall below 1.0 as CBO now projects through 2008.

Table 2 shows the likely effect on revenues and surpluses under two alternative scenarios. Both alternative scenarios assume CBO's January 1998 spending baseline. Both alternatives take CBO's nominal GDP projections, and the low real GDP assumptions implicit in them, as givens. These assumptions allow the alternative scenarios to reflect only the effect of changing the elasticity assumption.

Alternative I, a lower-growth scenario, assumes that beginning in 1999, revenue elasticity suddenly falls below its long-run average of 1.103 to 1.0. In this scenario, rather than revenues growing twice or even one-and-one-third times as fast as GDP, as they have since 1992, revenues grow apace with GDP. Under CBO's economic growth assumptions, this change in revenue elasticity translates into average revenue growth of 4.5 percent a year. Under this assumption, cumulative five-year surpluses would amount to $759 billion between 1999 and 2003.

Alternative II, a mid-range-growth scenario, shows what would happen if revenue elasticity did not fall to unity but only to the midpoint of the range in which it moved between 1992 and 1998. In other words, revenue would increase 1.36 percent for each one percentage point increase in nominal GDP. This assumption translates into average annual revenue growth of 6.1 percent. At this rate of revenue growth, five-year surpluses will amount to $1.2 trillion from 1999 to 2003.

Both alternatives are also superimposed on Figure 3 for ready comparison to historical values and CBO's past and current implicit revenue elasticity assumptions.

Table 2
Projected Federal Budget Surpluses Under Alternative Revenue-Elasticity Assumptions

Projected Federal Budget Surpluses Under Alternative Revenue-Elasticity Assumptions

Fiscal Year	1999	2000	2001	2002	2003	1999-2003
CBO Baseline Scenario (March 1998)						
Revenue Elasticity	0.894	0.686	0.865	0.984	0.851	0.856
Revenue (billions)	$1,738	$1,784	$1,847	$1,930	$2,008	$9,307
Revenue Growth Rate	3.8%	2.9%	3.8%	4.5%	4.0%	3.8%
Surplus (billions)	$9	$1	$13	$67	$53	$143
Alternative Scenario I (Revenue Growth equals GDP Growth)						
Revenue Elasticity	1.0	1.0	1.0	1.0	1.0	1.0
Revenue (billions)	$1,817	$1,893	$1,977	$2,067	$2,167	$9,921
Revenue Growth Rate	4.3%	4.2%	4.4%	4.6%	4.8%	4.5%
Surplus (billions)	$87	$111	$144	$204	$213	$759
Alternative Scenario II (Midpoint Revenue Elasticity, 1992-1998)						
Revenue Elasticity	1.36	1.36	1.36	1.36	1.36	1.36
Revenue (billions)	$1,844	$1,949	$2,066	$2,195	$2,339	$10,393
Revenue Growth Rate	5.9%	5.7%	6.0%	6.3%	6.5%	6.1%
Surplus (billions)	$114	$167	$233	$332	$385	$1,231

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. Therefore, the focus of this report has been CBO's economic and revenue forecasting records throughout the 1990s. The 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 the absence of convincing theoretical and empirical justification for them, which CBO fails to provide.

The report also has been critical of Congress for its delay last year in receiving CBO's mid-year economic and budget revisions until after it passed the BBA. This delay obscured the true fiscal health of the United States at the time the BBA was under negotiations and misled both politicians and taxpayers as to the true effects of the balanced budget agreement. The delay was critical last year because after so many years of deficits, politicians and taxpayers were predisposed to be skeptical that the revenue surge and surpluses were for real. Without timely and accurate revenue and surplus projections, Congress falsely assumed that the long-run fiscal environment was still one of deficits, not surpluses. Indeed, the very name of last year's budget agreement, The Balanced Budget Act, reveals this misguided mind set since in retrospect it is clear that budget surpluses were baked in the cake before the BBA was even enacted into law.

"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."

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. As recently as May of this year, for example, CBO produced another *ad hoc* revenue revision accompanied by the remarkable statement that "*current data do not consistently indicate any long-term improvement in the economy.*"

Within two weeks of CBO's most recent revenue revision, the Monthly Treasury Report revealed that through April, revenues are surging into the Treasury even faster than CBO thought. Based upon that report, there is every reason to believe that this year's budget surplus will come in substantially above CBO's upper-range estimate of $63 billion. Indeed, based upon Treasury's April revenue report, if revenues flow into the Treasury during the remainder of the year in the same pattern as last year, the 1998 federal budget surplus will amount to $100 billion this year.[14]

Less than one week after the release of the April Treasury report, in an extraordinary move, the Office of Management and Budget released its mid-year economic and budget revisions three months earlier than last year. Not only were the Clinton Administration's mid-year revisions made uncharacteristically early, the economic growth, revenue and surplus projections were incomprehensibly low. Within a week of the time that the Clinton Treasury Department was indicating a real likelihood of a $100 billion surplus in 1998, the President's budget office came out with a forecast of only $39 billion, less even than CBO's early-May minimum surplus forecast of $43 billion.

Last year, the White House delayed releasing its mid-year budget re-estimates to keep the fact of impending surpluses hidden from the American public long enough for the President to intimidate Congress out of enacting significant across-the-board tax cuts. This year, the Clinton Administration has reversed tactics and is rushing low-ball, mid-year budget revisions ahead in an apparent attempt to freeze in place a surplus estimate so low that there is no room for significant tax cuts.

While the White House works overtime to prevent tax cuts this year, the Congress is actually preparing to **raise** taxes by at least $65 billion. At the urging of President Clinton, the Congress is considering a tobacco tax increase, which would fall primarily on low- and moderate-income taxpayers and amount to about $1,000 per household on average each year.

"While the White House works overtime to prevent tax cuts this year, the Congress is actually preparing to raise taxes by at least $65 billion."

Congress is also considering targeted income tax cuts—at most $20 billion a year, and then only if they are "paid for" by offsetting spending reductions. The one bright spot on the horizon is the fact the House Budget Resolution contains a provision to use part of any budget surpluses to create private retirement accounts, which could provide a stepping stone toward a more comprehensive overhaul of the Social Security system based on private retirement accounts.

Finally, both the Congress and the President seem to be ignoring the larger economic picture as they go about business as usual. The current economic expansion, which began in March of 1991, is now 85 months old, within a half-year of the length of the 92-month Reagan expansion, the longest peace-time economic expansion on record. In spite of this recent stellar economic performance, there is a profoundly disturbing economic forecast buried in President Clinton's mid-year budget re-estimates. The Clinton Council of Economic Advisers forecasts that economic growth will plummet from its current robust annual rate of about 3.9 percent a year to 2.0 percent during each of the next two years, and that it will rise thereafter to no more than 2.4 percent.

"…both the Congress and the President seem to be ignoring the larger economic picture as they go about business as usual."

This news, along with President Clinton's statement that he would oppose any significant broad-based, pro-growth tax cuts, sent stock and bond markets, already concerned about lagging corporate profits, reeling the day the OMB Mid-Session Review was released. The potent combination of high tech and low inflation, coupled with a cut in the capital gains tax to 20 percent in 1997, has propelled this economy forward during the past five years in spite of the burdensome tax hikes imposed on workers, savers and investors first in 1990 and again in 1993. But eventually, the accumulated burden of these high tax rates could derail the economic expansion, especially if they are combined with the President's austerity strategy of retiring national debt under the guise of "saving Social Security." One does not have to be an alarmist to detect signs already, especially with Asia continuing to struggle, that the economic expansion may slow in the not too distant future.

The Clinton Administration's outlook for a languid economy and the stock market's reaction to the President's stubborn resistence to broad-based tax rate reductions may be indicative of pending economic weakness. And, such a possibility belies the argument that the economy does not "need" a tax cut with the stock market flying high and the unemployment rate at a 30-year low. If the President is correct and the economy does slow dramatically, revenue growth is certain to fall along with it. Hence, the argument being used by the President and many Members of

"We have at our fingertips the means to avert a slow-down."

Congress against tax cuts—that budget surpluses may be only transitory—will become a self-fulfilling prophecy. ***The fastest way imaginable to turn President Clinton's pessimistic economic forecast into a dismal economic reality is to maintain high tax rates on saving, working and investing just in order to hoard budget surpluses in Washington.***

Thus efforts aimed at giving targeted tax cuts to favored groups while "paying for them" by offsetting spending reductions miss the point in one direction while those who oppose any tax cuts whatsoever miss it in the other direction. 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.

"There is absolutely no downside to enacting broad-based, across-the-board, pro-growth, pro-family tax cuts now."

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 in a letter to House Budget Committee Chairman John Kasich, "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."

Appendix: Proposal for a Broad-Based, Across-the-Board Tax Cut

- Divert a sufficient share of the payroll tax into private retirement accounts to return the annual Social Security surplus to workers. Diverting the annual cash-flow surplus into private retirement accounts would entail a diversion of approximately two percentage points of the payroll tax into private retirement accounts. An additional two percentage points of the payroll tax could be diverted immediately if the annual interest payment to the Trust Fund were deposited into the private retirement accounts rather than being returned to the general fund as it is under current practice.
- Increase the contribution limit on Roth-IRAs by at least $10,000 and raise the income cap without regard to the aforementioned payroll tax diversion.
- Return the tax code to a flatter two-rate system by repealing the Bush and Clinton top-income-tax rate increases, including the phase outs of personal exemptions and itemized deductions, which were justified solely on deficit-reduction grounds.
- Attenuate real bracket creep and alleviate most of the marriage penalty by widening the 15-percent bracket for everyone and setting the threshold for married couples at twice that for singles while raising the standard deduction for everyone in such a way that, again, the standard deduction for married couples is twice that for singles.

- Cut the top capital gains tax rate to 15 percent—or preferably, enact a 60-percent capital-gains exclusion—and restore the 12-month holding period.
- Fix the Alternative Minimum Tax (AMT) by doubling and indexing the AMT exempt amount, or preferably, eliminate the AMT altogether.

Endnotes

1. In a series of letters to the congressional leadership last year, Jack Kemp questioned and accuracy of CBO's economic and budget projections and called attention to the prospect of budget surpluses in the very near future. He also urged congressional leaders to insist that CBO provide its mid-year economic and budget revisions prior to congressional consideration of tax cut proposals.

2. In a private memorandum to Kemp, Steve Entin (Executive Director of the Institute of Research on the Economics of Taxation), the author, Larry Kudlow (Chief Economist, American Scandia Life Assurance Co.), and Gary Robbins (President, Fiscal Associates) lay out the basis of their belief that cumulative 5-year surpluses would amount to more than $1 trillion in the period 1999-2003 under current law. The memorandum concludes that budget surpluses should be sufficient between 1999 and 2003 to "return the entire Social Security surplus into workers' private retirement accounts and still enact income tax rate reductions (estimated statically) of approximately **$1 trillion over 5 years** and still have a balanced budget." Private memorandum to Jack Kemp, April 30, 1998.

3. Private memorandum from Jack Kemp to Newt Gingrich and Trent Lott, May 6, 1998.

4. At the time of last year's April revenue surprise, it was clear that CBO's economic forecast was considerably at odds with reality. CBO was projecting real, inflation-adjusted, economic growth of 2.3 percent for 1997 and 2.0 average annual growth in the following years. In reality, the economy was growing at 4.1 percent, and most private economic forecasters were forecasting continued robust growth well into the future. Nevertheless, the official CBO economic forecast was not revised in April so the "April Surprise" was completely the result of "technical revisions." Therefore, even after the $185-billion revenue surprise in April, it was unambiguously clear that when CBO finally revised its economic forecast later in the summer to make it consistent with reality, the five-year revenue projections would rise once again.

5. For ease of exposition, in the remainder of this paper the Balanced Budget Act of 1997 and The Taxpayer Relief Act of 1997 are referred to interchangeably as the BBA.

6. The President's unabashed credit-taking for balancing the budget is doubly ironic in light of comments made at a meeting with congressional leaders on July 15, 1997, at a time when he and the congressional leadership were working to prevent higher revenue projections from emerging from CBO or the Office of Management and Budget. According to press accounts, "[Mr.] Clinton appeared annoyed that some financial analysts suggested the five-year spending blueprint is no longer necessary—and perhaps even counterproductive—because tax revenues are coming in so strongly that the deficit is falling far more sharply than expected. . . . The issue is sensitive for Clinton, who raised it without prompting yesterday after fuming to aides last week that he was not receiving due credit for his 1993 deficit reduction plan. It the deficit continues to plummet without further action in Washington, it could diminish any luster of being the president who balanced the budget for the first time since 1969." The meeting also revealed the deal cut between the President and Republican congressional leaders: "At one point, according to officials, House Budget Committee Chairman John R. Kasich (R-Ohio) flew out of his chair as he reminded the president of trade-offs made in a general budget accord in early May. 'You got the $35 billion for education,' he reportedly told Clinton, 'and we got to write the [$85 billion] tax cuts.'" ("Clinton Insists Economy Won't Eliminate Deficit," *Washington Post*, July 16, 1997).

7. June O'Neill letter to House Budget Committee Chairman John Kasich, May 5, 1998.

8. See, Gigot, Paul, "Gingrich Gets Tax Windfall From Kemp," *The Wall Street Journal*, Friday, May 8, 1998.

9. An area of future research is to explore what other variables affect annual revenue growth. Unfortunately, the Congress's proclivity for making major changes to the tax code (e.g., 1981, 1982, 1983, 1985, 1986, 1990, 1993) makes it difficult to isolate factors *ceteris paribus* beyond nominal GDP growth that determine revenue growth.

10. For each fiscal year 1992-1997, the ratio of the percentage change in CBO's revenue projection to the percentage change in CBO's nominal GDP projection was calculated using CBO's baseline forecasts from the January preceding the beginning of the fiscal year. For years 1998 and beyond, CBO's January 1998 baseline estimates were used.

11. In addition to lowering the rates and reducing the number of brackets to two, which was highly beneficial, Congress and the President also, unfortunately, raised the cost of capital more than 40 percent by increasing the capital gains tax and extending asset lives while simultaneously repealing the investment tax credit; devastated the real estate market by enacting new real estate provisions that abruptly collapsed real estate values; weakened American firms international competitiveness with the adoption of new foreign tax provisions; and adopted an alternative

minimum tax that only magnifies and exacerbates the worst anti-growth components of the tax code.

12. For tax year 1997, single individuals were thrown into the 28 percent tax bracket at $24,650, single parents at $33,050 and married couples hit the 28 percent bracket at $41,200, less that half the single threshold. See table below for full rate and bracket structure.

1998 Income Thresholds			
Rate	Single	Joint	HofH
15.0%	25,350	42,350	33,950
28.0%	61,400	102,300	87,700
31.0%	128,100	155,950	142,000
36.0%	278,450	278,450	278,450

13. The Alternative Minimum Tax, or AMT, is an inefficient provision of the federal tax code that has proven inordinately expensive to administer. It began in 1969 to ensure that every taxpayer paid some tax by disallowing certain tax deductions if they reduced tax liability beneath a certain level.

Today, it does not even accomplish that goal. In 1998, only about 1 out of every 150 taxpayers are affected by the AMT. Within the next 10 years, nine million taxpayers a year, one of every 14 taxpayers, will be ensnared by the AMT. The biggest increase in AMT filers over the next ten years will be taxpayers with incomes between $50,000 and $100,000. While these taxpayers accounted for 26 percent of AMT returns in 1997, they will make up 40 percent in 2007. The focus of the tax is quickly shifting away from the rich to those of more modest means—the middle class. See Robbins, Gary and Aldona Robbins, *Complicating the Federal Tax Code: A Look at the Alternative Minimum Tax*, Institute for Policy Innovation, March 1998.

14. Extrapolating the rest of FY 1998 from last year's spending and revenue patterns yields a surplus estimate of $101 billion on revenues of $1,754 billion and outlays of $1,653 billion.

About the Author

Dr. Lawrence A. Hunter is Chief Economist at Empower America. He served as a member of Presidential candidate Bob Dole's Task Force on Tax Reduction and Tax Reform. During the 103rd and 104th Congresses, Dr. Hunter served on the staff of the Joint Economic Committee, first as Republican Staff Director and later as the Chief Economic Advisor to the Vice Chairman where he was the lead staff person in charge of putting together the economic growth and tax cut component of the Contract With America. Prior to joining the JEC staff in 1993, Dr. Hunter was with the U.S. Chamber of Commerce for five years where he served first as Deputy Chief Economist and later as Chief Economist and Vice President. Dr. Hunter received his Ph.D. from the University of Minnesota in 1981.

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