Issue Brief

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Congress' $1 Trillion Opportunity

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The surging U.S. economy is producing an unprecedented tidal wave of tax receipts into the federal coffers this year. The just-released Congressional Budget Office report shows revenues up 11 percent for the first 7 months of the 1998 fiscal year. Americans have already paid $100 billion more to the IRS than they did last year with five months to go.

We predict that given the continued strength of the economy and given the unexpected surge in tax revenues, the federal budget surplus could be roughly $1 trillion higher (over the five-year period) than Congress expected when it drafted the bipartisan budget deal this time last year.

"The federal budget surplus could be roughly $1 trillion higher than Congress expected when it drafted the bi-partisan budget deal this time last year."

One reason taxes are growing so rapidly is that Americans are now confronting the insidious effects of *real* income tax bracket creep. Because of the progressivity of the income tax code, higher income growth is pushing Americans into higher tax brackets. The result: federal taxes are rising at almost twice the pace of wages and salaries. This is creating what Dick Armey referred to last year as a "middle class squeeze."

The dramatically changed budget conditions of the last 12 months underscore the economic and political imperative for a much larger tax cut than is now under discussion.

This is no time to be timid on tax cuts. The congressional leadership is now discussing a $100 billion tax cut for the next five years. This would mean that the government would keep roughly 90 cents of the tax windfall and return only 10 cents to the taxpayers. It will almost certainly invite exactly the flurry of new spending—as President Clinton has proposed—that caused the deficit problem in the first place.

The best budget alternative presented in Congress so far this year was drafted by the Republican House members of the Conservative Action Team (CATs). In that budget, Reps. David McIntosh of Indiana and Mark Neumann of Wisconsin call for a $400 billion tax cut over five years. Although we applaud the spirit of this budget, even the CATs tax cut is too small given the flood of receipts.

"This is no time to be timid on tax cuts."

We believe that at least half of this $1 trillion windfall—and preferably all of it—should be returned to taxpayers via a very large tax cut enacted immediately. If only half is returned, the other half should be used to start the financing of a privatized Social Security system as House Budget Committee Chairman John Kasich and Texas Senator Phil Gramm among

others have proposed. None of the money should be used to expand our already bloated $1.75 trillion federal budget.

A $500 billion-plus five-year tax cut would still allow Congress to balance the budget and reduce debt in every one of the next five years.

"None of the money should be used to expand our already bloated $1.75 trillion federal budget."

We believe that some combination of the following tax relief measures should be adopted this year in a $500 billion to $1 trillion tax cut package:

❶ Use the surplus revenues to begin rolling back the payroll tax and allow workers to put that money into personal retirement accounts.

❷ Widen the current 15% income tax bracket so it applies to all middle income Americans.

❸ Index the income tax brackets in order to end *real* income bracket creep.

❹ Terminate the complicated capital gains holding periods and establish a uniform capital gains tax rate of 15 percent.

❺ Expand tax free savings accounts for education, health care, and retirement.

❻ Reduce income tax rates by one percentage point per year for the next five years, drawing from expected operating budget surpluses (i.e., non-Social Security).

What The New Budget Trends Are Telling Us

Let us begin with a brief summary of critically important recent budget and tax developments.

❶ Federal tax receipts are soaring. Through the first seven months of FY 1998 federal revenues have risen by an enormous 11 percent over last year. If this trend continues through the rest of the year—and we predict only a mild slowdown in receipts—federal tax collections will rise by $120 billion and the budget surplus will climb to at least $65 billion. The table below shows that revenues are already up $70 billion and we have five months to go in the fiscal year.

Table 1
The Tax Revenue Windfall

Source: Congressional Budget Office, May 6, 1998

THE TAX REVENUE WINDFALL
Federal Tax Receipts ($billions)

Month	FY 1997	FY 1998	% Change
October	100	115	15%
November	98	104	6%
December	148	168	13%
January	151	163	8%
February	90	98	9%
March	108	118	10%
April (est.)	229	260	11%
Total Oct.-Apr.	**924**	**1,025**	**11%**

❷ Budget surpluses are already large and growing. They are no longer speculation—they are here. Over the past twelve months the federal government has run roughly a $20 billion surplus. Congress should rightly claim a large share of the credit for this dramatically positive fiscal development. The budget deficit has fallen in four years by more than $400 billion below the 1993-94 Clintonomics baseline of $200 billion deficits as far as the eye could see.

Budget surpluses for the next several years are going to be much larger than either the Congressional Budget Office or the Office of Management and Budget predicted a year ago. The five year budget deal between Newt Gingrich and Bill Clinton envisioned 4 percent revenue growth per year through 2002. But over the past five years we've had 7 percent revenue growth. This year, we're up 11 percent. At this moment, the five year revenue forecast used in the budget deal appears to have lowballed federal tax receipts over the five-year period 1998-2002 by at least $500 billion and perhaps as much as $1 trillion!

"Lower capital gains tax rates are almost certainly one explanation for higher tax revenues."

We recomputed the CBO budget baseline using a reasonable 7 percent revenue growth forecast for the next five years, rather than the unrealistically low 4 percent. Under this scenario, budget surpluses get very large, very quickly. [See Table 2.]

Table 2
Re-Estimated Budget Baseline

Source: Authors calculations based on CBO baseline, 1998.

Re-Estimated Budget Baseline (10% revenue growth in 1998) (7% revenue growth in 1999-2002) (CBO March 3, 1998 outlay path)					
Year➤	**1998**	**1999**	**2000**	**2001**	**2002**
Receipts	1737	1858	1989	2128	2277
Outlays	1672	1730	1782	1833	1863
Surplus	**65**	**128**	**207**	**295**	**414**
Cumulative surplus 1998-2002 = $1,109 billion ($1.1 trillion)					

❸ Lower capital gains tax rates are almost certainly one explanation for higher tax revenues. We still don't have the official IRS data to confirm this, but preliminary CBO data suggest that capital gains tax receipts have ratcheted up from $40 billion a year in 1996 to an expected $80 billion this year. This result, of course, will fit the historical pattern of the last forty years: capital gains rate cuts always lead to more tax revenues, just as a rise in the capital gains rate always reduces tax collections because of the lock-in effect. At a 28 percent rate we were on the wrong side of the Laffer Curve and well above the long term revenue maximizing rate. Re-incentivized risk taking and new capital investment at the lower 20% tax-rate are boosting tax revenues.

❹ Defense cutbacks account for almost all of the slowdown in federal spending. On the expenditure side of the federal ledger, nondefense outlays are up 5 percent per year since 1996. The major reason we have reached a balanced budget is a continued shrinkage of the military budget. Since the peak of the Reagan Cold War build-up in 1987, real military costs have fallen by 30% and $100 billion. Over that same time period domestic outlays have risen by $300 billion. [See Table 3.]

"The major reason we have reached a balanced budget is a continued shrinkage of the military budget."

Table 3
Reaganomics In Reverse

Reaganomics In Reverse (Real Federal Outlays $billions)		
	Defense	**Domestic**
1987	379	832
1998	264	1,160
1987-98	**-115**	**+328**
% Change	-30%	+39%

Needed: A New Budget Downsizing Strategy

Republicans have controlled both houses of Congress now for 3 years, but there is not a single major domestic program—out of the thousands crammed in our $1.75 trillion budget—that has been eliminated by the GOP. This year's Senate Budget resolution didn't even bother to try to eliminate agencies that have been thorns in the side of conservatives for decades: the Legal Services Corporation, the NEA, bilingual education programs, foreign aid, etc.

John Kasich deserves credit for targeting the Commerce and Energy Departments and many other obsolete programs for total elimination in this year's House budget proposal. But many in Congress are back-pedaling from the government downsizing agenda. For example, since there is no longer any energy crisis, why do we need a $16 billion Department of Energy?

"… there is not a single major domestic program… that has been eliminated by the GOP."

In private industry—which is driving this remarkably bullish economic expansion—sweating out waste and unproductive operations to cut costs has allowed American firms to outcompete international rivals. The $1.75 trillion federal government appears to be the only institution in America immune from this competitive restructuring. Over the past 20 years almost no obsolete or ineffective federal government agencies—out of thousands—have been shut down.

We recommend four steps on the spending front.

❶ Enact all of Rep. Kasich's budget cuts and devote every penny of the savings to tax cuts.

❷ Reject all of President Clinton's new spending initiatives. Runaway entitlement spending created the red ink budget mess that has plagued the country for the past twenty years. It makes no fiscal sense to create new entitlements in the areas of health care, day care, and education, as the Clinton White House has requested. So far Congress has done a good job of withstanding the creation of such new entitlements. The best way to deal with Americans' problems of funding quality education, health care, and day care is to cut their taxes, so they can fund these services themselves.

❸ Fix the fiscally reckless highway bill. The highway bill exceeds budget caps by $30 billion. It is also contains more pork-barrel spending projects than any spending bill in at least the past fifteen years. Table 4 (below) shows the escalation of "demonstration projects" in the last four highway bills. Congress should defund the pork projects and bring the spending down to below the budget caps.

Table 4
Pork: Higher and Deeper

Source: U.S. General Accounting Office data.

*House bill, H.R. 2400.

Pork: Higher and Deeper
Earmarked Demonstration Projects in Highway Bills

Year	# of Projects	Cost ($millions)
1982	10	$386
1987	152	1,300
1991	539	6,200
1998	1,467*	9,000

❹ Reject the $18 billion IMF bailout package. Dick Armey is absolutely on the mark in attacking this foreign aid racket.

On Taxes, Time To Be Bold

So far this year Congress has refused to pursue a tax cutting agenda that would provide meaningful relief for working Americans. The problem is worse in the Senate. The original Senate Budget Resolution drafted by Senator Pete Domenici of New Mexico in March called for a microscopic $6 billion tax cut per year—even as a $120 billion revenue flood pours into the Treasury. The original Senate Budget would have had the government keep at least 96 percent of the cash windfall. Taxpaying workers would have gotten back only a pitiful 4 cents on every additional dollar they paid into the federal treasury. Fortunately, Senator John Ashcroft of Missouri has won concessions from the Senate leadership for the larger tax cut levels in the House.

But even the House tax cuts estimated to be roughly $100 billion over five years are minuscule. This would leave at least $400 billion extra revenue for Washington to spend. Moreover, a $100 billion tax cut this year on top of last year's would still amount to only half the relief promised in the original Contract with America budget—when revenues were projected to be much lower. And it would still mean that Republicans will have only repealed about one-third of the tax increases enacted by George Bush and Bill Clinton in 1990 and 1993.

Congress must take aggressive steps to reverse five years of real income tax bracket creep. Because of the steep progressivity of the income tax code, more American families are paying higher marginal tax rates today than at the end of the Reagan years.

"Americans' tax payments are rising at a faster rate than their incomes are."

That is to say, Americans' tax payments are rising at a faster rate than their incomes are. For example, this year income is up a respectable 6 percent, but tax receipts are up 11 percent. The result: federal taxes are now above 20 percent of GDP—the highest burden since the end of World War II. On the margin, the yearly change of individual tax receipts as a share of the change in personal income (less transfer payments) has reached an extraordinary 38 percent. This is the real effective tax burden on middle income working Americans.

To counteract real bracket creep and prevent a torrent of new federal spending, we recommend that the following bold tax cut strategy be enacted this summer.

"… a $500 billion tax cut over five years…would still leave federal revenue projections above the 1997 budget deal forecast. It would still produce a balanced budget with surpluses for debt reduction…"

❶ **AT LEAST A $500 BILLION TAX CUT OVER FIVE YEARS.** This would still leave federal revenue projections above the 1997 budget deal forecast. It would still produce a balanced budget with surpluses for debt reduction every year from 1998-2002.

❷ **INDEX INCOME TAX BRACKETS TO OFFSET REAL INCOME GROWTH.** In 1981 Ronald Reagan wisely indexed the income tax brackets for inflation. Now real income bracket creep should be ended by indexing tax brackets for inflation plus real income growth. Real income tax bracket creep means that over time more and more Americans are pushed into the 28 percent tax bracket, the 31 percent bracket, the 36 percent bracket and so on. Milton Friedman proposed indexing brackets for real income growth many years ago and recently reiterated his support for the policy on April 15th in the *Wall Street Journal*. We strongly agree with Friedman's recommendation. We would also note that this policy costs very little in terms of lost revenues in the short term. But the tax savings multiply dramatically over time because of the insidious compounding effect of real bracket creep. This is also an important step toward a flat rate tax system.

❸ **EXPAND THE INCOME THRESHOLD FOR THE 15 PERCENT TAX BRACKET SO THAT MOST MIDDLE AMERICANS DO NOT PAY A 28 PERCENT RATE.** The 15 percent tax bracket should apply to virtually all middle-income workers. This is especially important because workers with incomes up to $65,000 a year now pay a 15.3 percent payroll tax on top of the 28 percent income tax giving them a very high marginal tax rate. Real bracket creep should be countered by widening the income tax threshold for the 15 percent bracket to a taxable income of $50,000 or more. Currently, singles start paying the 28 percent bracket at a taxable income of $26,000. This idea is being promoted by Senator Paul Coverdell (R-GA), Rep. John Thune (R-SD) and Rep. Mac Thornberry (R-TX).

"The 15 percent tax bracket should apply to virtually all middle-income workers"

❹ **FIX THE CAPITAL GAINS COMPLEXITY AND CUT THE RATE FURTHER.** The 30 new lines on the schedule D tax forms are an abomination. The new holding periods insisted upon by Treasury Secretary Robert Rubin provide no revenues for the government but lots of new revenue for tax accountants. There are now five capital gains tax rates and a multitude of incomprehensible holding periods. Congress should enact a single uniform capital gains tax rate for everyone. We suggest 15 percent.

❺ **CUT THE PAYROLL TAX RATE AND ALLOW WORKERS TO PLACE THE SAVINGS IN PERSONAL RETIREMENT ACCOUNTS.** President Clinton says that the budget surplus should be used to "save Social Security." One way to do that is allow at least 2 percentage points of the payroll tax for each worker to be invested in IRA-type personalized accounts. Democratic Senators Pat Moynihan of New York and Bob Kerrey of Nebraska have supported such a plan, which suggests that a bipartisan privatization plan could be drafted. The Kasich IRA proposal also deserves consideration—but the size of the accounts must be tied to the amount of payroll taxes paid.

We support full and immediate privatization of Social Security, but at least a 2 to 3 percentage point payroll tax cut to finance personal retirement accounts is a good start.

"There are now five capital gains tax rates and a multitude of incomprehensible holding periods."

❻ **ALLOW TAX-FREE SAVINGS ACCOUNTS FOR EDUCATION, HEALTH CARE, AND RETIREMENT**. These are individual-choice, market-based solutions to the three biggest problems facing America today. School choice advocates have the upper hand in the education debate by pursuing initiatives such as the Coverdell education accounts.

❼ **CUT INCOME TAX RATES BY ONE PERCENTAGE POINT PER YEAR FOR FIVE YEARS**. This would lower the top tax rate from 40 percent to 35 percent and the bottom rate from 15 percent to 10 percent. This would have strong pro-growth effects, because taxes, of course, matter most at the margin. Money from operating budget surpluses will be available to fund a rate cut of at least this magnitude.

Conclusion

Congress must recognize that this is the moment to harness prosperity and make bold use of the new era of surplus revenues. Our recommended tax cut measures would represent significant downpayments on even greater future tax simplification and streamlining. They would also put us on the road to long-lasting privatization of Social Security.

The budget and tax strategy we describe would maximize opportunity, enhance individual responsibility and restrain government. Congress has a $1 trillion opportunity. Now is the time to act.

About The Authors

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He is a regular commentator on CNBC and a weekly columnist for Bloomberg News. Mr. Kudlow is also a regular op-ed contributor to the *Wall Street Journal* and the *Washington Times*. He is a contributing editor and editorial board member of *National Review*, and author of *American Abundance: The New Economic and Moral Prosperity*, published by Forbes in January 1998.

During President Reagan's first term, Mr. Kudlow was the associate director for economics and planning, Office of Management and Budget, Executive Office of the President. Mr. Kudlow served as co-chairman of the Economic Recovery Council in New Jersey Governor Christine Todd Whitman's first election campaign in 1993.

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Mr. Moore is a contributing editor to *National Review*. He is also a regular contributor to *The Wall Street Journal*, *Human Events*, and *Reader's Digest*.

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