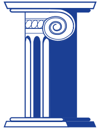

INSTITUTE BRIEF

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Tax Cuts and Revenue Growth

By Jonathan J. Miltimore

In August, the non-partisan Congressional Budget Office (CBO) released a report that received scant media attention. The authors wrote that the budget deficit is expected to decline by $90 billion from the previous year. The current budget deficit is projected to be $158 billion, or a mere 1.2 percent of Gross Domestic Product (GDP).[1]

Although federal outlays are expected to be $16 billion higher than what CBO predicted in its preliminary report issued in March, projected revenues are a whopping $35 billion higher than the March estimate. CBO attributes this increase to "[h]igher-than-anticipated revenues, mostly from individual income taxes…which improved the budget outlook for this year."[2]

This is good news and these numbers deserve scrutiny. A deficit of $158 billion might sound like a large amount, but in an economy that boasts a GDP of over $13 trillion this figure is actually quite insignificant — less than 1.2 percent of overall GDP, well below the 2 percent average over the last quarter century.[3]

The short-term federal budget outlook is entirely sound despite the massive tax reduction on wages and investment following the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA). What is remarkable is that the short term federal budget looks so promising despite the combination of tax reductions and massive spending increases witnessed in recent years.

Since 2000, one year prior to the first tax cut, federal outlays have increased nearly 50 percent — from $1.789 trillion in 2000, to $2.655 trillion in 2006.[4] Federal spending increased at an average annual rate of 8 percent; the rate of inflation increased at an average rate of 2.8 percent per year.[5]

Quite simply, government spending has grown at a rate nearly three times that of inflation. If federal spending had increased at a rate parallel with inflation, the government would not merely have balanced the budget; it would have run a $299 billion dollar surplus. If discretionary spending alone had grown at a rate equal to inflation — meaning entitlement programs such as Social Security, Medicare, etc. are allowed to grow well beyond the inflation rate — the government would still have run a $46 billion surplus in 2006.[6]

What is clear is that those who predicted that tax relief for American families would harm both state and federal budgets and send the economy into a tailspin were wrong. In its last report on the economic outlook, the U.S. Treasury Department announced that a "combination of solid economic growth and improved corporate tax yields have contributed to revenue growth of over 35% since 2003."[7] Two years after the JGTRRA tax cut, the National Conference of State Legislators reported that state budgets were "showing strong signs of recovery in nearly every state. Buoyed by robust revenue performance, states are collecting more revenue than they projected for nearly every major tax."[8]

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But what about the idea that the tax cuts were merely windfalls for the rich? Well, not quite. As the *Wall Street Journal* recently reported, new tax data by the Treasury Department reveals that the earners in the top 1 percent are bearing a *higher* percentage of the overall income tax burden since the JGTRRA tax cut.

Income earners in the top 1 percent currently pay 35.7 percent of all federal income taxes, higher than the estimated 30.5 percent they would have paid without the tax reduction; the top 25 percent pay 84.4 percent, a higher figure than the estimated 81.8 percent it would pay without the 2003 tax cut. Ironically, these figures (35.7 and 84.4 percent) represent significantly higher percentages of total income tax revenue than those in 1980 (19 and 73 percent), when the top income tax bracket was 70 percent (compared to today's top tax bracket of 35 percent).[9]

What can explain this apparent paradox? How did lower tax rates on wealthy income earners (but still significantly higher rates than those paid by lower income earners) result in these earners paying a higher percentage of federal income taxes? The answer is simple: there were lots of more people making lots of more money to tax. From 2003 to 2005 the number of households declaring gross income above $1 million shot up 65 percent, to 300,000. More millionaires mean more taxes at high percentage rates.[10]

The lesson is this: a "soak the rich" tax policy is unlikely to either soak the rich or significantly raise tax revenues. Incentives matter and being able to pay for your daughter's college tuition or move your family to a nicer neighborhood are incentives more likely to inspire citizens to work and acquire skills in high demand than stocking government coffers.

What these government figures reveal is that allowing citizens to work hard and keep a reasonable percentage of their income to improve their lives is not only part of the American dream, it is good economic policy. They also reveal that Congress does not have a revenue problem; it has a spending problem.

(Endnotes)

1. Congressional Budget Office, "The Budget and Economic Outlook: An Update," August 2007, p. 1, <http://www.cbo.gov/ftpdocs/85xx/doc8565/08-23-Update07.pdf> (August 27, 2007).
2. Ibid.
3. Congressional Budget Office, "Surpluses, Deficits, Debt, and Related Series, 1962 to 2006," <http://www.cbo.gov/budget/historical.pdf> (August 27, 2007).
4. Congressional Budget Office, "Revenues, Outlays, Surpluses, Deficits, and Debt Held by the Public, 1962 to 2006," <http://www.cbo.gov/budget/historical.pdf> (August 27, 2007).
5. United States Department of Labor: Bureau of Labor Statistics, "CPI [Consumer Price Index] Inflation Calculator," <http://www.bls.gov/data/home.htm> (August 29, 2007).
6. Congressional Budget Office, "Revenues, Outlays, Surpluses, Deficits, and Debt Held by the Public, 1962 to 2006," <http://www.cbo.gov/budget/historical.pdf> (August 27, 2007).
7. United States Department of Treasury, "Financial Report of the U.S. Government," p. 4, <http://www.fms.treas.gov/fr/06frusg/06frusg.pdf> (August 29, 2007).
8. National Conference of State Legislators, State Budget Update: November 2005, <http://www.ncsl.org/programs/fiscal/sbu200511.htm> (January 30, 2006).
9. "How to Raise Revenue," *The Wall Street Journal*, p. A14, August 24, 2007.
10. Ibid.

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