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Mid-Session Budget Review Shows Surging Tax Revenues

Brian M. Riedl

The Office of Management and Budget has released its annual Mid-Session Review (MSR), an update of its budget projections from this past February. Though a rapid increase in federal revenues shows that the 2003 tax cuts have succeeded in boosting economic activity, the tsunami of Social Security, Medicare, and Medicaid spending still threatens America's fiscal and economic future.

The Big Picture

- The MSR projects a $205 billion budget deficit in fiscal year 2007, down slightly from $248 billion last year. Tax revenues are projected to rise by $167 billion (7 percent), and spending is projected to rise by $123 billion (5 percent). One hundred percent of the budget deficit's decline is caused by revenue increases, and none by spending cuts. Lawmakers have not cut one dollar from the budget.[1]
- At 1.5 percent of GDP, the budget deficit is now lower than it was in 24 of the past 30 years.
- Many will focus on the declining budget deficit. The budget deficit, however, is an overused economic statistic that does not impact economic performance as much as overall spending and tax policies do. To the extent that government borrowing affects the economy, most economists consider the debt-to-GDP ratio—currently 37 percent, below the level of the 1990s—the key measure.[2]

Surging Tax Revenues[3]

- The tax cuts are working exactly as intended. Lower tax rates have increased the incentives to work, save, and invest, and as a result the economy has grown faster than projected. Tax revenues have always been more closely correlated with the rate of economic growth than with tax rates.
- By historical standards, Americans are now overtaxed. Total 2007 tax revenues (18.8 percent of GDP) and individual income tax revenues (8.5 percent of GDP) are well above their historical averages, and even above their averages in the 1990s.[4] Concerns that the Bush tax cuts would lead to a long-term shortfall of government revenues have proven false.
- After increases of 15 percent and 12 percent the past two years, tax revenues are projected to increase an additional 7 percent in 2007.
- The inflation-adjusted 2004–2007 revenue surge of 25 percent represents the largest three-year tax revenue surge since 1966–1969.
- At 2.7 percent of GDP, corporate tax revenues are at their highest level since 1979.
- A low take-up rate for telephone tax refunds also contributed to higher-than-expected tax revenues this year.
- Tax revenues in 2007 are now estimated to be $70 billion above the level projected even *before*

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www.heritage.org/Research/Budget/wm1549.cfm

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214 Massachusetts Avenue, NE
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(202) 546-4400 • heritage.org

the 2003 tax cuts. In other words, tax revenues are now *above* their pre-tax cut baseline.[5]

Federal Spending

- The MSR projects a 5 percent increase in federal spending in 2007, twice the level of inflation. This marks the 14th consecutive year that spending growth has outpaced inflation.
- Total 2007 federal spending is estimated to be 20.2 percent of GDP, up from 18.5 percent when President Bush took office. Had spending remained at 18.5 percent of GDP, this year's budget would show a $35 billion *surplus*. The tax cuts did not create the 2007 budget deficit; rather, an enormous increase in spending created the deficit.
- By the end of FY 2007, federal spending will have increased 49 percent since 2001 (26 percent after inflation). This 7 percent annual growth rate under President Bush is double the 3.5 percent growth rate under President Clinton. One cause for this growth is that necessary increases in national security and war spending have not been balanced with reductions in lower-priority programs.
- Defense and homeland security are not the only areas that have received healthy spending increases since 2001. Large inflation-adjusted increases have also been granted for: education (129 percent), health research and regulation (46 percent), international affairs (55 percent), community development (301 percent, mostly temporary spending related to Hurricane Katrina), and veterans' benefits (34 percent). Federal antipoverty spending now tops 3 percent of GDP for the first time ever. [6]
- Despite this recent spending spree, the budget resolution passed by the Democratic congressional majority increases discretionary spending by another 9.4 percent—$23 billion more than the President's request. If enacted, this spending would likely become part of the permanent spending baseline, costing taxpayers an additional $2,000 per household over the next decade.

Balance by 2012?

- President Bush has pledged to put the budget on a path to balance by 2012. The MSR projects a $33 billion surplus by that year.
- Critics correctly point out that the MSR projects a 2012 surplus by excluding any costs associated with the war on terrorism and excluding the roughly $100 billion cost of extending the Alternative Minimum Tax (AMT) patch.
- However, the projections also likely underestimate tax revenues elsewhere. The MSR:
    1. Assumes no long-term impact from this year's revenue surge.

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1. Unless otherwise noted, all 2007 budget data comes from the Office of Management and Budget, "Mid-Session Review: Budget of the U.S. Government: 2008," July 11, 2007, at *www.whitehouse.gov/omb/budget/fy2008/pdf/08msr.pdf*. All pre-2007 budget data comes from the Office of Management and Budget, "Budget of the United States Government: 2007 Historical Tables," Tables 1.2, 1.3, 2.2, and 2.3, at *www.whitehouse.gov/omb/budget/fy2008/hist.html*.
2. Council of Economic Advisors, "Economic Report of the President: 2007" Table B-79, January 2007, at *www.gpoaccess.gov/eop/tables07.html*.
3. For more on the Bush tax cuts, see Brian Riedl, "Ten Myths About the Bush Tax Cuts," Heritage Foundation *Backgrounder* No. 2001, January 29, 2007, at *www.heritage.org/Research/Taxes/bg2001.cfm*.
4. Office of Management and Budget, "Budget of the United States Government: 2007 Historical Tables," Table 2.3, at *www.whitehouse.gov/omb/budget/fy2008/hist.html*. The 20-, 40-, and 60-year historical averages range from 17.9 to 18.4 percent of GDP for total tax revenues, and 8.0 to 8.4 percent of GDP for individual income tax revenues. During the 1990s, the figures were 18.6 percent and 8.4 percent of GDP, respectively.
5. Following the 2003 tax cuts, the Congressional Budget Office (CBO) lowered its 2007 revenue projections from $2,504 billion to $2,421 billion. Now, 2007 tax revenues are projected at $2,574 billion. See the Congressional Budget Office, "An Analysis of the President's Budgetary Proposals for Fiscal Year 2004," March 2003, at *www.cbo.gov/showdoc.cfm?index=4129&sequence=0#pt3*, and the Congressional Budget Office, "The Budget and Economic Outlook: An Update," August 2003, at *www.cbo.gov/ftpdoc.cfm?index=4493&type=0&sequence=2*.
6. Brian M. Riedl, "Federal Spending by the Numbers," Heritage Foundation *WebMemo* No. 1390, March 8, 2007, at *www.heritage.org/Research/Budget/wm1390.cfm*.

2. Assumes a reduced level for long-term potential real GDP. Specifically, the MSR reduces projected 2007 real GDP growth from 2.7 percent to 2.1 percent but fails to balance this decline with higher growth in subsequent years. There is no discussion as to why there would be a decline in potential GDP and, in fact, no reason to expect a reduction in any of the factors that give rise to long-term potential GDP. This curious practice effectively shifts downward the long-term GDP and tax revenue trend lines.
3. Includes new tax cut proposals that would reduce projected receipts by about $25 billion in 2012 but that are unlikely to be enacted.

- These three factors give the 2008–2012 revenue projections a significantly conservative flavor. It is possible that actual revenues could exceed the MSR's projections enough to compensate for most of the AMT and war on terrorism costs, making a balanced budget possible by 2012.

The Coming Entitlement Crisis

- Despite this short-term deficit reduction, the implications of the long-term spending projections remain dire. In just 6 months, the first of 77 million baby boomers will reach early retirement age, unleashing an unprecedented avalanche of Social Security, Medicare, and Medicaid costs. Funding all of this spending will require permanently raising taxes by $11,651 per household (adjusted for both inflation and rising incomes) or eliminating every remaining federal program.[7]
- Health care spending is skyrocketing. The MSR projects that Medicare will grow 14 percent this year (on top of 12 percent growth last year) and that Medicaid and SCHIP will grow 9 percent. Combined Medicare and Medicaid spending now exceeds Social Security spending.
- Over the next decade, Medicare and Medicaid costs will surge by nearly 8 percent per year, and Social Security costs, by 6 percent annually.
- The Medicare drug entitlement is now projected to cost $822 billion through 2017. It will cost $60 billion per year by 2012 and $119 billion per year by 2017. Its annual expense will continue to rise thereafter.[8]
- There is no way that the revenue sources considered in the MSR can—much less should—cover all of this projected spending. Lawmakers therefore must remain vigilant on spending. They should focus on pursuing long-term entitlement reform and creating a budget process compatible with spending restraint.

—Brian M. Riedl is Grover M. Hermann Fellow in Federal Budgetary Affairs in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.

7. *Ibid.*
8. Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2008 to 2017," Box 3.2, January 2007, at *www.cbo.gov/ftpdocs/77xx/doc7731/01-24-BudgetOutlook.pdf.*