Some Implications of the Revenue Shortfall

C. Eugene Steuerle

"Economic Perspective" column reprinted with permission.

Document date: August 30, 2002
Released online: August 30, 2002

[1] The Congressional Budget Office (CBO) recently released a paper examining changes in its projections of the revenues expected for fiscal year 2002. Revenues dropped precipitously, much more than could be ascribed solely to the slowdown in the economy. One obvious implication is that deficits will be much larger than previously expected. But a number of other implications also deserve attention. Because the amount of fiscal stimulus is very large by any historical standard, the need for additional fiscal stimulus is reduced. The models that project capital gains income and income from stock options need to be revised significantly. Finally, the IRS and Treasury are compelled to come up with a much better and swifter system for tracking changes in receipts.

[2] Between January 2001 and August 2002 CBO's projection for fiscal year 2002 dropped by $376 billion or from 20.5 to 18.0 percent of GDP. [See CBO, "Where Did the Revenues Go?" A Revenue and Tax Policy Brief, August 19, 2002.] The common explanations, of course, were there. New legislation, including the recent stimulus legislation and the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), cut taxes, but ended up to be responsible for only $75 billion or about one-fifth of the shortfall. EGTRRA's full effect on receipts, of course, will be greater in the long-term as more provisions become phased in, but much of the stimulus will go away and, in fact, reverse itself as accelerated deductions today mean smaller deductions in the future.

[3] An economic slowdown will, of course, reduce receipts. If total economic growth is, for example, 4 percentage points below what had been predicted, then receipts might drop by 1 percentage point of GDP if the average tax rate applying to the income shortfall from all taxes, including Social Security and income taxes, equals 25 percent. The CBO projections indicate that the decline in economic growth forced receipts down by $125 billion between the January 2001 and March 2002 projections, but was not a factor in the latest set of revisions from March 2002 to August 2002. While there is no indication yet that the economy performed worse than was known in March, there's still a good chance that national income estimates will be revised.

[4] In the end, economics is not enough, and CBO can only speculate on other causes for the technical shortfall. These include: dramatic drops in capital gains realizations (capital gains distributions from mutual funds alone, it suggests, may have been down by 80 percent in 2001, and reflected largely in lower taxes due and increased refunds in 2002 when people finally filed); and a more equal distribution of income. In the last case, a drop in income at the top of the income distribution reduces marginal tax rates much more than a drop at other income levels. Hence average tax rates fall as well as the total taxes that would be collected if that average rate stayed constant.

[5] There are a number of implications of this shortfall for future legislation, as well as in preparing for future economic cycles:

[6] The amount of countercyclical stimulus is extremely large by historical standards and reduces the need for additional stimulus.

[7] A drop of $376 billion is extraordinary by any stretch of the imagination. The total equals about 3.5 percentage points of GDP -- approximately 1 percentage point of which is due to the drop in GDP itself if average tax rates had stayed constant and some 2.5 percentage points due to the drop in average rates. Keep in mind also that federal expenditures have also been increased by Congress over this period, while receipts have fallen precipitously for state governments. In effect, a very large share of the total drop in national output has been borne by the government sector, and, unlike a typical recession, the private sector as a whole has seen only a tiny drop in its aggregate after-tax income.

[8] At least on a relative basis, this weakens the need for further stimulus and strengthens the call for greater budget frugality.

[9] The models that project capital gains income need to be revised significantly.

[10] Treasury and CBO have models that attempt to estimate capital gains receipts. These models could not have been expected to predict the timing of a decline in the market, but they need also to be revised to reflect the changes in gains that would be expected when the market goes up and down in the future. Of course, there was limited historical experience on which to base the extent to which capital gains receipts would fall after the bubble market of recent years. Therefore, I am not being critical here but simply indicating a clear need for more work. These models, of course, are sensitive not only to economic conditions but to other factors such as tax rates. Therefore, they must sort out how much behavioral change is due to each of these different factors. Complicating matters is the extent to which mutual funds behave differently from individuals acting alone, although it may turn out that investment company behavior is the more predictable of the two.

[11] Significant improvement is also needed in the ability of the Treasury to trace what is happening with stock options. Although these may have been less of a factor in the shortfall -- increases in personal income tend to be offset by declines in corporate income -- they still are important and must be understood.

[12] IRS and Treasury are compelled to come up with a much better and swifter system for tracking changes in receipts.

[13] This is an old story, but the IRS has long been deficient in handling its responsibilities for dealing with matters other than enforcement. Among the many government "programs" under its control is the matching of information on tax returns with information that comes in as people and businesses pay over their estimated and withheld taxes. A larger statistical sample of returns, examined on a more timely basis, is probably required. Included in this sample must be a number of businesses and individuals who are tracked from year to year. Sometimes the analyst or statistician must eyeball the returns themselves to detect changes hidden in simple tables of statistics.

[14] A better tracking system is needed not simply to estimate receipts, but to inform the Bureau of Economic Analysis so it can better estimate changes in national income and product and to give the monetary authorities more timely information for their own decision-making. Thus, any improvement here might allow the nation to achieve a better macro-economic policy.

Other Publications by the Authors

- C. Eugene Steuerle