**Tax Cuts, Budget Deficits and the Economy**

This week, the White House will revise its fiscal year 2006 budget deficit estimate to roughly $300 billion, a significant reduction from its January forecast of $423 billion. This will continue the White House’s pattern of very conservative estimates.

Our calculations suggest that the federal budget deficit this year will be approximately $260 billion. This is down from $318 billion in FY-05 and $413 billion in FY-04.

Strong gains in tax receipts have overwhelmed increased federal spending. Congressional Budget Office (CBO) data show that federal tax receipts during the nine months ending in June were 12.8% above the same period in FY-05. Withheld income taxes increased 9% in June from last year; non-withheld income tax payments surged by 20%, while corporate tax receipts grew by 17%.

If federal receipts continue to grow in a similar fashion during the final three months of this fiscal year, they will climb to an all-time high of $2.4 trillion dollars, $275 billion above last year, $400 billion more than in 2000, and equal to 18.5% of GDP.

Federal spending is on track to increase 9% this year, and will end the year at 20.7% of GDP, up sharply from the 18.4% share in 2000. If federal spending had remained at 18.4% of GDP this year, the US would have recorded a small surplus of $21 billion.

It has become popular to say that, “tax cuts do not pay for themselves.” In fact, Henry Paulson, who will be sworn in today as US Treasury Secretary, was all but forced to say this in his confirmation hearing last month. The problem is that it is not clear whether this statement actually means anything.

In a static world, tax cuts do not pay for themselves. But the world is not static. As Secretary Paulson said at his Congressional hearing, tax changes affect people’s behavior. As a result, tax changes alter the course of the economy. To assume otherwise is naïve. Equally as important is the fact that different types of tax cuts impact the economy in different ways.

In 2001, most reductions in marginal income tax rates were phased-in over many years. But, if people know that tax rates will be lower in future years they will push as much economic activity as they can into those lower tax years. This resulted in anemic economic growth (and declining tax revenue) during 2001, 2002 and early 2003 even though the Fed was cutting interest rates.

The 2003 tax cut ended the phase-in, accelerated the tax cuts and reduced tax rates on qualified dividends and long-term capital gains. This caused an immediate acceleration in business investment and tax revenues surged. In fact, inflation-adjusted tax revenues have grown more than 10% annually over the past two years; a feat rarely accomplished in US economic history.

As a share of GDP, tax receipts are still well below the 1998-2000 average of 20.3%. But those were abnormal years. Since 1930, there have only been 19 years in which the tax share of GDP was at or above 18.5%, and in the past 20 years, tax receipts have averaged 18.3% of GDP. This means tax receipts in 2006 will be above historical norms.

Since the tax cut was passed in May 2003, US GDP has expanded by more than 20%, or roughly $2.2 trillion. To put this in perspective, we have added more to GDP in the past three years than an entire China (current estimate of $1.9 trillion in annual GDP). In the three years before the tax cut, GDP in the US grew just 10.4%.

Most importantly, tax revenue trends suggest that government statistics are underestimating economic growth. People and companies do not pay taxes on income or profits they do not earn. There is no sign of a slowdown in the budget data.