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RSC Policy Brief:

What Happens to Revenue *Without* New Taxes?

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"If at the end of the day we need to raise taxes, we should raise taxes."
-Paul Volcker, April 8, 2010, on the possibility of a U.S. Valued Added Tax (VAT).

Background: The President's "Fiscal Responsibility" Commission held its first meeting this week. The goal of the commission is to reduce the deficit to $552 billion by 2015—**a higher deficit than any year from 1789 to 2008**, but still lower than the President's budget request with a $793 billion deficit in that year. One concern that conservatives may have with the commission is that the 12 Democrat appointees will likely propose tax increases as a means to bring down the deficit.

In many quarters, the conventional wisdom is that putting the federal budget on a sustainable path will require both spending reductions (compared to current law) and tax increases (compared to current law). On spending, the conventional wisdom is undoubtedly correct, as even many liberal budget experts will concede. CBO's long-term budget outlook projects that spending will increase from the recent historical average of 20.7% of GDP to 31.7% of GDP by 2050 (from there it continues to grow).

But while federal spending projections lead to unsustainable red ink, current law federal revenue projections actually *improve* the budget outlook. Over the last forty years, tax revenue has averaged 18% of GDP. If federal revenues were projected to decline by as much as federal spending is projected to increase, it would have to decline all the way to 7% of GDP. Instead, CBO projects tax revenues will increase from 18% of GDP to 23.4% of GDP by 2050—an additional 5.4% of economic output will be consumed by federal taxes.

CBO Baseline Projections of Federal Revenue: Under current law, over the next ten years, federal revenue will increase from $2.105 trillion to $4.567 trillion—an increase from 14.8 to 20.3 percent of GDP (*Source:* CBO March 2010 baseline). Beyond that, CBO's Long-Term Budget Outlook projects two different courses for federal revenues:

Extended-Baseline Scenario: Under the first scenario, CBO projects that federal tax revenues will follow current law. Of note, this means that all expiring tax provisions would expire as per current law. Among other things, this means that the AMT would gradually hit more and more of the middle-class, the marriage penalty would return, the child tax credit would be reduced to $500, and the marginal income tax rates would return to the pre-2001 rates. For a full list of expiring tax provisions, see this RSC document.

Under this scenario, CBO projects federal revenue will increase from the historic average of 18% of GDP, to 20.3% of GDP in 2020, to 21.8% of GDP in 2035, to 23.4% of GDP in 2050, to 25.9% of GDP in 2080. (*Source:* CBO June 2009 long-term budget outlook).

Extended-Baseline Scenario Projected Federal Budget as Percentage of GDP

	Spending	Revenue	Deficit
2009	24.7	***14.8***	9.9
2020	22.6	***20.3***	2.3
2035	27.4	***21.8***	5.6
2050	31.7	***23.4***	8.3
2080	43.7	***25.9***	17.8

Alternative Fiscal Scenario: This scenario presumes that some expiring tax cuts are extended. Specifically it presumes that all income tax provisions from the 2001 and 2003 tax cuts are made permanent, and the AMT is extended for inflation, instead of expanding to impact more and more taxpayers. With regard to the death tax, this scenario assumes that tax revenues grow at the same rate as economic growth (under current law, the tax is completely repealed for 2010).

Under this scenario, federal tax revenue still increases from the historic average of 18% of GDP to 18.6% of GDP in 2020, to 19.2% of GDP in 2035, to 19.9% of GDP in 2050, to 21.9% of GDP in 2080 (*Source:* CBO June 2009 long-term budget outlook).

Alternative Fiscal Scenario Projected Federal Budget as Percentage of GDP

	Spending	Revenue	Deficit
2009	24.7	***14.8***	9.9
2020	26.0	***18.6***	7.4
2035	33.9	***19.2***	14.6
2050	42.2	***19.9***	22.2
2080	64.7	***21.9***	42.8

Historical Perspective: To put current law projections for federal revenue in perspective, the highest federal tax burden in U.S. history is 20.9% of GDP in 1944, at the height of World War II. In fact, the only other times in U.S. history federal revenue has exceeded one-fifth of GDP was 1945 (20.4% of GDP), and 2000 (20.6% of GDP). The high revenue in these years was due to World War II and the dotcom bubble, respectively. (*Source:* OMB Historical Tables)

Proposed Tax Increases by Democrats: Even as current tax laws will cause federal revenue to climb to levels never before seen in American history, the following are examples of tax increase proposals by the Democrat Congress and the President (this is *not* a comprehensive list):

- **VAT:** Paul Volcker, Chairman of the President's Economic Recovery Advisory Board, endorsed the creation of a Value Added Tax (VAT). A VAT would be a regressive tax that falls on each stage of the production of consumer goods, and would therefore increase the price of everything in the family budget.
- **National Energy Tax:** The House passed an *$843 billion* ten-year tax increase on energy production and usage.
- **Limit on Itemized Deductions:** The President's FY 2011 budget proposes to limit the value of itemized deductions. Among other things, this could have a negative impact on non-profits, churches, faith-based schools, hospitals, and other charitable organizations. *$291.2 billion* tax increase over ten years.
- **New Taxes on Driving:** Chairman Oberstar is looking at various tax increases as part of the next highway bill. These potential tax increases include a new tax on miles driven, as well as a higher gasoline tax.
- **4.6% Income Tax Increase:** Chairman Rangel introduced legislation to "pay for" AMT repeal by increasing the top income tax rate to 44.2% (including the effects of both allowing the 2001 and 2003 tax rates to expire and the new "surtax").
- **Payroll Tax Increase:** During the campaign, candidate Obama discussed increasing the Social Security tax on people making more than $250,000 by eliminating the Social Security wage cap. In conjunction with allowing the 35% rate to go back up to 39.6%, this would cause the top marginal tax rate (not counting state and local taxes) to be 53.9%.

Conclusion: By any available projection, over the long-term, both spending and taxes grow as a proportion of total economic output. The federal government's fiscal problems are *entirely* the result of a spending problem. Under current law, without any new taxes, the American people will still be asked to pay for a tax burden without precedent in American history. And it will be necessary to cut some taxes, compared to current law, just to keep the federal tax burden at historic levels.

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