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The 2006 Budget Numbers Show Impact of Pro-Growth Tax Policy, but also Continued Spending Increases

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The Office of Management and Budget recently released final budget numbers for the 2006 fiscal year (FY2006), which began October 1, 2005 and ended September 30, 2006. These end-of-year numbers are particularly noteworthy because they show pro-growth tax rate reductions, such as those made in 2003 tax legislation, do boost growth and thus expand taxable income, resulting in more tax revenues than shown by static estimates. But the numbers also show that federal spending is still growing too fast, a fact often overshadowed by focus on the budget deficit. Moreover, the growing burden of entitlement programs will make spending an even bigger problem in the future. The FY2006 numbers demonstrate the benefits of maintaining pro-growth tax policies, but also the need to reduce spending and reform entitlement programs.

Key numbers from FY2006

- Federal tax collections jumped by 11.8 percent, climbing from $2.15 trillion in FY2005 to $2.41 trillion in FY2006. This $254 billion increase was more than three times faster than needed to keep pace with inflation. Federal tax revenues reached 18.4 percent of gross domestic product (GDP), above the post-World War II average of 18.3 percent.
- Federal spending jumped by 7.4 percent, climbing from $2.47 trillion in FY2005 to $2.65 trillion in FY2006. This $182 billion increase was about two times faster than needed to keep pace with inflation. Entitlement programs alone grew by almost $100 billion. Federal government outlays now consume about 20.3 percent of GDP.
- Because tax revenues increased by more than outlays, the share of the budget financed by borrowing fell from $319 billion in 2005 to $248 billion in 2006. Debt-financed spending now consumes 1.9 percent of GDP.
- The national debt fell as a share of national economic output, dropping from 37.4 percent of GDP to 37.0 percent of GDP. This is because debt (the numerator in the debt/GDP ration) did not rise as quickly as national economic output (the denominator in the debt/GDP ratio).

Many are praising these higher tax revenues as proof that the 2003 tax rate reductions have been successful. Indeed, lower tax rates on work, capital gains, and dividends have boosted economic activity. This expansion of economic activity has created more taxable income, leading to more revenue for government—what economists call a Laffer Curve effect. Tax revenues in 2006 were about $40 billion

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higher than Congressional Budget Office projections in January 2003—before the tax cut was enacted. This is evidence that good tax policy boosts economic performance. But, this additional revenue also has the unfortunate effect of masking the problem of excessive government spending. Indeed, new revenue exacerbates the problem since it encourages even more spending.

Lessons from the 2006 Budget Numbers

- Good tax policy generates a Laffer Curve effect and can lead to a net result of more revenues. The Bush Administration has demonstrated why some tax cuts are more desirable than others. The 2003 tax bill included significant reductions in marginal tax rates on work, saving, and investment. The subsequent economic growth led to the significant increase in taxable income, which resulted in the boost in tax revenues evident today. The faster economic growth unambiguously is desirable, and America's competitive position in the world has improved. The 2001 tax cut, by contrast, with its short-term focus on rebates and credits—lower tax rates were included, but deferred until the future—did very little to improve incentives for productive behavior. As a result, there was little economic benefit. The Laffer Curve-induced increase in tax revenue from the 2003 bill, however, is a mixed blessing. On the plus side, politicians likely now have a better understanding of the benefits of lower tax rates, but they also have less incentive to control spending.
- Spending is the problem, not deficits. America's economic health, today and in the future, relies in part on keeping government from becoming an even bigger burden. This is a huge challenge since the future spending explosion from entitlement programs will make recent spending increases seem paltry. Sole focus on the deficit can induce a sense of complacency about the threat of big government. A good example is Sweden. That nation has a budget surplus, but since taxes and spending consume more than 50 percent of GDP, the economy is weak, unemployment is high, and the average Swede has less than 50 percent as much disposable income as the average American.

Conclusion

The FY2006 budget numbers are mixed signs of good fiscal policy. The huge revenue gains of 11.8 percent on the tax side of the ledger show the pro-growth impact of lower tax rates. The spending side of the ledger disappoints as spending jumped by 7.4 percent. This increase in spending does not bode well given the need to reform entitlement spending to prevent a deeply worrying burden of government. With the entitlement challenge on the horizon, there is all the more reason to ensure that pro-growth tax policies are kept in place.

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