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Part III. Fiscal Issues

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VI. Summary of U.S. Revenue Surprises: Are Happy Days Here to Stay?

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by Andrew Swiston, Martin Mühleisen, and Koshy Mathai

1. ***Recent fiscal developments in the United States have been considerably more favorable than expected***. The Administration's goal of halving the deficit by FY 2009 was achieved three years early, mainly as a result of a sharp rebound in tax revenue from a post-recession, post-tax-cut trough in 2004. Underlying this strong revenue performance has been a sharp increase in revenue buoyancy—i.e., an increase in tax collections faster than GDP growth—that has been widely noted in the press but not fully explained. A key question for policymakers, who need a reliable revenue forecast in order to formulate sensible spending plans, is whether and for how long this trend is likely to continue. If tax buoyancy remains high, the revenue-GDP ratio will continue growing; if it instead declines, the revenue ratio could stagnate or possibly fall.

2. ***In order to assess underlying trends, we construct tax revenue series that are adjusted for the impact of tax policy changes***. This allows us to examine the response of revenue to economic variables under a hypothetical, unchanged tax system. Without this crucial first step, our analysis could confound changes in the tax system with changes in the tax base and thus obscure the extent to which relationships between revenue and its fundamental determinants have changed. Put another way, our adjusted data allow us directly to analyze *tax elasticity*—the underlying responsiveness of constant-policy revenue to growth in the tax base—rather than relying on *tax buoyancy*—the responsiveness of headline revenue to the tax base.

3. ***Using these policy-adjusted data, we model revenue as a function of labor and capital income tax bases, the income distribution, and other variables***. The paper estimates both a long-run equation in levels and a short-run equation in year-to-year changes, with an error-correction term that measures the short-run response of revenue to deviations from the long-run equilibrium. The results confirm that revenue is strongly related to the tax bases of its major components—personal income and corporate profits—as well as capital gains realizations and the distribution of income. The model fits the data well, with the explanatory variables accounting for 95 percent of the annual variation in revenue since 1987.

4. ***Most of the recent surge in revenue is explained by changes in the independent variables and thus should not be seen as a "surprise."*** Our forecasts indicate that forty percent of the 2004–06 revenue surge can be explained by corporate profits' growing faster than GDP (Figure 1). Another forty percent is attributable to growth in capital gains, and much of the remaining twenty percent is explained by stronger income growth at the upper end of the income distribution (which, given the progressive tax system, implies higher average tax rates). In general, only a small part of the revenue surge is left unexplained, suggesting no structural change to the relationship between revenue and fundamentals.

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