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Introduction

There has been much speculation and many theories about what led to the United States budget surpluses experienced in the late 1990s and 2000. Most of the speculation and theories I have heard have been from economists and politicians. Because there are now many years of historical data available, the following is prepared as an analytical review of some available data to determine if the causes of any trends or anomalies can be identified. The analysis was prepared to begin to answer two simple questions, "What happened?" and "Can it be repeated?" The first step in trying to repeat the budget surpluses experienced in the late 1990s and 2000 is to understand how the budget surpluses occurred. The CBO, in the often cited 2001 Budget and Economic Outlook, described the economic activity existing in 2000. The 2001 Budget and Economic Outlook is the starting point for the analysis to follow.

Before beginning the analysis, an understanding of the Gross Domestic Product (GDP) is required. There are references on the website to begin to [explain GDP](#). The importance of understanding GDP is because, based on conversations with people, there often appears to be a misunderstanding that GDP is somehow correlated to "value." The Income Approach to GDP has several components, the largest of which is Salaries and Wages or also referenced as Compensation of Employees. The component is the actual wages and salaries paid. Because GDP is not based on "value," it is possible to increase the GDP by simply paying someone to do nothing. In addition, worker productivity will be increased if a person is paid the entire compensation in one hour versus two hours, regardless of the eventual market value of the work performed. Therefore, when

you see a GDP line, remember, it is not intended to be an indication of "value" being generated in the economy.

The next step before looking at any of the following analysis is to read the original [CBO Budget and Economic Outlook: Fiscal Years 2002-2011](#). The document is 190 pages and supports the summary figure of a \$5.6 trillion budget surplus projection by 2011. Only a light reading will reveal the extensive qualifiers and concerns surrounding the \$5.6 trillion budget surplus projection. For example, the CBO includes a [section only on the uncertainties](#) in the projection. I suggest reading the original document, as I did, and then proceed to [my review notes](#) for each section. The uncertainties stated by the CBO were used by me to select the areas to evaluate. I do not attempt to evaluate all of the points made by the CBO in the Budget and Economic Outlook issued in January 2001.

After you have obtained the necessary background directly from the CBO report, you will be ready to proceed to the analytical review section. When you read the analysis you will see most of the presentation is text and graphs, with graphs being identified as Figures. Not included at this time are the [Regression Analysis](#) results that calculate the correlations between a dependent and independent variable.

The analytical review also includes the use of [Trend lines](#). An example demonstrating the use of trend lines versus other options is presented with the first graph using a trend line.

The analytical review begins with a figure on the annual budget results. The analysis then proceeds to the activity in the major components, outlays (government spending) and revenues (tax revenues), in the budget. Often times the GDP trend line is included to evaluate the activity relative to the GDP. After the major components of the budget are identified, the details supporting the major components are evaluated. For outlays, the sub-categories are Discretionary and Non-Discretionary spending. For revenues, there are many sources including

individual, corporate, estate and social security taxes. Because revenue is more difficult to evaluate than outlays, an analysis is performed to begin to understand the anomalies in the revenue trend lines. The analysis includes the potential for Capital Gains taxes, the sources for any salaries and wage gains and the changes on Adjusted Gross Income (AGI) for taxpayers. The analysis also includes the sources of funds for the increases in AGI experienced leading up to 2000. The revenue analysis then looks at corporate book profits and corporate income taxes. Each major section of the analysis concludes with how the results of the economic activity in 2000 then led to a "budget projection", as opposed to a "budget prediction," of \$5.6 trillion surplus by the year 2011. A "prediction" would require a probability of occurrence in excess of 50%.

As a final note, the CBO was perfectly clear in the Budget and Economic Outlook document, highlighting there were considerable [uncertainties](#) surrounding the results. Therefore, I believe the CBO acted responsibly in their presentation. Under no circumstances is any of the following presentation to be considered an evaluation of the CBO's budgeting techniques. The CBO states the document is a [baseline](#) budgeting tools and is not a prediction of future results.

Based on the definition of baseline budgeting, the final budget is the projection of current year results into the future based on a series of assumptions. When you look at the analysis remember the basis of the 10 year projection of a \$5.6 trillion surplus by 2011 is based on the results of the year 2000. To understand the CBO's constraints and qualifiers surrounding a \$5.6 trillion dollar budget projection requires a reader to get beyond the [second sentence of the introductory Summary](#) section of a 190 page document.

What happened?

To attempt to understand the budget and economic activity of the 1990s and 2000s a series of graphs and comments will be presented.

The following graph is the actual surplus/(deficit) from 1962 to 2006.

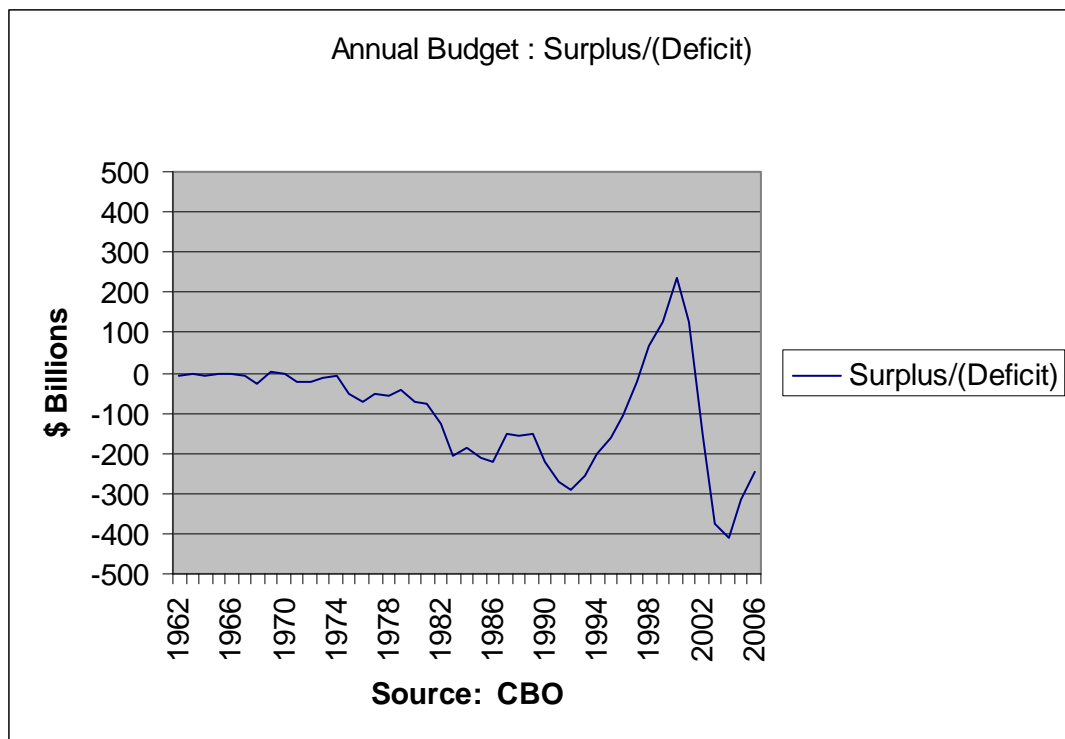


Figure 1

Looking at Figure 1, the deficit worsened in 1975 and declined through 1992. Starting in 1993 the deficit lessened resulting in near budget balance in 1997 and surplus in 1998 through 2001. The maximum budget surplus was \$236 billion in 2000. The budget deficit returned in 2002 and bottomed in 2004 at (\$412) billion.

Because the budgeting process includes On-budget as well as Off-budget items, Figure 2 is Debt Held by the Public (DHBP) compared to the accumulation of annual surpluses and deficits. DHBP does not include any debt or surplus associated with the Social Security Trust Fund.

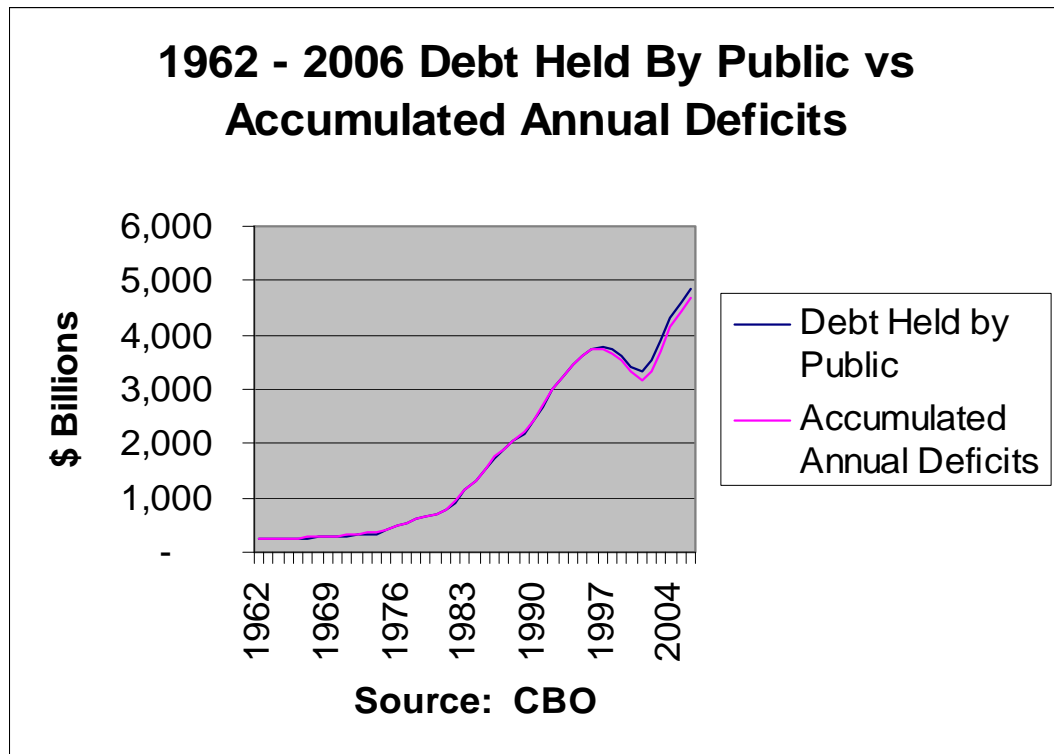


Figure 2

The DHBP in Figure 2 is a close accumulation of the annual budget surpluses or deficits reflected in Figure 1. Some separation began in 1998 and expanded until 2001.

Because the annual budget deficit or surplus is the net of revenues less outlays, Figure 3 shows the actual revenues versus outlays.

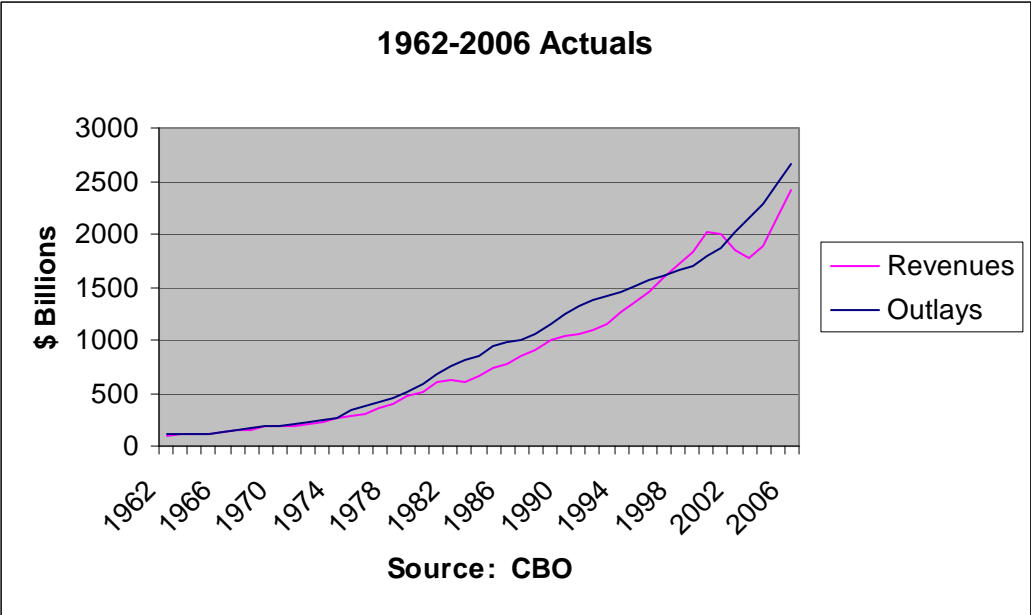


Figure 3

Looking at Figure 3 reveals the surpluses of the late 1990s were a combination of revenue increases and a reduction in outlays.

To add additional insight, the Nominal Gross Domestic Product (GDP-N) trend line is inserted in Figure 4.

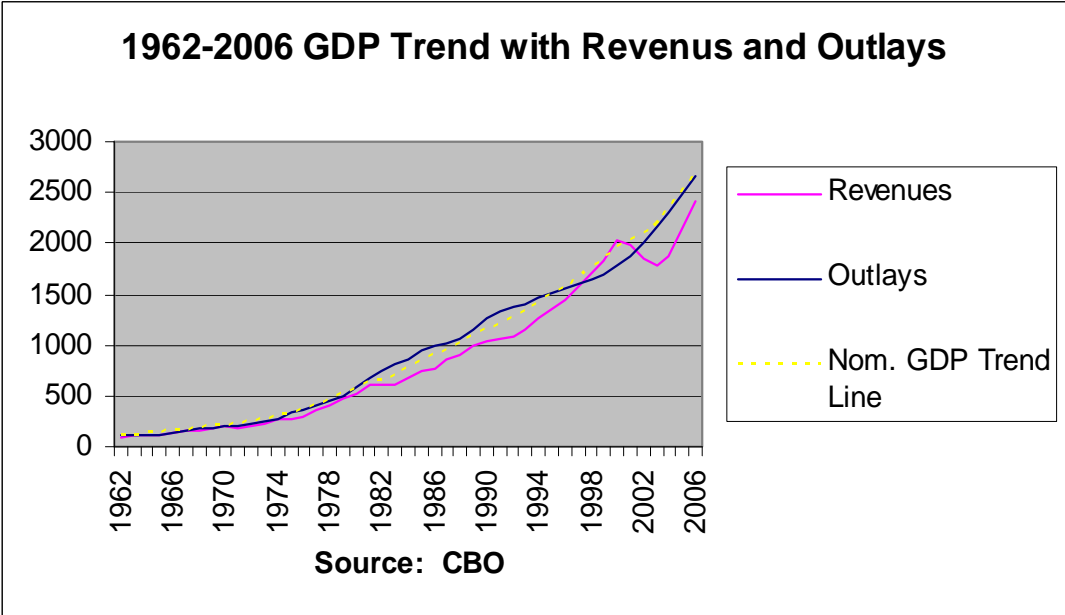


Figure 4

As stated in the introduction, the GDP-N Trend line can only be used to evaluate the direction of movement in the line and the amount of movement relative to only the trend line. The actual data for Figure 4 above is presented in Figure 5.

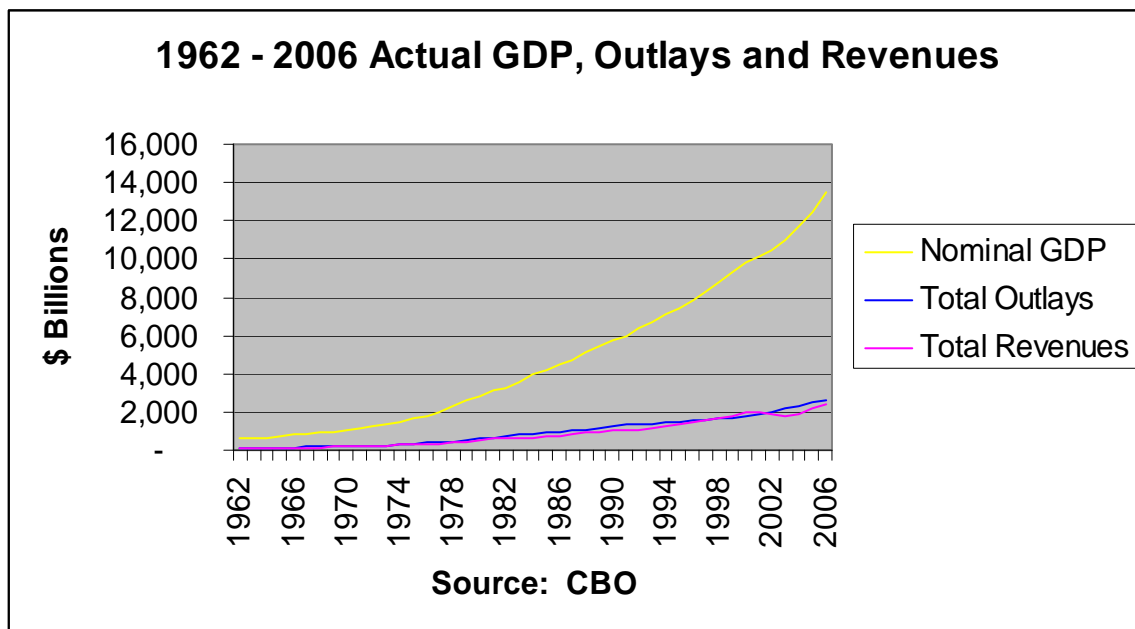


Figure 5

Figure 5 demonstrates the significant difference between GDP-N and outlays and revenues. However, Figure 5 does not demonstrate that Outlays and Revenues have historically been in the 16% to 20% range of GDP-N. The next figure is another example on how trend data can be graphed. You will see in Figure 6 how the logarithmic presentation (the y-axis increases geometrically [each horizontal scale is 10 times the previous line] as opposed to linearly) of the data presented in Figure 5 shows the correlation between GDP-N, outlays and revenues. With Figure 6 you will see the correlation between GDP-N and revenues and outlays that is not obvious in Figure 5. (The background colors are different because this is the only logarithmic graph in the analysis.)

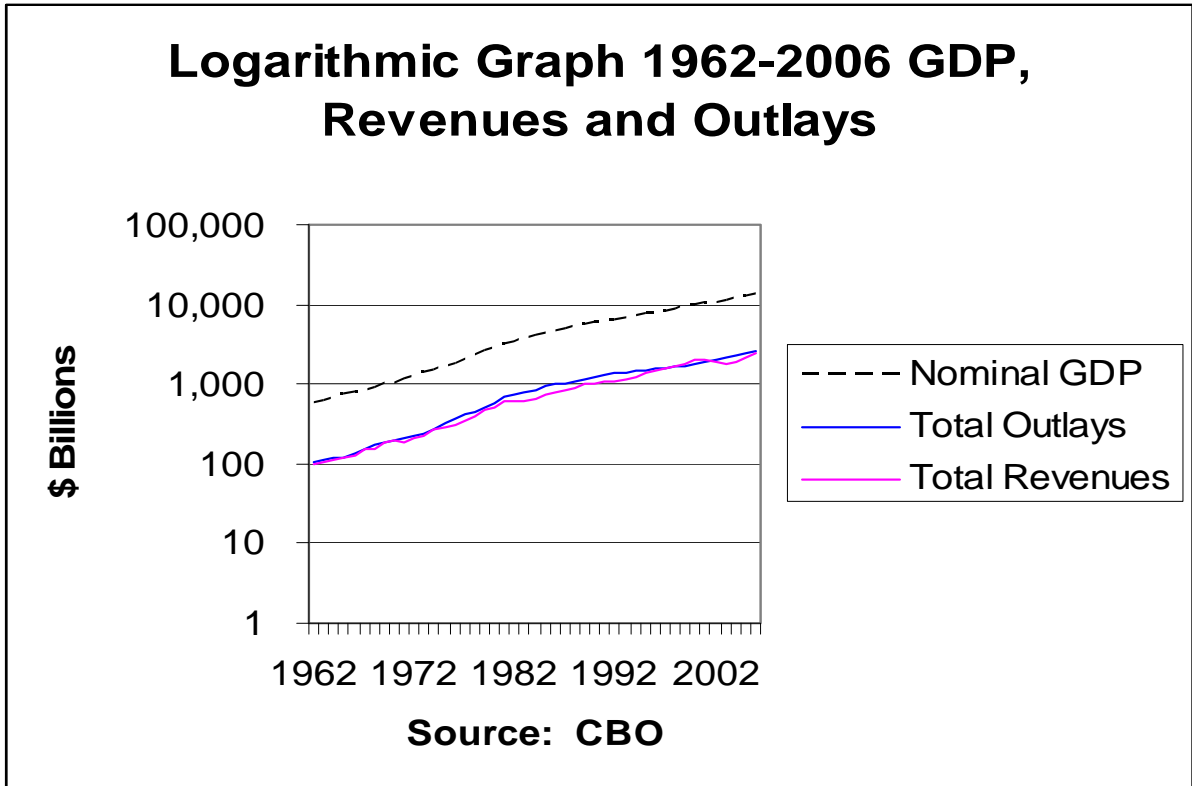


Figure 6

The logarithmic graph in Figure 6 demonstrates the correlation between GDP-N, outlays and revenues. For the remainder of the analysis, trend lines are used versus a logarithmic presentation. Figure 4, Figure 5 and Figure 6 should clarify how trend lines should be viewed throughout the remaining analysis.

Returning to the analysis, the next graph focuses on the GDP-N trend, revenues and outlays for 1992 through 2001.

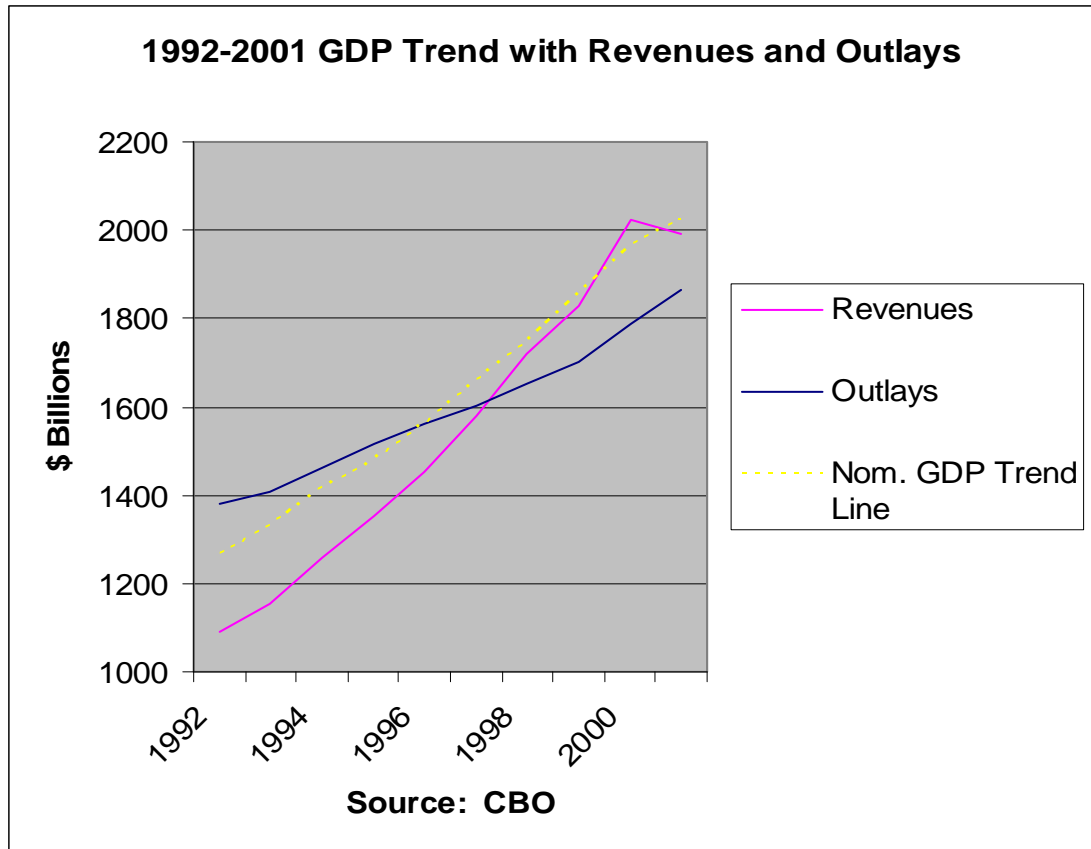


Figure 7

The conclusion of Figure 7 is the budget surpluses experienced in the late 1990s and early 2000s were a combination of increased revenues as a percentage of GDP-N and reduced outlays as a percentage of GDP-N. To understand the budget surpluses of the 1990s and early 2000s, an understanding of how the revenues increased as a percentage of GDP and how outlays as a percentage of GDP were reduced. Because the explanation of outlays is easier to understand, i.e. what outlays were cut in relation to the historical GDP, changes in outlays will be presented first.

OUTLAYS

The outlays budget is comprised of Discretionary and Non-Discretionary expenditures. For details on the [components in each category](#) there is extensive information available at the

CBO including comments in the 2001 report included in another location in this website.

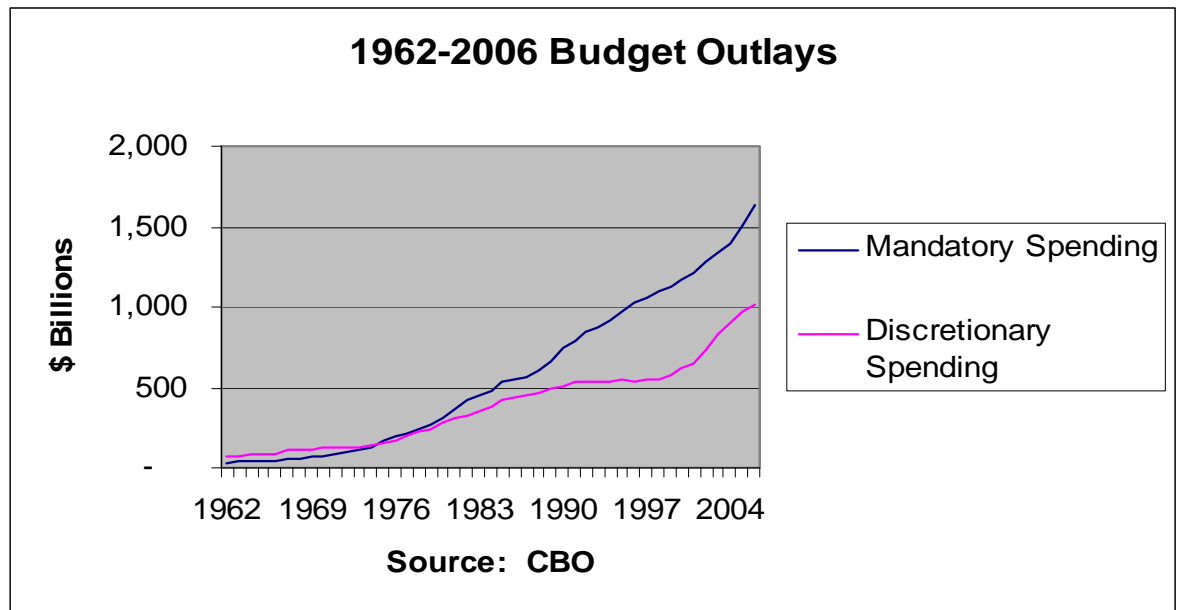


Figure 8

The observation from Figure 8 is Discretionary spending was nearly flat during the 1990s and the rate of Discretionary spending increased starting in 2002. The next graph will include the GDP-N trend line.

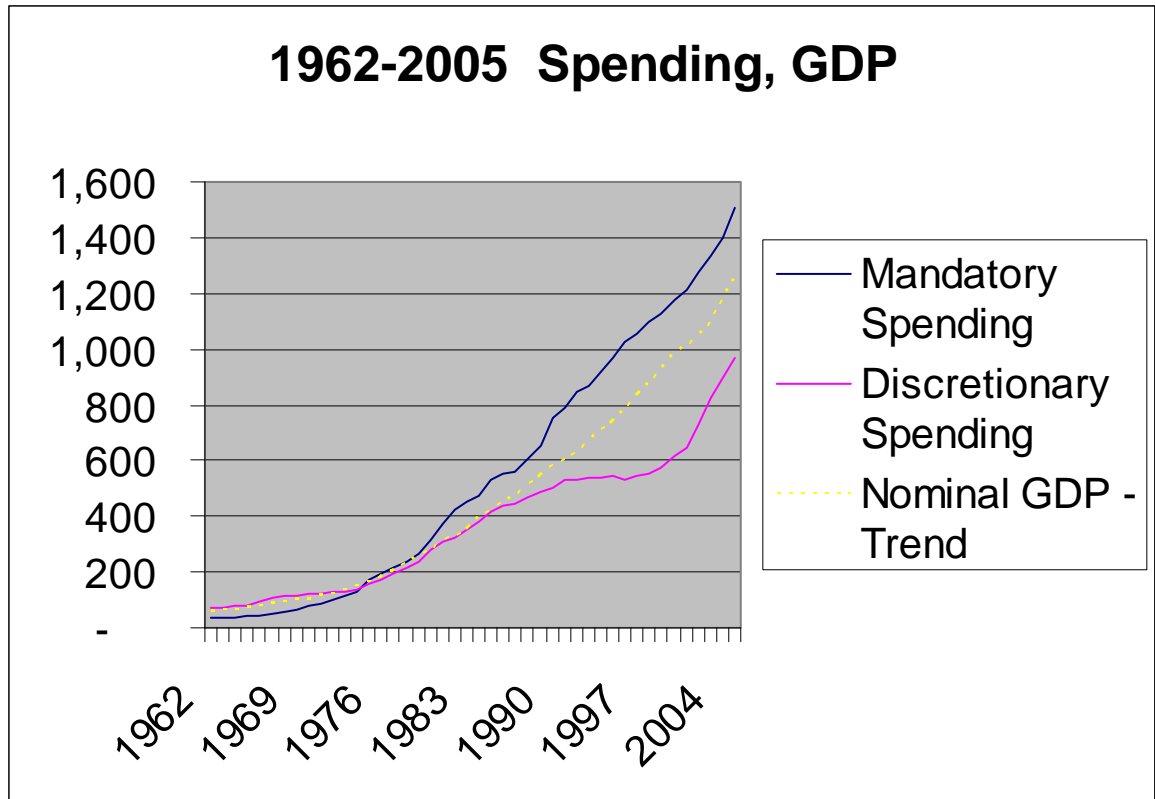


Figure 9

The conclusion from Figure 9 is the increases in Mandatory spending were being offset by decreases in Discretionary spending. Another observation is there was a dramatic leveling in Discretionary spending starting about 1993. The next step is to analyze the components of Discretionary spending.

For budgeting purposes Discretionary spending is divided into Defense, International and Domestic. The following figure discloses the components of Discretionary spending to determine the effect each component had on the reduction of Discretionary spending.

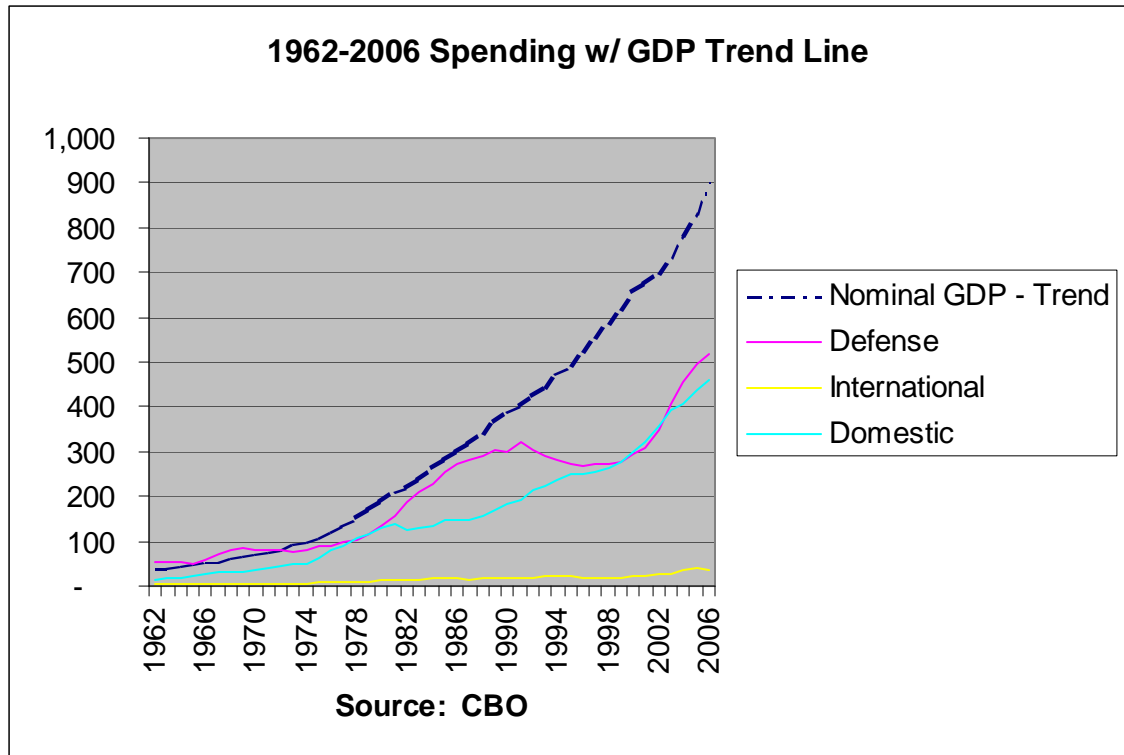


Figure 10

Based on Figure 10, Defense spending, as a percentage of GDP-N, was reduced beginning in 1993 and continued until 2001. Therefore, the primary source for the reduction of Discretionary spending from 1993 to 2001 was Defense. During some years in the late 1990s there were declines in actual defense spending, without taking into account inflation or growth in the GDP-N. Figure 11 focuses on the years 1991 to 2003.

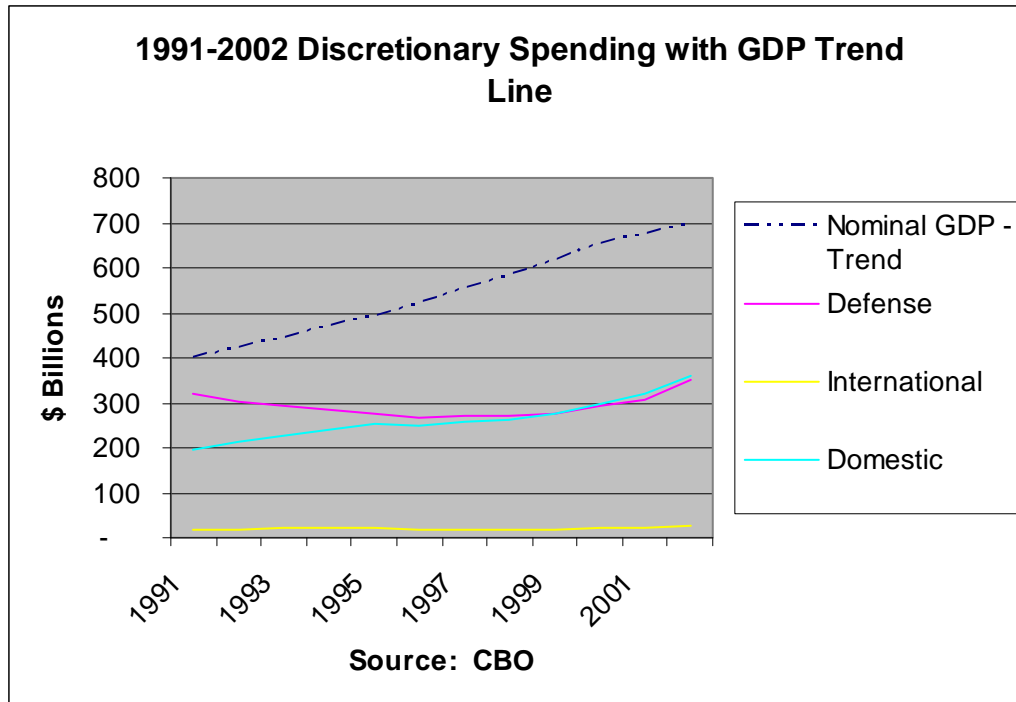


Figure 11

Based on Figure 9, Figure 10 and Figure 11, from 1993 through 2001 there was a reduction in Discretionary spending as a percentage of GDP-N. Within the Discretionary spending classification, the figure reveals Defense spending was the largest source for spending reductions.

With reference to the CBO report issued in January 2001, the CBO states that [expenditures are projected](#) based on current rates, current legislation and legislative restrictions. Based on the CBO projection process as detailed in the report, the CBO projected the Discretionary spending rates for the next 10 years. The following schedule compares the Projection rates versus Actual rates.

As a percentage of GDP
CBO Budget Projection versus Actual

Discretionary
Spending
As a Percentage of
GDP

| | CBO 2001 Projection | Actuals |
|------|---|-------------------------|
| 2000 | 6.3 | 6.3 |
| 2001 | 6.3 | 6.5 |
| 2002 | 6.3 | 7.1 |
| 2003 | 6.2 | 7.6 |
| 2004 | 6.0 | 7.7 |
| 2005 | 5.9 | 7.9 |
| 2006 | 5.8 | 7.8 |
| 2007 | 5.6 | |
| 2008 | 5.5 | |
| 2009 | 5.4 | |
| 2010 | 5.2 | |
| 2011 | 5.1 | |

Based on the results of declining Discretionary spending in the 1990s, the CBO forecasted the declines to continue as detailed in the percentages cited above. As stated in the 2001 report, the CBO is required to base projections on current year activity. Therefore, a component of the CBO's \$5.6 trillion budget surplus projection was the forecast of future Discretionary spending reductions based on the 40 year historically low Discretionary spending as a percentage of GDP incurred in 2000 and the downward trends of the 1990s as displayed in Figure 11.

Non-Discretionary spending, because of the lack of volatility (see [Figure 9](#)), will be evaluated when time and demand exist.

REVENUES

As stated in the January 2001 CBO report, the CBO stated outlays are easier to forecast than revenues. Also stated in the CBO report, revenue [fluctuation normally correlates to the GDP and legislation](#). The CBO further stated the increased tax [revenues of 2000 were not projected](#) and not entirely understood. Therefore, with the benefit of available historical data and the comments of the CBO describing the difficulty in understanding the source of revenues, the following provides correlation detail on sources of revenues.

Figure 12 shows the revenue and GDP-N trend lines for 1962 to 2006. The graph includes Social Security receipts as tax revenue.

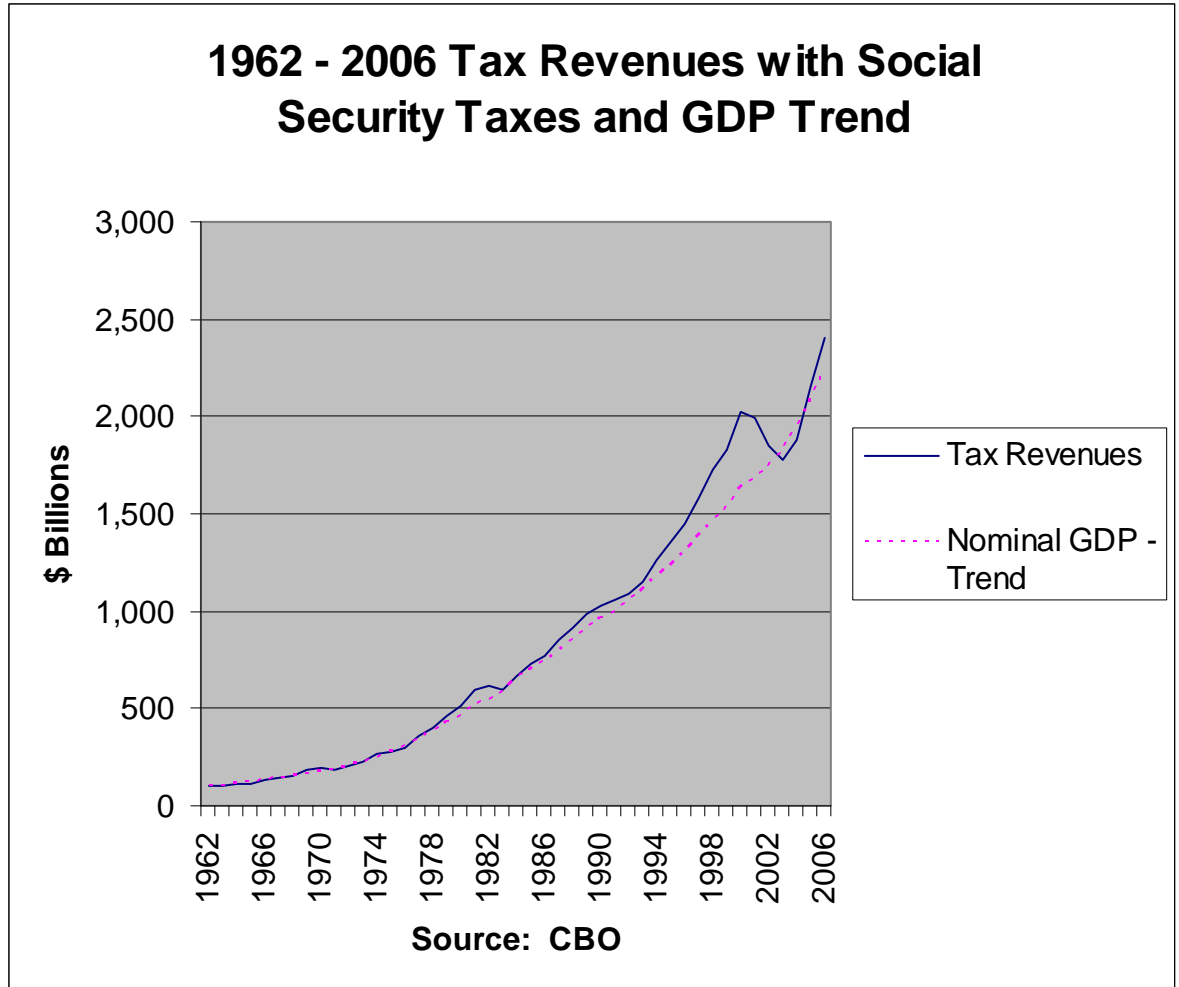


Figure 12

For reference purposes only, the Social Security surplus as a percentage of net revenues peaked in 2003.

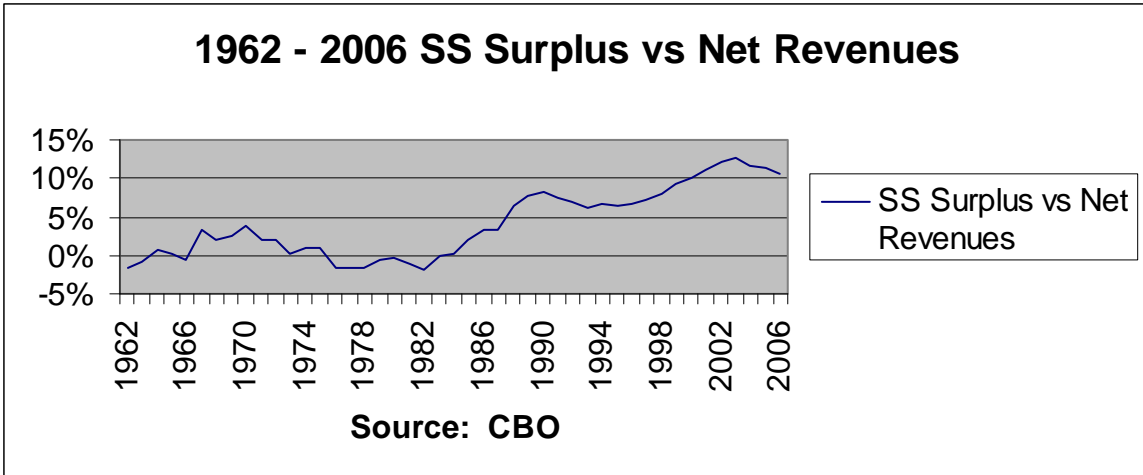


Figure 13

Returning to the analysis, Figure 14 adjusts the revenue amount to include only the Social Security surplus as tax revenue. From 1962 to 1995 there is a high correlation between revenues and the GDP-N trend line.

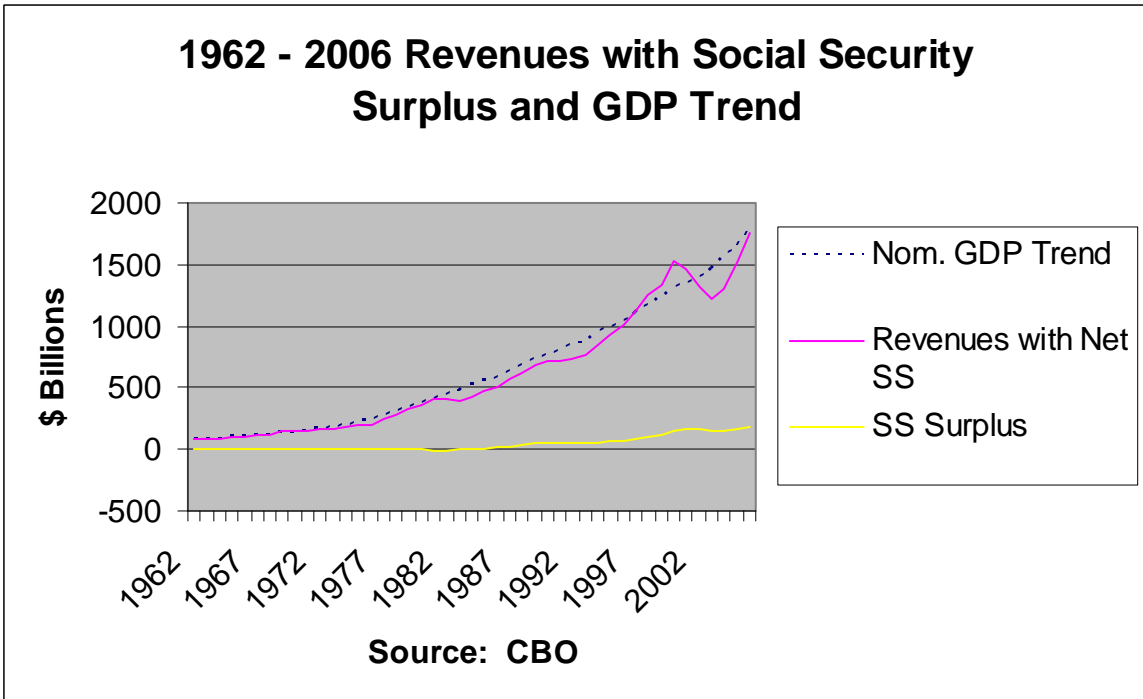


Figure 14

As can be observed from Figure 14, the tax revenues including the Social Security surplus are equal to the GDP trend line in 1997. Before 2000, the widest negative margin between the GDP-N and revenue line occurred in 1993 and revenues to GDP increased until 2000. In 2000 there was the widest positive margin between the GDP-N trend line and revenues. The revenue line declines beginning in 2001 until it is at the widest negative margin in 2003. As can be seen in Figure 14, an explanation as to what happened from 1995 to 2000 is required to understand the unprecedented high revenue as a percentage of GDP in 2000. In addition, an understanding as to what happened from 2001 to 2005 is required to understand how revenues as a percentage of GDP fell precipitously until 2003 and then recovered to near historical norms in 2006. In addition, a close observation of the GDP trend line for 1995 to 2005 reveals the biggest decline occurred in 2001.

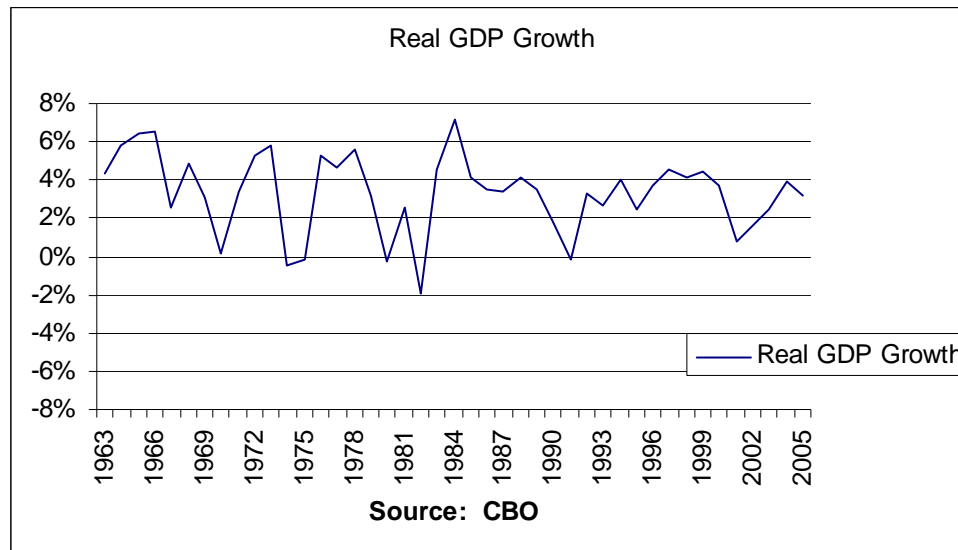


Figure 15

Referencing the CBO's 2001 report, the CBO stated revenue [fluctuations can normally be tied to economic or tax legislation](#); however, the CBO stated in the same report the [economic phenomena occurring in 2000 was not completely understood](#). The CBO also stated in the report there are at least two factors at work to explain the increase in revenue. One factor was Capital Gains tax realization. Because [Capital Gains taxes are](#)

[not contingent upon GDP](#), fluctuations in Capital Gains taxes can occur without any correlation to GDP. The second factor cited in the CBO report was an increasing percentage of a more [highly taxed component](#) in GDP (wages and salaries).

Specifically, according to the CBO, wages and salaries are the most highly taxed component of GDP and, therefore, when wages and salaries are a larger component of GDP, more tax revenue as a percentage of GDP will be generated.

The analysis for tax revenues will begin with the potential of Capital Gains tax revenue.

Capital Gains

There are many sources for Capital Gains tax revenues; however, as referenced in the CBO 2001 report, there was [considerable activity in the stock market](#) during the Dot-Com boom from 1995-2000. (The stock market being one of the sources for Capital Gains tax revenues.) Figure 16 shows the maximum NASDAQ closing price from January 1985 to January 2006. The index started the most dramatic increase in 1995, peaked in March 2000 and declined until it reached a bottom in late 2002. Capital Gains tax recognition occurs during a rising stock market and, to a lesser degree, in a falling Stock Market.

Is there also a correlation between the stock market activities and wages and salaries? That question will be analyzed later. Figure 16 is the Maximum NASDAQ Index Close.

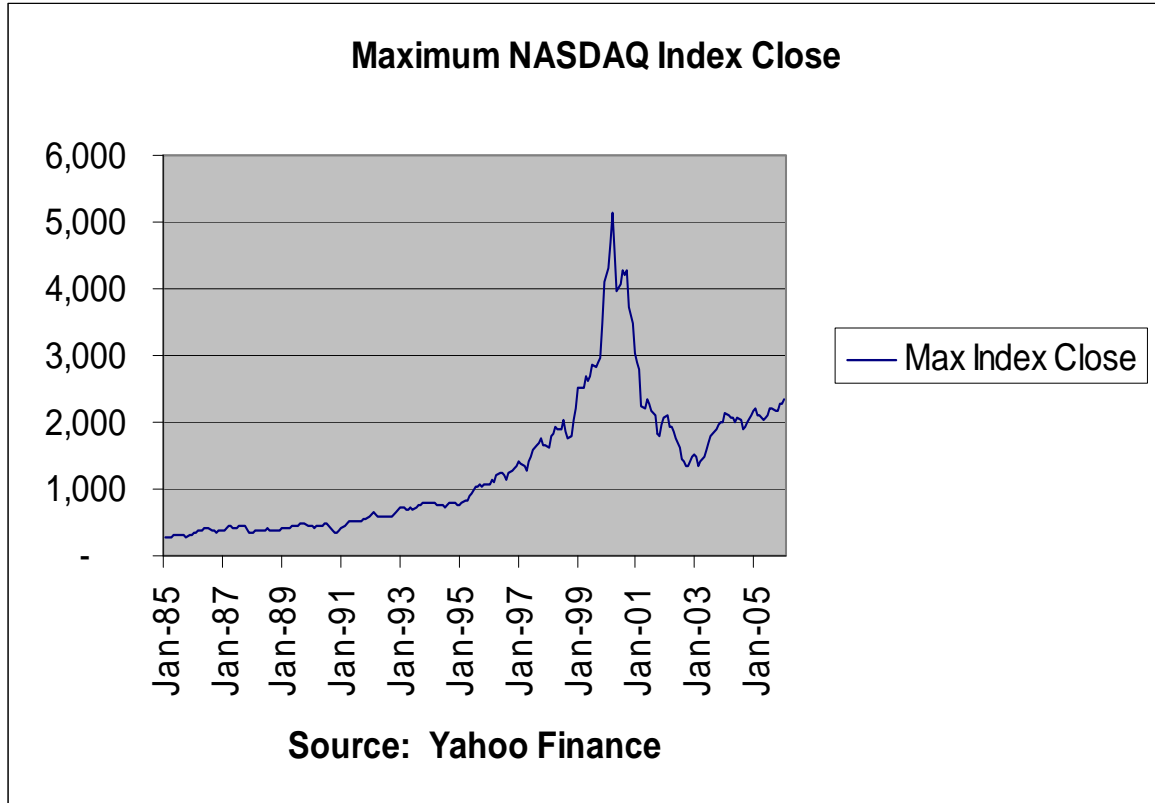


Figure 16

Price fluctuation is only one factor associated with Capital Gains tax recognition. Another factor is volume. Figure 17 reflects the NASDAQ volume.

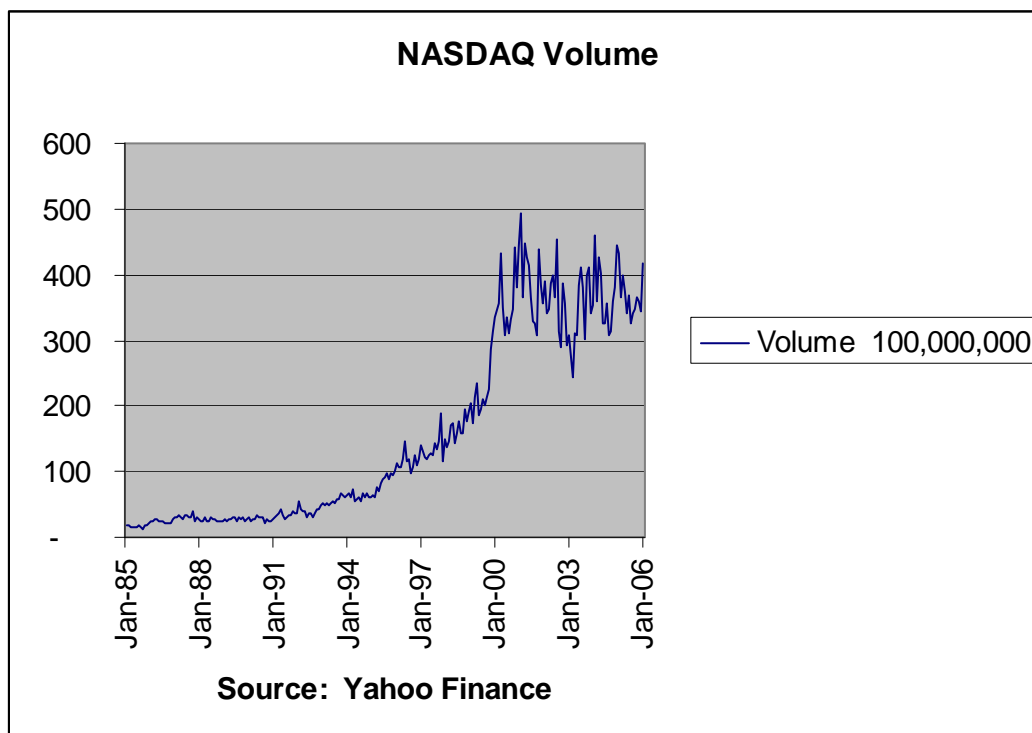


Figure 17

Figure 17 indicates the volume began to increase in 1995 and peaked in 2000. Volume has remained essentially at 2000 levels through 2006. The increase in NASDAQ volume corresponds to the increase in the NASDAQ index as observed in Figure 16.

As stated earlier, price fluctuations and volume are the two primary stock market factors in calculating the potential for Capital Gains taxes. Figure 18 displays a NASDAQ factor which is the result of multiplying the NASDAQ Index times the volume. The potential for Capital Gains taxes, based on the previously described factor, appears in the following graph.

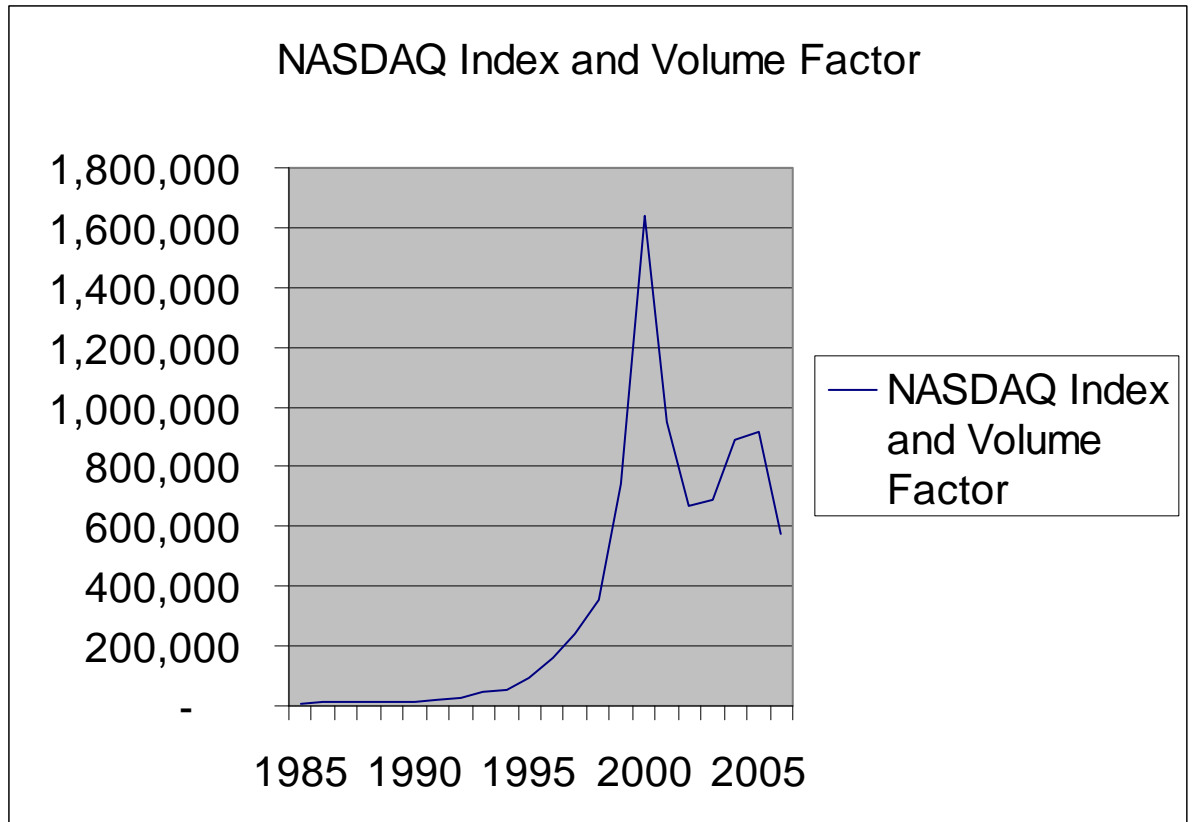


Figure 18

Figure 18 shows the peak potential for Capital Gains taxes based on price and volume occurred in 2000. As stated in the CBO report, Capital Gains taxes appear in Individual, Corporate and Estate taxes. Therefore, to evaluate the possible correlation of the NASDAQ activity to the fluctuations in tax revenue, Figure 19 has the NASDAQ factor, the tax revenue categories that contain Capital Gains taxes (Individual, Corporation, Estate), and the GDP-N trend line. See [Appendix II](#) for examples of individual stocks.

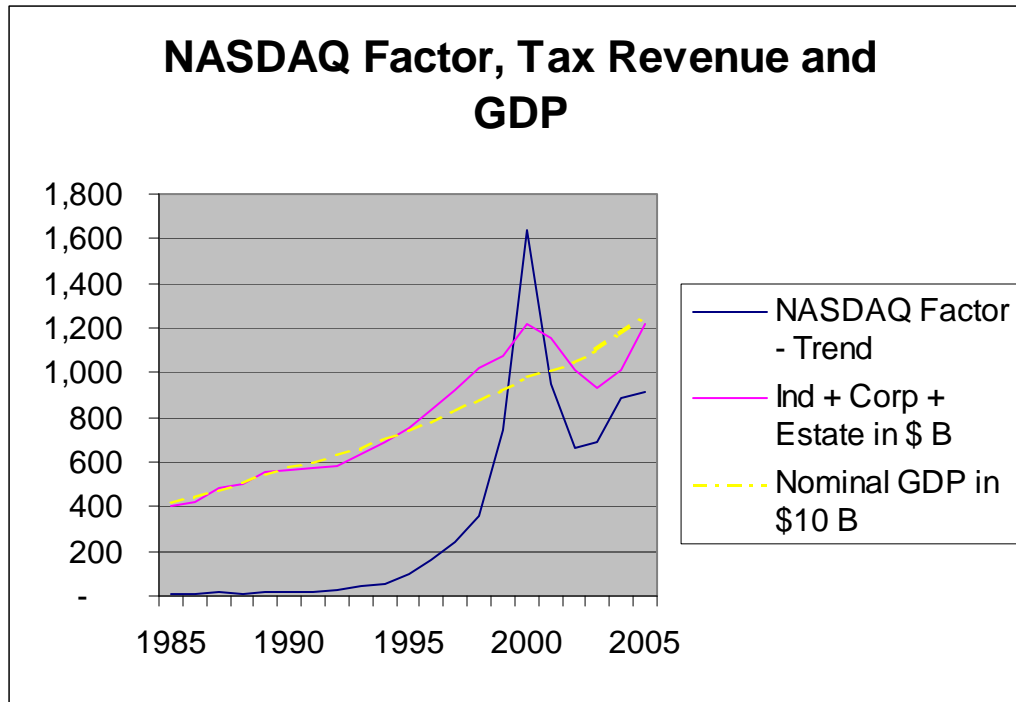


Figure 19

Figure 19 indicates the tax revenue for those categories containing Capital Gains were moving in the same direction as the NASDAQ factor from 1995 through 2004. Therefore, Figure 19 indicates there is a correlation between the [NASDAQ factor and the Individual, Corporate and Estate taxes](#) for 1995 to 2004. The correlation, as just stated, exists during the revenue downturn. Figure 19 also indicates there is a close correlation between tax revenues and GDP for the time period between 1985 and 1995. After 1995, the tax revenues appear to be a function of both GDP and the NASDAQ factor.

Why does the tax revenue line fall below the GDP trend line in 2003 and continue to follow the NASDAQ decline? One reason could be the correlation between [business spending and wage activity was based on the sentiment caused by the stock market](#). There are certainly other factors at work but another factor is the obvious tax consideration of Capital Losses being limited to \$3,000 per year with the additional losses being carried forward to future years. To some degree, the effect of having the extensive Capital Losses associated with the

dramatic stock market decline beginning in March of 2000 had some effect on future years Capital Gains tax revenue because the losses incurred during the decline of 2000 and 2001 were offsetting Capital Gains taxes in subsequent years..

The next step is to analyze wages and salaries.

Salaries and Wages

Another factor cited in the CBO 2001 report was the [higher marginal rates of salaries and wages component in GDP](#). The largest single component in GDP is salaries and wages. Therefore, an increase in salaries and wages increases GDP and further increases the highest taxable factor in the GDP. In conclusion, the higher the percentage of salaries and wages in the GDP, the higher the tax revenue will be, relative to GDP. The [CBO in 2001 cites the higher wages and salaries](#) was the biggest reason for the surge in tax revenues. The following figure shows the percentage of salaries and wages to GDP.

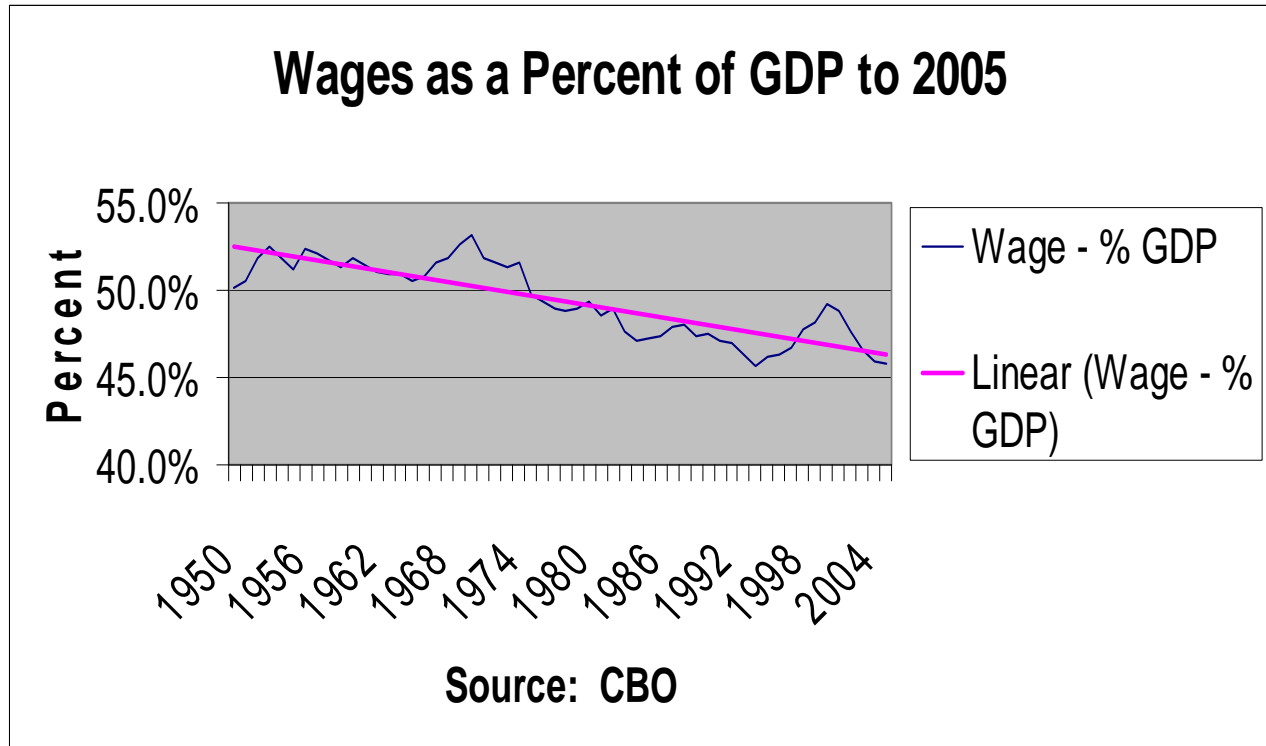


Figure 20

(In a global economy with workers around the world willing to work at a small fraction of the cost of American workers, is it reasonable to believe an American economy, which competes by attracting massive capital investment, can sustain itself where wages and salaries as a percentage of GDP are increasing? The 1990 to 2005 peak occurred in 2000. Also, people should beware of any political references to 1970 when salaries and wages as a percentage of GDP are discussed.)

Figure 20 shows a steady decline in the wages and salaries percentage of GDP from 1970 until 1994, and then in 1995 the percentage increased and peaked in 2000. The year 2000 was also the year when the NASDAQ factor peaked. Are the two simultaneous peaks of the NASDAQ and wages and salaries as a percentage of GDP a coincidence? The wages and salaries percentage then declined from 2000 until 2005. Is there a correlation between the wages and salaries percentage to GDP and tax revenues from 1996 to 2003? Figure 21 addresses the correlation.

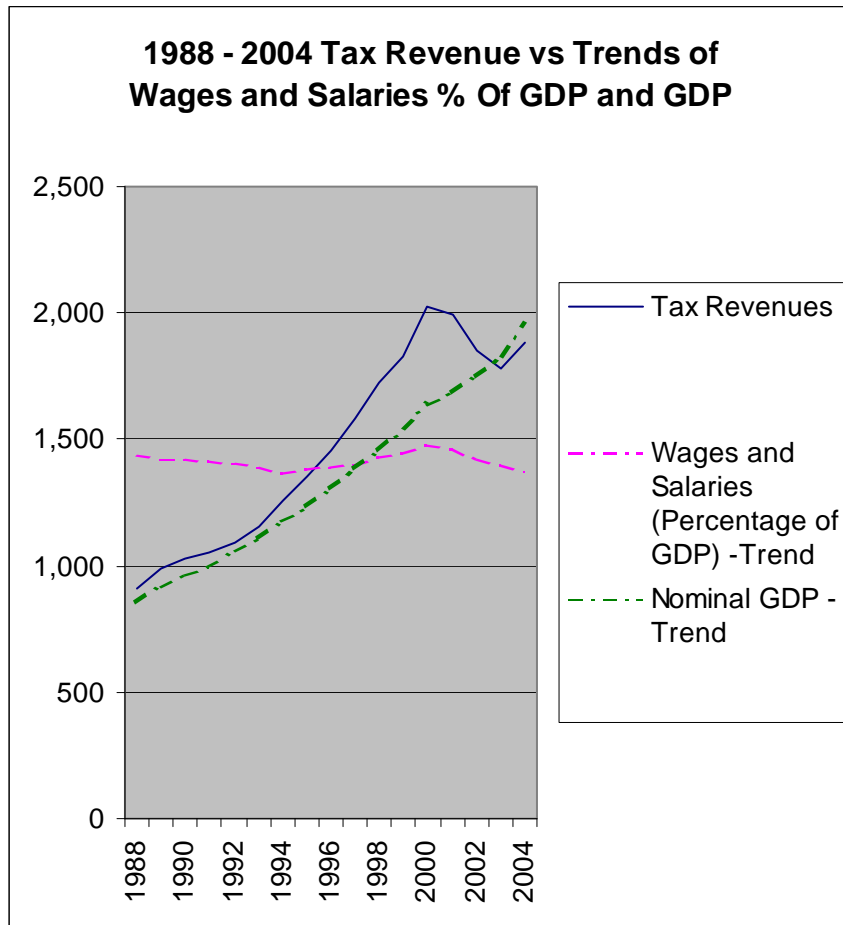


Figure 21

Based on the increases in both tax revenues and the percentage of wages and salaries to GDP-N from 1996 to 2000, Figure 21 indicates there is a correlation between wages and salaries as a percentage of GDP-N and tax revenues for 1996-2000. This reverses a trend that had been occurring since the 1970s where GDP-N was increasing as wages and salaries as a percentage of GDP-N was falling (refer to [Figure 12](#) for the GDP-N trend line). At this point it is critical to understand the components of GDP-N. With wages and salaries being a component of GDP-N, an increase in wages and salaries will increase GDP-N, regardless of the overall value or benefit to the future economy. This is especially true if the wages and salaries are capitalized as an asset to be depreciated or written-off in a future year.

Figure 19 indicated there is a correlation between the NASDAQ Factor and the tax revenue based on the generation of Capital Gains taxes.

Figure 20 and Figure 21 indicates there is a correlation between the wages and salaries as a percentage of GDP and tax revenues from 1995 to 2000, as a result of higher tax rates on wages and salaries. Therefore, Figure 21 supports the CBO's assumption that a higher percentage of wages and salaries in GDP will generate higher tax revenues.

With wages and salaries making up a larger percentage of GDP from 1995 to 2000, there is an obvious question. Were Adjusted Gross Income's (AGI) of individual taxpayers affected? Figure 22 highlights the increase in AGI thresholds for various categories of taxpayers. The figure is not adjusted for inflation. Figure 22 addresses AGI thresholds. A threshold is the amount of AGI required for a taxpayer to be in the designated percentile of all taxpayers. For example, in 2000 the threshold for a taxpayer to be in the top 1% of all taxpayers was just over \$300,000.

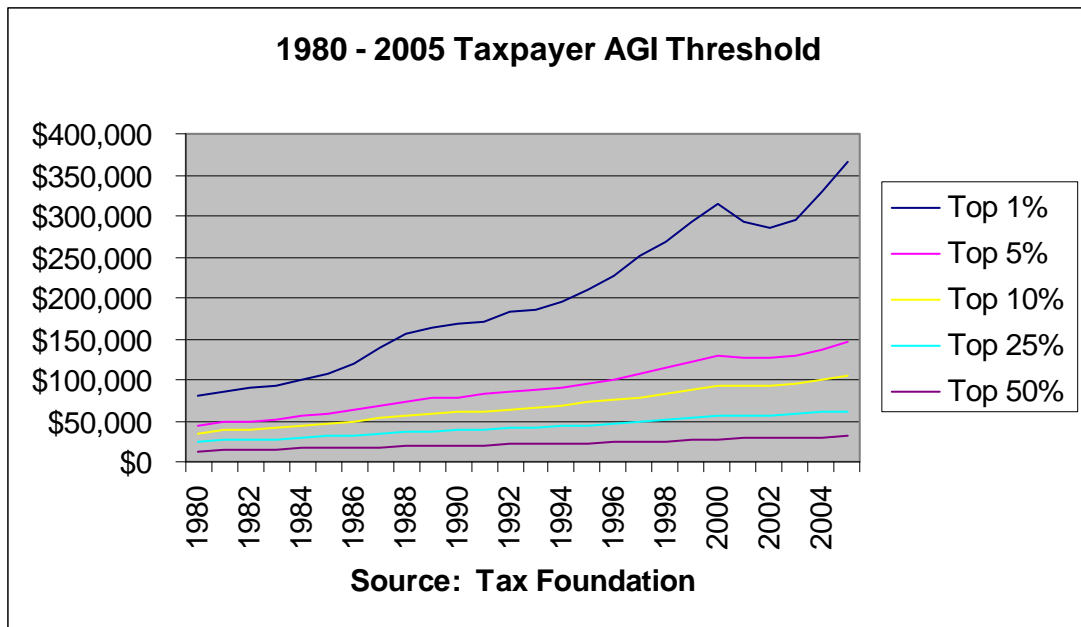


Figure 22

Figure 23 is an inflation adjusted Figure 22 plus the year 2005. The graph accentuates the significance of the increases in AGI from 1993 to a peak in 2000.

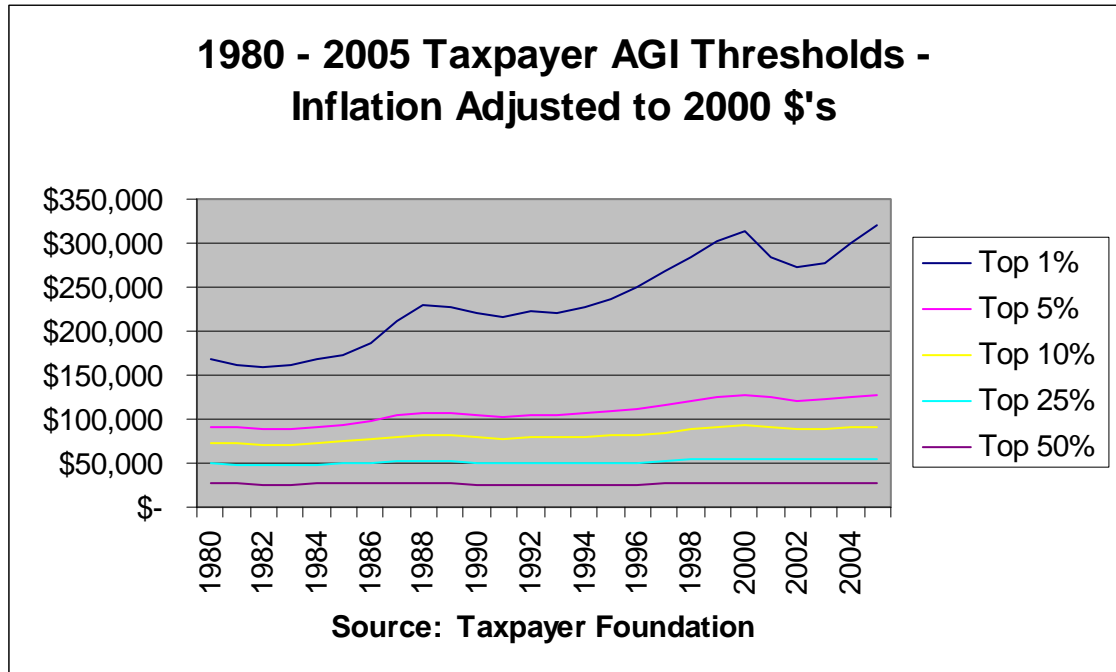


Figure 23

A point to notice in Figure 23 is the higher the AGI threshold, the greatest increase was from 1993 to 2000 with the top 1% experiencing the greatest increase. A close look at the graph indicates all thresholds experienced the same trends but to different degrees.

To correlate the AGI increases to the increase in tax revenue, the following graph shows the AGI tax thresholds with the tax revenue trend line and the GDP trend line. [AGI includes Capital Gains](#).

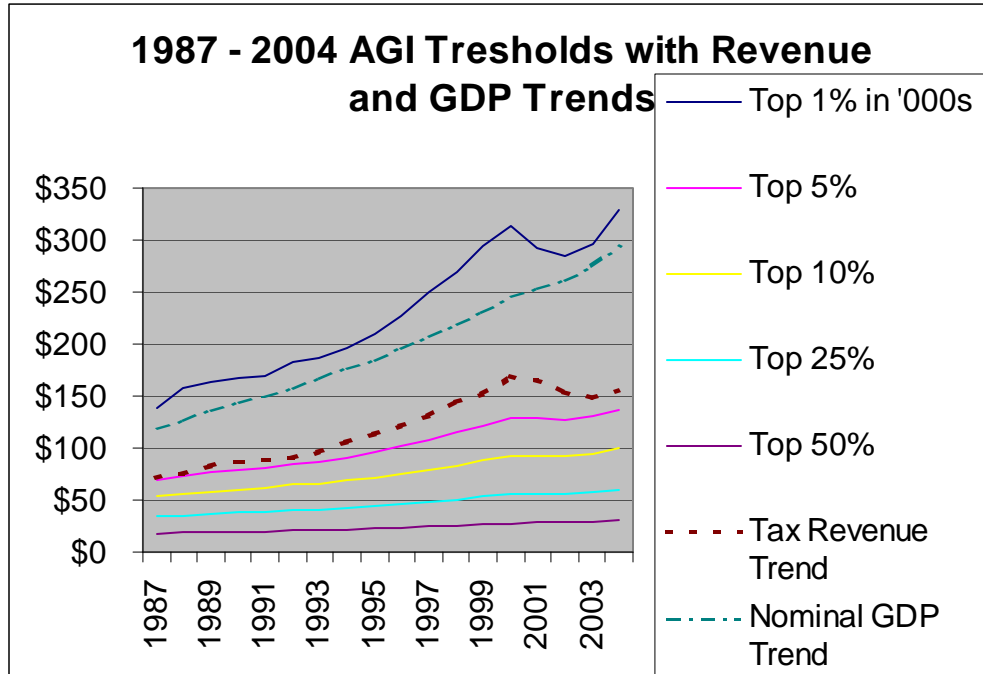


Figure 24

From 1995 to 2003 Figure 24 shows a correlation between the increases in AGI, which because of the [progressive tax rates is expected to result in higher tax revenues](#), and the actual receipt of higher tax revenue. The graph confirms the CBO's assumption in the 2001 report that higher AGI for taxpayers will lead to higher tax revenue. The CBO further assumed the taxpayer wage gains would continue. Figure 24 and Figure 23 show the gains made as of 2000 were not maintained. To reiterate, the CBO based the 2001 Projection on the assumption the wage gains could be maintained, and they were not maintained.

Figure 25 highlights the gains made by the 50% AGI taxpayer threshold.

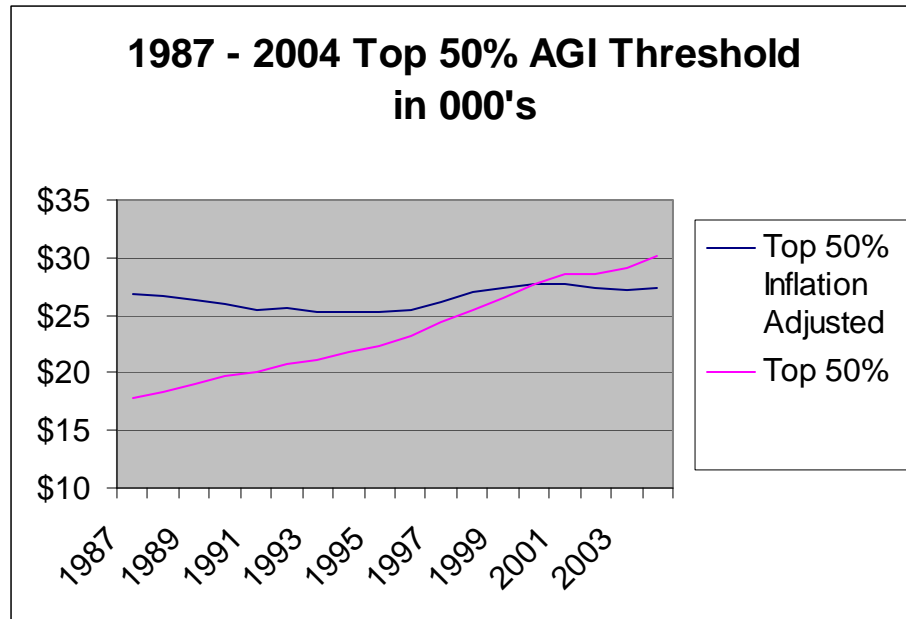


Figure 25

Figure 25 confirms there were some AGI gains for the 50% threshold from 1996 to 2000, essentially returning to the levels of 1988.

[There were significant AGI gains](#), especially at the higher wage rates, made in the 1990s through 2000 and, with the progressive tax rates, led to higher tax receipts when compared to the GDP trend. What was the source of funds for the wage gains? The CBO indicated in the 2001 report there were considerable investments being made in the new economy and the investments were forecasted to continue. What were the sources the investments and did they continue?

To evaluate two sources of new funds the [Initial Public Offerings](#) (IPO) and [Venture Capital](#) (VC) activity will be analyzed. There are other sources of funds including private funding and corporate debt; however, the IPO and VC are only analyzed as an indication of business sentiment. The following graph shows VC investments with the tax revenue trend and GDP-N trend lines. See [Appendix I](#) for the Direct Foreign Investment.

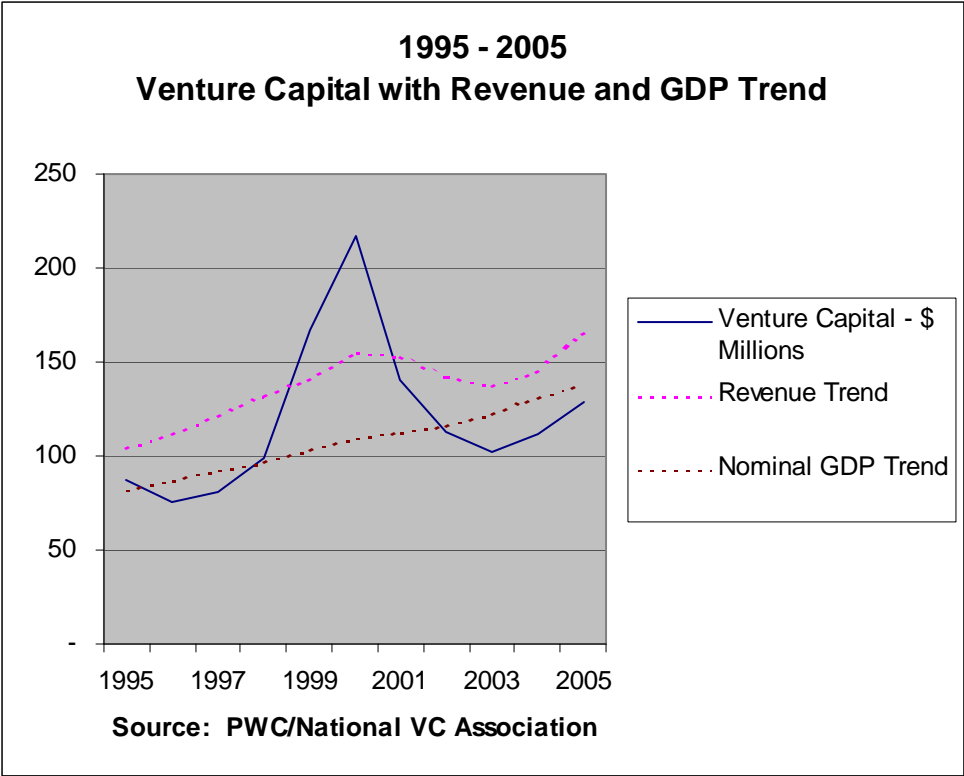


Figure 26

Figure 26 shows a correlation between VC activity and tax revenue for the period 1995 and 2005. The next graph evaluates IPO activity for 1995 to 2005.

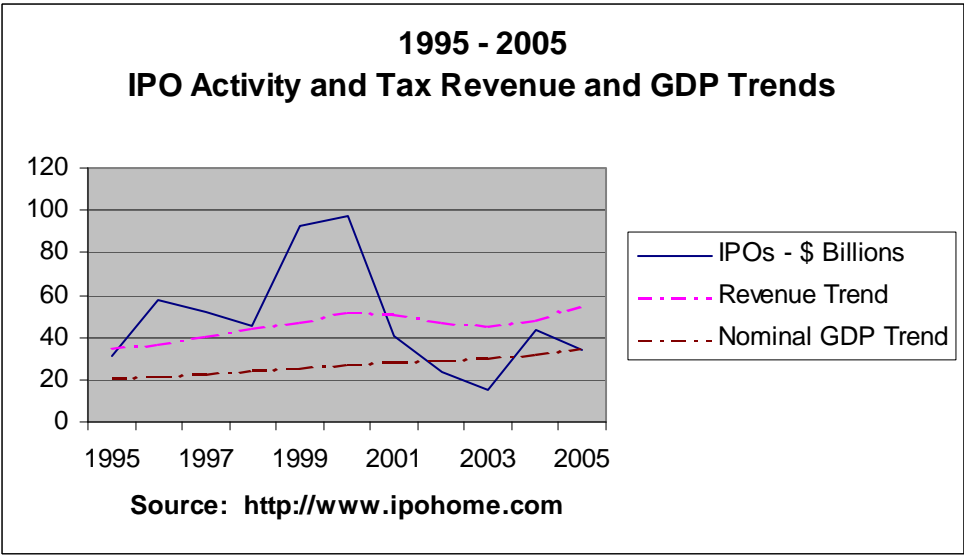


Figure 27

Figure 27 shows a correlation between IPOs and tax revenue from 1998 and 2004. Based on Figure 26 and Figure 27, the new funds for VC and IPOs have a correlation to the increase in tax revenue. Because Figure 24 shows there was a correlation between tax revenue and AGI trends, and Figure 24 shows a correlation between VC and IPO activity and tax revenue, there should be a correlation between VC and IPO activity and AGI threshold movement. Figure 28 plots the trends of VC and IPO activity and AGI thresholds. See [Appendix I](#) for the Direct Foreign Investment.

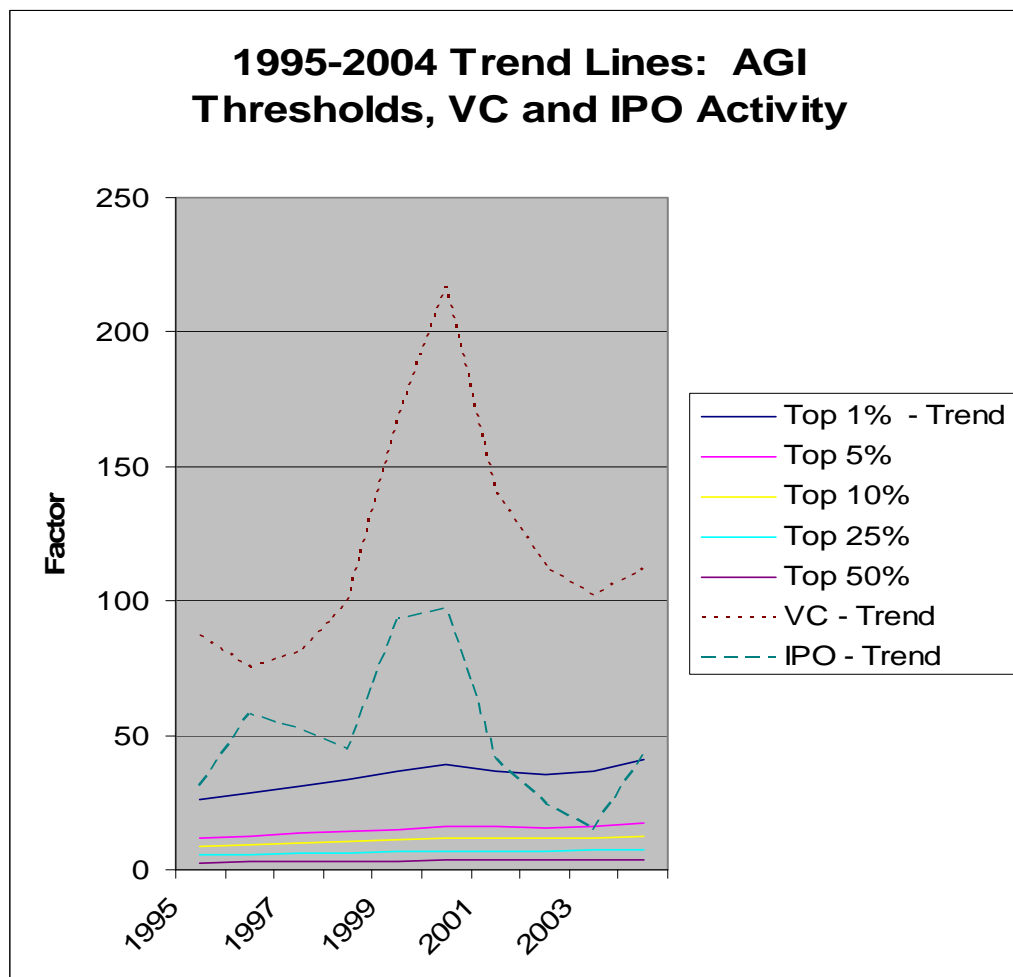


Figure 28

Figure 28 shows a correlation between VC and IPO activity and trends in AGI for taxpayers at all levels. Figure 28 indicates IPO and VC activity were the source of at least some of the AGI

gains made from 1995 to 2000. Figure 28 also shows the reduction of IPO and VC activity after 2000 as an explanation for falling AGI threshold levels. The CBO stated in the 2001 report that investment in the new economy was expected to continue. Based on the figures above, the assumption proved to be incorrect. Therefore, 2000-2001 marked a turning point in the economy.

Moving from wages and salaries contribution to tax revenues, the following analyzes corporate activity.

Corporate Activity

To begin, Corporate Book Profits and Corporate Tax revenue will be analyzed. The following graph evaluates Corporate Book Profits, Corporate Income Taxes and the GDP trend line for 1987 to 2005.

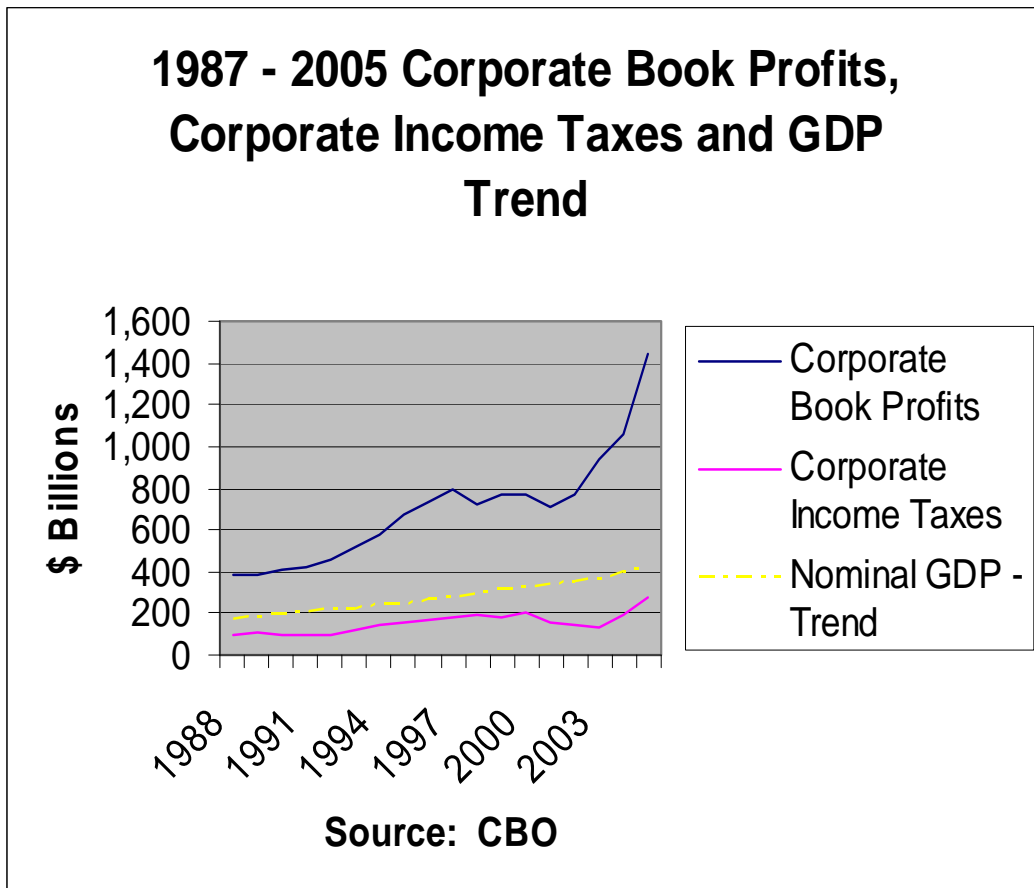


Figure 29

Figure 29 shows that Corporate Book Profits from 1995 to 2000 were essentially flat. The next figure shows the trend lines of Corporate Profits and actual Corporate Income Tax revenue. Were flat corporate profits also an indication that money was being spent on wages and salaries and thereby increasing wage and salary tax revenues? If corporate profits were being sacrificed to pay higher salaries and wages, for there to be an increase in GDP, the salaries and wages would have to be capitalized versus expensed in the year incurred. One point appears certain, corporate profits were flat from 1995 to 2000. What about corporate tax revenues?

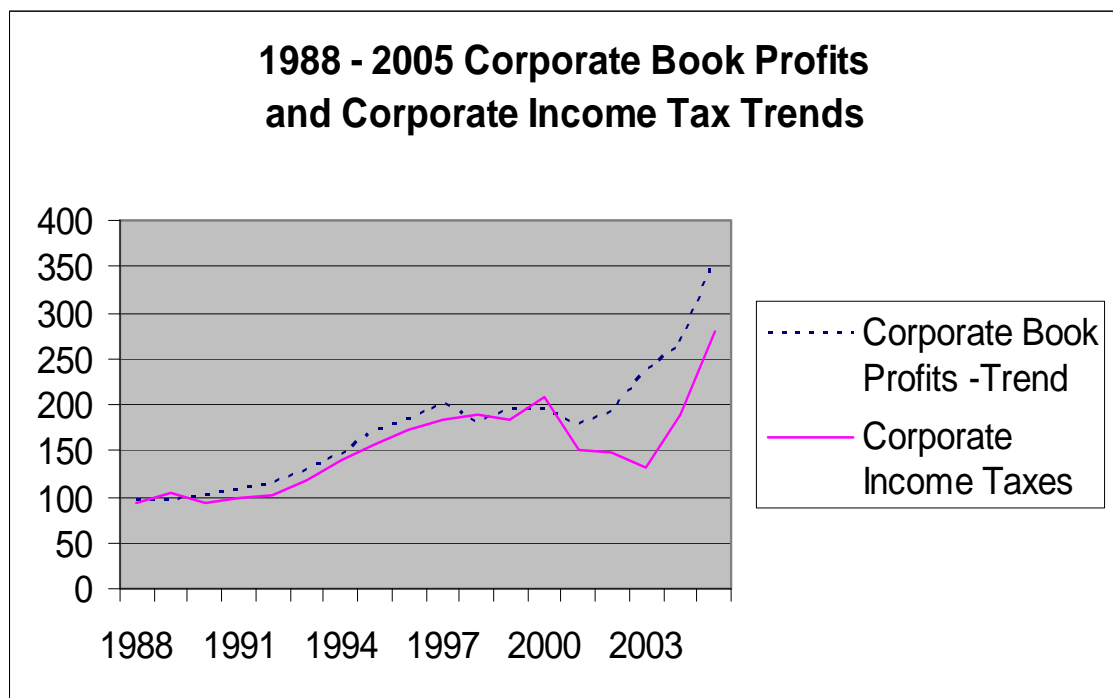


Figure 30

Figure 30 shows a close correlation between Corporate profits and Corporate tax revenue from 1988 to 1999. Then in 2000 the Corporate Tax revenue line was higher than the Corporate Book Profits trend. The lines had a dramatic separation starting in 2001. In 2004 the lines began to move again in the same direction.

Based on the unusual separation occurring in 2001, the following graph charts the Corporate Book Profits and Income Taxes trend lines from 1962 to see if this phenomenon has previously occurred.

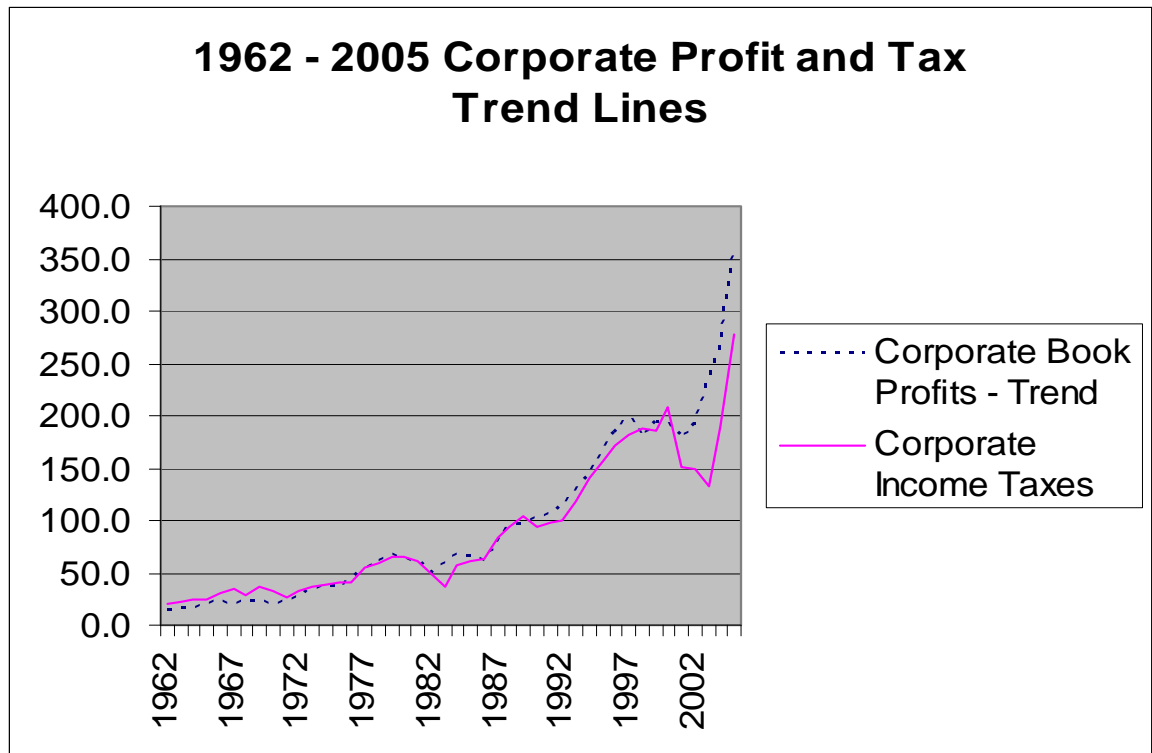


Figure 31

Figure 31 highlights the unusual separation in Corporate Book profits trend line and Corporate Income Taxes that occurred starting in 1997. The year 2000 also had a peak in the Corporate Tax trend line when Corporate Book profits had been flat from 1997. The CBO stated in the 2001 Projection there was an economic phenomenon taking place that was not completely understood. The flat corporate earnings from 1997 to 2002 and a peak in Corporate Taxes in 2000 appear to be part of the economic phenomenon of 2000.

How could the separation between the Corporate Book Profits and Corporate Tax revenue be so dramatic starting in 2001? There is an important point to know about the Corporate Book

Profits number. Corporate Book Profits are Net Profits. That is to say, both corporate profits and losses are totaled to arrive at the Corporate Book Profit number. An obvious point concerning corporate income taxes is that Corporate Income Tax revenue is obtained from profitable corporations. If a corporation never makes a profit, it will pay zero taxes and it will never apply the tax loss against any income. (The wages and salaries expenses generating the losses are taxable to the individuals as described earlier.) Therefore, if two corporations in their first year result in one making \$1 million, the other losing \$1 million and there is a 30 percent tax rate, the tax revenue will be \$300,000 while corporate book profits will be \$0.00. There will also be a \$1 million tax loss carry-forward to offset against future tax liabilities. This could explain the spike in corporate tax revenue relative to corporate book profits that occurred in 2000, immediately after the fallout of the Dot-Com began. In addition to some corporate tax recognition occurring in the year following the corporate profits, the next point about corporate tax losses is they can be carried-back to past years and then carried-forward to future years to adjust corporate tax liabilities. The corporate tax losses can be carried forward for up to 20 years, so a significant corporate bust as occurred in the late 1990s, will have a potential impact on several years of corporate income tax revenues. The CBO indicated the Dot-Com activity was having an economic impact that was not fully understood in 2000. Based on Figure 31, the economic activity associated with the Dot-Com boom beginning in 1995 and the bust beginning in 2000 probably impacted corporate tax revenues as a percentage of corporate profits for several years after 2000.

Based on the figures and discussions presented in the revenue analysis, the tax revenues for individuals and corporations as a percentage of GDP had a historical high of 20.9 percent in the year 2000. For purposes of basing a projection, the CBO projected the historical peak year for tax revenue receipts to GDP into the next 10 years. The following table is the [CBO](#)

[Revenue projections](#) as a percentage of GDP and the [actual percentages](#) as reported in subsequent years by the CBO.

As a percentage of GDP, CBO Budget Projection versus Actual

| | Year | CBO Projected 2000 | Actual |
|--------|------|--------------------|--------|
| Actual | 2000 | 20.6 | 20.6 |
| | 2001 | 20.7 | 19.7 |
| | 2002 | 20.5 | 17.7 |
| | 2003 | 20.4 | 16.3 |
| | 2004 | 20.3 | 16.1 |
| | 2005 | 20.3 | 17.3 |
| | 2006 | 20.2 | |
| | 2007 | 20.2 | |
| | 2008 | 20.2 | |
| | 2009 | 20.3 | |
| | 2010 | 20.3 | |
| | 2011 | 20.4 | |

Figure 30 plots the actual revenue percent of GDP and the percentage projected by the CBO in 2001.

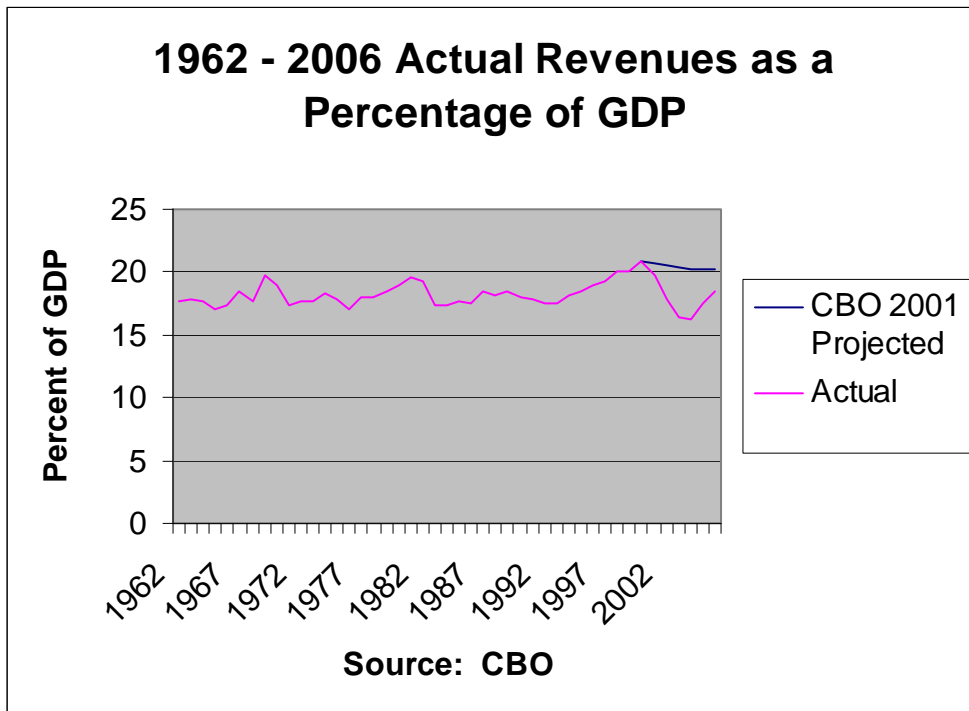


Figure 32

Figure 32 confirms the historical high revenue as a percentage of GDP in 2000. In addition, [based on the CBO's assumption](#)

[the economic activity associated with the boom in the new economy would continue](#), the CBO projected the revenue collections to remain at a historical high levels. The CBO did note in the 2001 projection that the [economy was weakening](#) at an unexpected rate; however, the decline was assumed to be temporary.

Returning to [Figure 30](#), in 2002 there was a significant separation between Corporate Book Profits and Corporate Tax revenue trend lines beginning in 2001 and continuing until 2004. The separation was unprecedented since 1962. Was the separation based on tax cuts or corporate losses? The following attempts to address the question.

Figure 33 is the Return on Equity (ROE) for the S&P 500 for 1977 to 2005. There was a significant decline in the return on equity beginning in 2001 and it continued through 2005. With flat corporate profits and elevated ROE, this is an indication the economic activity in the late 1990s was financed with debt.

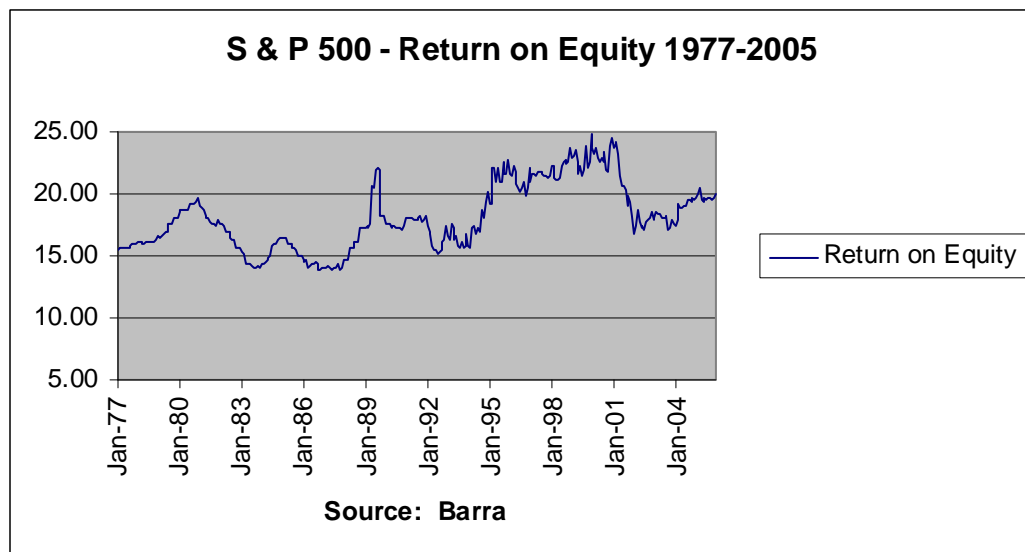


Figure 33

Figure 34 compares the S&P 500 Price Earning ratios when companies with losses are excluded from the calculation and when companies with losses are included in the calculation.

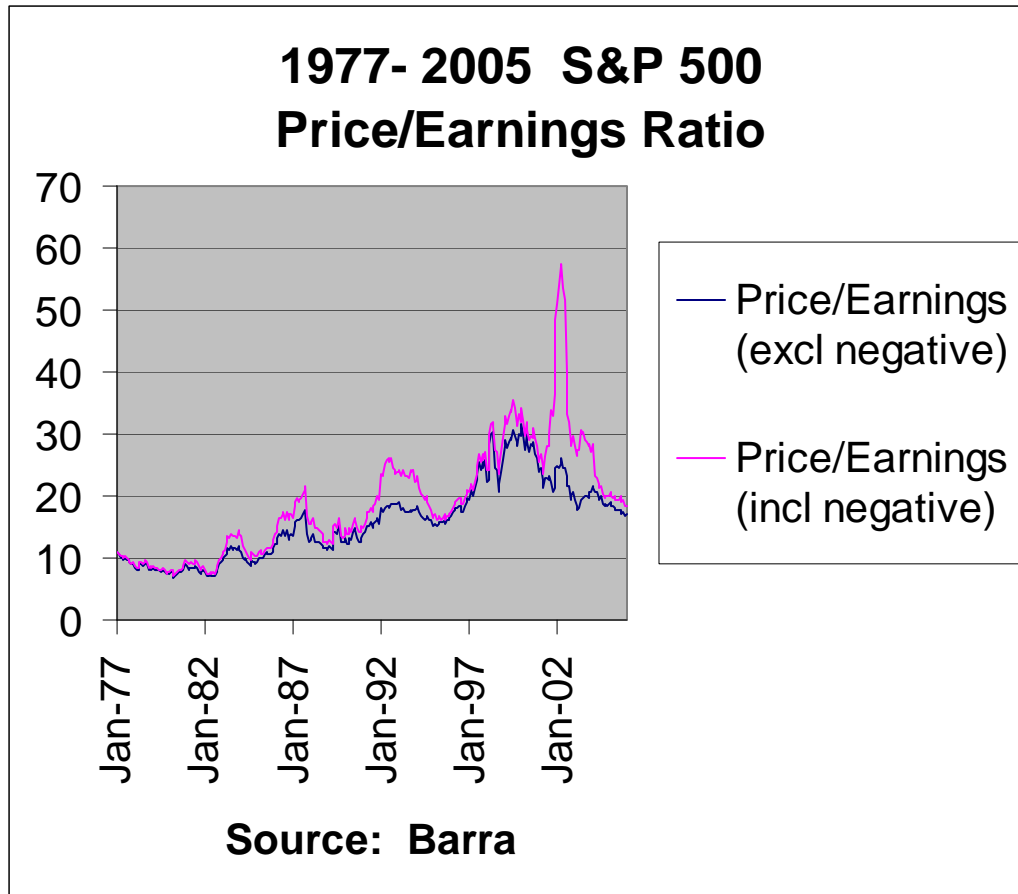


Figure 34

Figure 34 shows significant corporate losses beginning in 2001 and continuing through 2003. Were these losses the result of writing-off nonproductive assets capitalized during the Dot Com boom? The CBO stated in 2001 there was a considerable investment in [short depreciable lived asset](#). As described earlier, with the ability to carry tax losses back and then forward, the significant corporate losses from 2001 to 2003 could be the cause of the unprecedented separation from 2001 to 2004 in Figure 31. In any event, Figure 34 shows a significant corporate loss event occurred in 2002. What was the cause of the significant event 2002? [Was it related to the write-off of assets from the Dot-Com bust?](#) The answer may be in a future update.

Conclusion

Based on the figures presented in the analysis, starting with Figure 1, there was an economic phenomenon taking place from 1994 to 2005 that peaked in 2000 and appears to have bottomed in 2004. The phenomenon from the revenue side of the analysis is the dramatic increase in revenues when compared to GDP that peaked in 2000. The CBO stated in the January 2001 there was an economic phenomenon taking place and it was expected to continue. In the same report the CBO also stated the economy was slowing at an unanticipated rate. How is a \$5.6 trillion budget surplus projection derived from the conflicting data?

First, the CBO made the assumption [the investment in the new economy was going to continue](#). From the figures presented covering VC and IPO activity, clearly the investment in the new economy did not continue. Also, refer to [Appendix I](#) for the Direct Foreign Investment.

Second, the CBO forecasted [the wage gains made during the boom would be maintained](#). The figures concerning AGI show the AGI gains that peaked in 2000 were not maintained. This is especially true of the higher taxed AGI taxpayers. This is an interesting point. One of the reasons for the decline since 2000 in revenues to GDP is because the higher AGI taxpayers were not able to maintain their earning levels. Therefore, any criticism concerning an inability to maintain the historic high level of tax revenue to GDP that peaked in 2000 is because the highest AGI taxpayers were not able to maintain the gains experienced in the late 1990s that peaked in 2000.

Third, the CBO stated in the report there is [uncertainty in determining the Capital Gains](#) taxes in any one year. The CBO acknowledged the significant stock market activity that certainly was generating, the difficult to quantify, Capital Gains taxes. The CBO went on to state the Capital Gains tax revenue was anticipated to return to [more historic levels over the next few years](#) and the CBO had made the adjustment in the revenue forecast (if Capital Gains taxes are difficult to quantify, what is

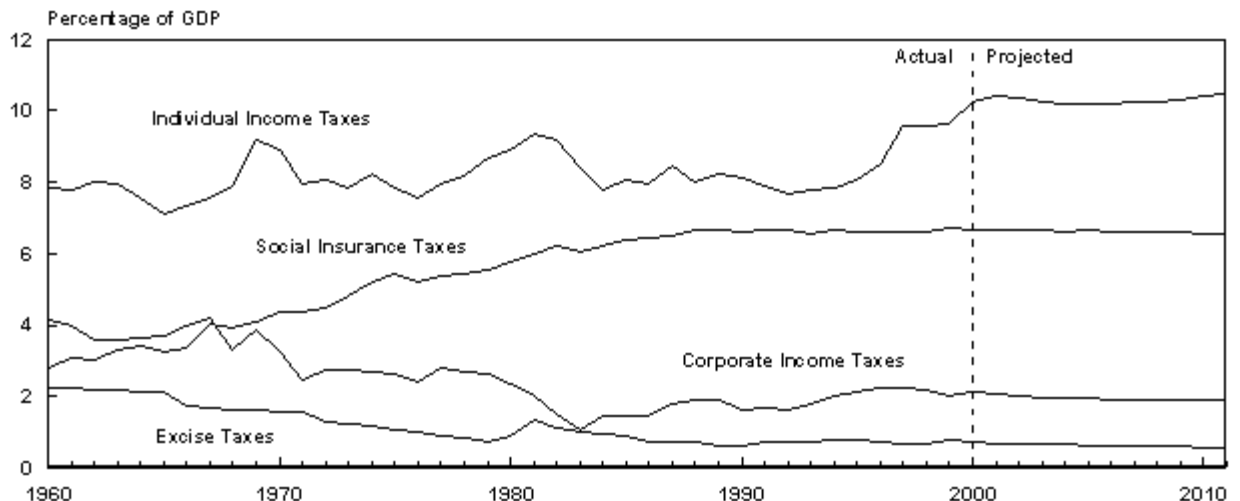
the confidence in the ability to factor out a Capital Gains revenue spike?) Based on the NASDAQ activity, Capital Gains tax revenues did not need a few years to return to historic levels. The [decline was dramatic](#) and certainly generated tax loss carry-forwards that reduced future years Capital Gains taxes.

Fourth, [Figure 20](#) may be the most important graph in the presented analysis. In 1995 the wages and salaries as a percentage of GDP (Figure 20) reversed the declining trend that began in 1970 and bottomed in 1994. In 1995, wages and salaries as a percentage of GDP increased to a post 1970 high in 2000. Obviously with wages and salaries as a percentage of GDP increasing, the sum of the other components in GDP had to decrease because the sum of the GDP components equals 100 percent. Using the Income Approach to GDP, the other significant GDP components are depreciation, proprietor's income, corporate profits, net interest, rental income and other items. Because many of the non-wage and salary components of GDP are profit oriented ([Figure 31](#) shows that corporate book profits were flat through the late 1990s) it is clear the wages and salaries paid during the late 1990s and 2000 did not generate profits at the rates experienced before the Dot-Com boom and after the Dot-Com boom. Therefore, in a global economy with workers around the world willing to work at a small fraction of the cost of American workers, is it reasonable to believe an American economy which competes by attracting massive capital investment, can sustain itself where wages and salaries as a percentage of GDP are increasing? Based on [Figure 20](#) and the [CBO's statement the economy was slowing at an unanticipated rate](#), the answer in 2000 is "No." The increase in wages and salaries as a percentage of GDP that began in 1995 and reversed in 2000 may be the single best barometer of the temporary economic phenomena taking place in the late 1990s. Instead of asking the question, "Can the 2000 economy be repeated?" the real question should be, "Do we want to repeat the 2000 economy?"

Fifth, overall spending as a percentage of GDP was cut in the 1990s. Overall spending includes both Mandatory spending and Discretionary spending. Mandatory spending increased as a percentage of GDP, therefore, Discretionary spending decreased to more than offset the increase in Mandatory spending. In the Discretionary spending category, there was a slight decline in the rate of increase in Domestic spending. Therefore, to offset the increases in Mandatory spending, Defense spending was cut. Defense spending was cut as a percentage of GDP as well as actual dollars, without taking into account inflation.

To answer the question on how this data turns into a \$5.6 trillion dollar CBO baseline projection surplus in 2001, the peak tax revenue being generated in 2000 by the events described in this analysis are projected to continue for 10 years. The following graph is taken [directly from the CBO January 2001 report](#). Although corporate income taxes are not at historical highs, [Figure 30](#) shows a slight spike in 2000 of Corporate Income Taxes when compared to recent years. The slight spike was used as the basis for the corporate income tax projection.

Figure 3-3.
Revenues, by Source, as a Share of GDP for Fiscal Years 1960-2011



SOURCE: Congressional Budget Office.

With the above graph showing how record high revenues were being forecasted to continue without interruption (look at the previous 10 years to evaluate the probability of this occurring) and combine significant reductions in Defense spending, you will arrive at a \$5.6 trillion dollar budget surplus over 10 years.

The final point concerning the analysis relates to [Figure 13](#). Figure 13 shows the Social Security peak surplus occurred around 2002. Even with all the optimistic projections contained in the January 2001 report, the CBO states in the same report the [future social security shortfalls](#) that will occur after 2011 are capable of devastating the American economy.

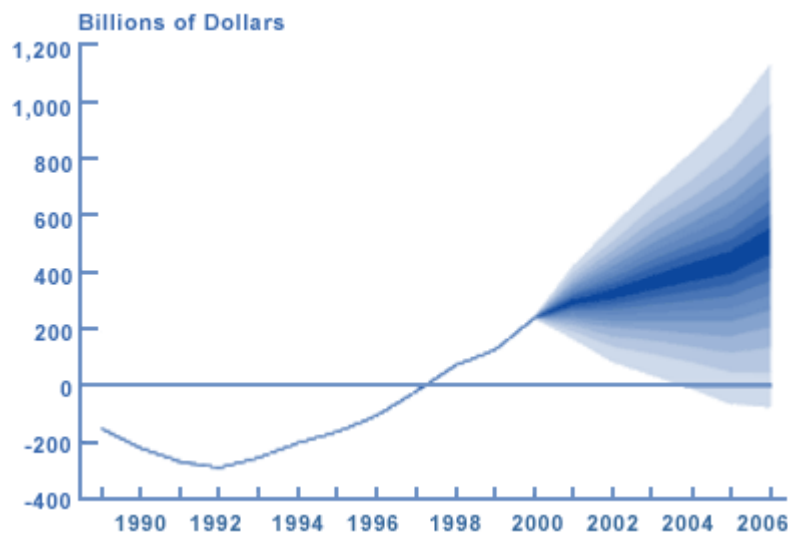
Moving from the analysis presented to general comments, one point should be obvious from the graphs covering VC and IPO activity. Based on those graphs, attracting capital investment is a requirement for increased taxpayer AGI in the American economy.

It may appear in the conclusion there is criticism of the CBO and their budgeting techniques. The CBO stated several times in the report the constraints under which they work and the controls placed on them by congressional legislation. The CBO disclosed these constraints and qualifiers in the report and that is what is required to meet any obligation when reporting on a projection to avoid any misunderstanding on the use of a projection. As stated in the introduction, to understand the assumptions, constraints and qualifiers surrounding a \$5.6 trillion dollar budget projection requires a reader to get beyond the second sentence of the introductory Summary section of a 190 page document. The CBO states in the report that based on their forecasting results, there is [only a 10 percent chance](#)

of the \$5.6 trillion dollar surplus being in a narrow range around that number.

Included in "The Budget and Economic Outlook: Fiscal Years 2002-2011" [is the following graph](#). **Does this look like a prediction of a \$5.6 trillion budget surplus to you?**

Summary Figure 2.
Uncertainty in CBO's Projections of the Total Budget Surplus Under Current Policies (By fiscal year)



SOURCE: Congressional Budget Office.

NOTES: The figure shows the estimated likelihood of alternative projections of the surplus under current policies. The calculations are based on CBO's past track record. The CBO projections described in [Chapter 1](#) fall in the middle of the darkest area. Assuming that policies do not change, the probability is 10 percent that actual surpluses will fall in the darkest area and 90 percent that they will fall within the whole shaded area.

Actual surpluses will of course be affected by legislation enacted during the next 10 years, including decisions about discretionary spending. The effects of future legislation are not included in this figure.

An explanation of how this probability distribution was calculated will appear shortly on CBO's Web site at www.cbo.gov/otherdoc.html

[Appendix I – Direct Foreign Investment](#)

[Appendix II – Individual Stock Activity](#)

[Appendix III – Weekly Initial Jobless Claims](#)

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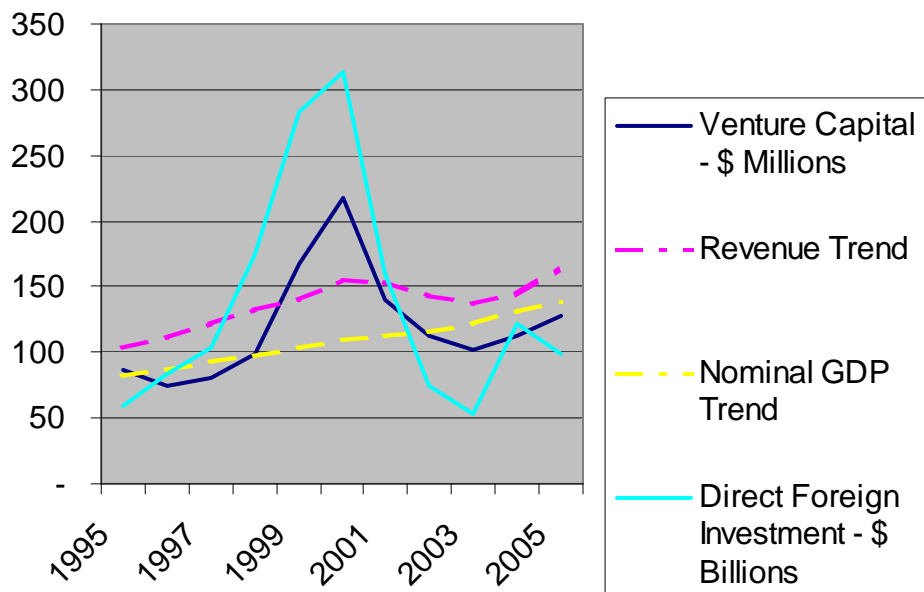
Appendix I

The following figure contains the Direct Foreign Investment (DFI) into the USA from 1995 through 2005. The figure further demonstrates the importance of capital investment in the US economy that eventually translated into the higher wages and ensuing tax revenues experienced in the late 1990s and early 2000s. Based on the 2001 CBO report, high DFI in the USA occurred because of [poor opportunities abroad](#).

The Direct Foreign Investment is compared to the Venture Capital and tax revenue trend line and GDP trend line as displayed in [Figure 26](#).

Because [Figure 28](#) in the analytical review displays the correlation between the AGI gains and the VC investment, the following figure further demonstrates the significance of capital investment during the time period when significant AGI gains and tax revenue were experienced.

1995 - 2005 Investments, Revenues and GDP



Source: BEA, CBO,
PWCmoneytree.com

Figure i

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Appendix II

Stock Activity Examples

The following stocks are included as examples of potential capital gains and capital loss. The data was adjusted by the source provider for stock splits.

[Amazon](#) [Broadcom](#) [EBAY](#) [Gateway](#) [Intel](#) [Intuit](#) [Level 3](#) [NYSE NASDAQ](#)
[Priceline](#) [Qwest](#) [Rambus](#) [Tyco](#) [Yahoo](#)

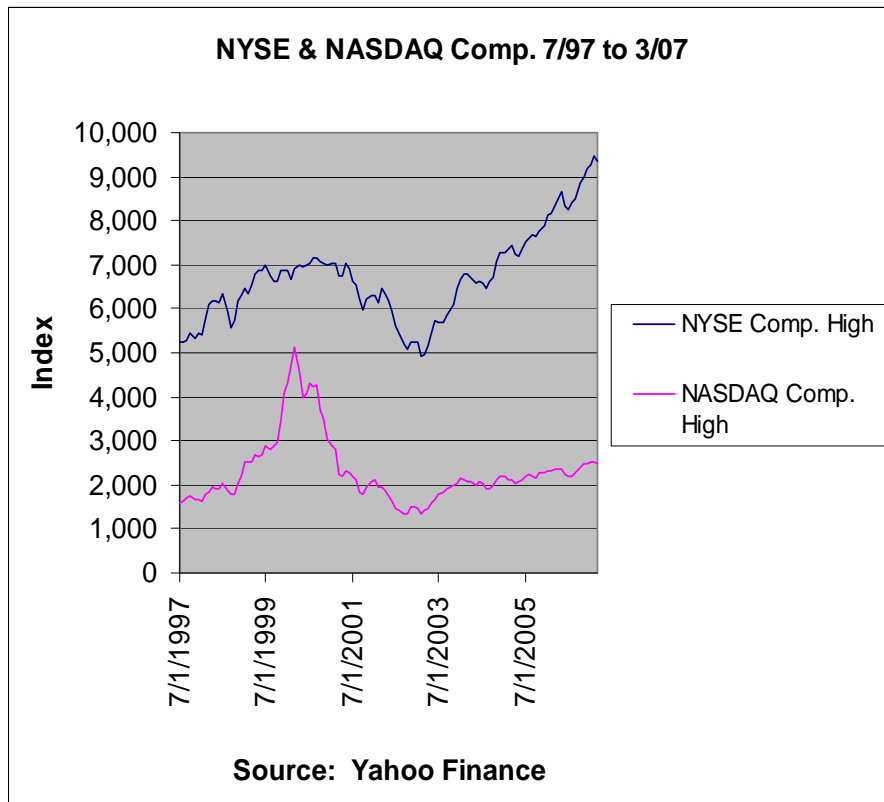


Figure I

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Appendix III Weekly Jobless Claims

Minimum – April 2000

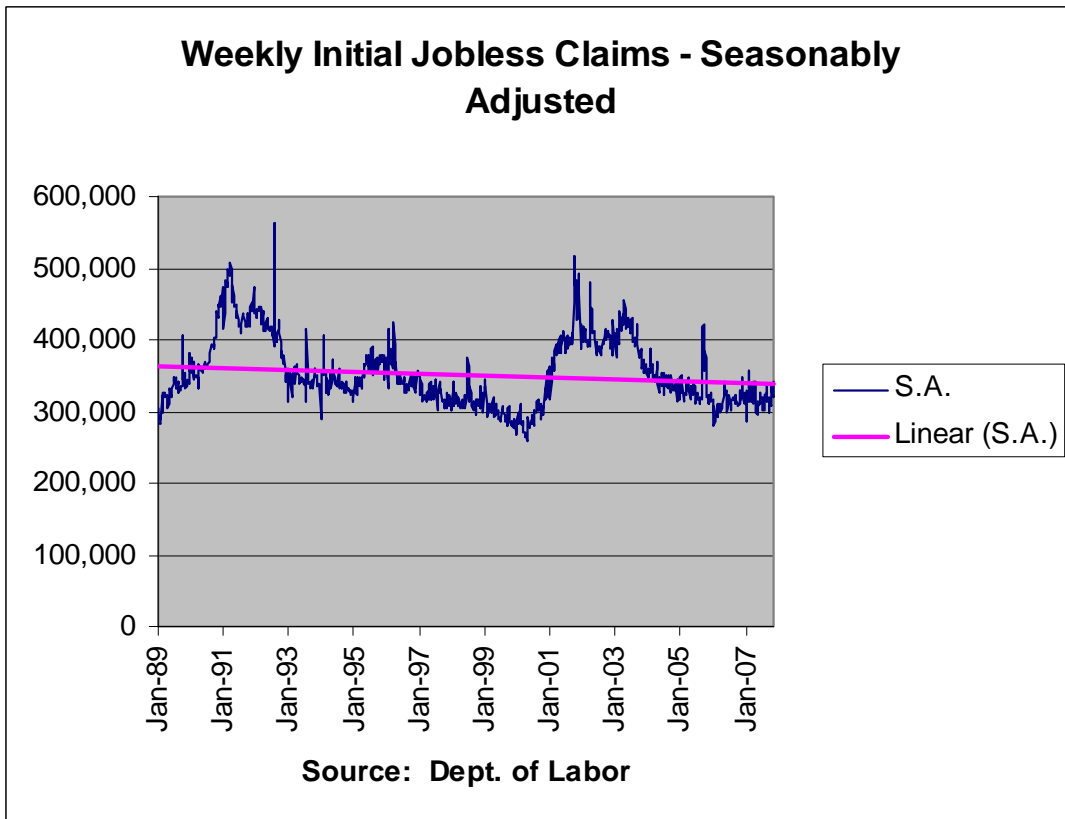


Figure I