

## ***FISCAL POLICY: AN EVALUATION OF THE 2001 - 2004 TAX CUTS***

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### **ABSTRACT**

US economic growth turned negative in 2001 following the stock market reversal and the terrorism attacks of September 11. Fiscal policy was shifted through tax cuts, tax reforms, and direct cash payments to individual taxpayers. Some of the important tax reforms were set to expire and revert to their previous form by 2011. This paper will examine those tax policy changes and suggest policy alternatives.

### **INTRODUCTION**

This paper will provide an analysis of the 2001 - 2004 tax cuts and related fiscal policy. While some claim strong macroeconomic effects for these policies, others describe them as tax cuts for the rich which should be reversed. This issue was a key focus of the 2006 Congressional elections, and it will be a very important factor in the 2007-2008 election cycle.

Economic growth began to decline in the third quarter of 2000, soon after the strong stock market of 1995 - 2000 reversed course in March 2000. The President began campaigning for a tax cut then to end the coming recession, and the checks for \$600 or \$300 went out to taxpayers in August 2001. Subsequent tax reforms also had been passed to be phased in over time. Then the terrorist attacks of September 11, 2001 created a large negative effect on economic growth. Swift Congressional response provided certain fiscal stimulus, and massive corporate actions were taken to offset the downturn expected – such as zero interest financing of autos. Congress passed a tax bill in May 2003 that accelerated previously enacted tax reforms. Some of these reforms were passed to be effective only through 2010.

This paper will provide an analysis of the fiscal impacts of these tax changes in terms of projected and actual tax revenues. The policy implications of these tax reforms are important as they will be a central issue in the 2008 Congressional and Presidential elections that will, in turn, determine fiscal policy for years to come.

### **STRONG ECONOMY OF THE 1990 DECADE**

After the successful conclusion of the Desert Storm/Desert Shield conflict in Iraq and Kuwait in 1991, the economy of the US quickly returned to prosperity. Real GDP growth exceeded 4% and the unemployment rate was below 4% in four of the years late in the decade. The Federal budget surplus reached \$557 billion (current dollars) for the four consecutive years 1998 - 2001, the longest run of consecutive surpluses in fifty years. Table 1 shows key economic results for the decade.

**TABLE 1**  
**STRONG ECONOMY OF THE 1990 DECADE**

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Real GDP Growth (%)	-0.2	3.3	2.7	4.0	2.5	3.7	4.5	4.2	4.5	3.7
Unemployment Rate (%)	6.8	7.5	6.9	6.1	5.6	5.4	4.9	4.5	4.2	4.0
New jobs (000)	1113	350	2118	3447	3007	2410	3000	3154	3063	2792

Sources: Bureau of Economic Analysis (2007), Bureau of Labor Statistics (2007)

### **CHANGING REALITIES AND THE SHIFT IN FISCAL POLICY**

During the late 1990s the economy grew rapidly, and investment surged along with the US stock market. In what has now come to be called the internet bubble, speculation in unproven business concepts, such as pets.com, led Chairman Greenspan to warn against “irrational exuberance” in 1998. A popular book of the time was called *Dow 15,000*, although the Dow Jones Industrial average was destined to dip near 7,000 in a few short quarters.

The inflated stock market started to decline in March 2000. Many investors, especially day traders, were faced with margin calls and evaporating paper profits. Many consumers who had adopted expanded spending habits were forced to rein in their lifestyle. Especially hard hit were the “dot com” firms, especially in the Silicon Valley of California. Some of these firms never earned a profit and had survived on stock issues and “angel investors”. This downturn in the market led to recession, and it prompted President Bush to advocate the 2001 tax cut and reform measure, called the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). That bill provided certain tax reforms and refund checks of \$300 or \$600 to every taxpayer in August 2001. Most of its provisions are set to expire in December 2010.

Then came the terrorist attacks on New York, Washington D.C., and Pennsylvania on September 11, 2001. Suddenly the nation was pushed into a more serious recession as the travel and hospitality industry was severely disrupted. The destruction in New York and the more than 3,000 lives lost made this incident the worst single event in US history. Economic recovery during 2001 and 2002 was slower than in most recessions, prompting another fiscal stimulus bill in 2003. This bill, the Jobs and Growth Relief Reconciliation Act of 2003 (JGTRRA) accelerated some of the provisions of the 2001 bill, although many of its provisions are set to expire in December 2008.

In the following year another tax bill was passed. This bill, the Working Family Tax Relief Act of 2004 (WFTRA) extended the life of many of the 2003 tax provisions from 2004 to 2010, and it extended Alternative Minimum Tax exemptions one additional year. These three tax bills constitute the fiscal reforms made by the Bush administration, and it is useful here to evaluate their impact on economic growth and fiscal results.

### **RESULTS OF TAX CUTS AND REFORMS**

To evaluate the tax policies of the 2001 - 2004 period, we present below the actual pattern of federal tax revenues and federal expenditures and the resulting

surplus or deficit. First we present the projected revenues and expenditures that were reflected in the President’s budget of 2001, which was prepared before the magnitude of the adverse events of 2000 - 2001 were evident. It is clear in Table 2 that the strong economy of the era brought expectations of continuing budget surpluses “as far as the eye could see”.

**TABLE 2  
STRONG ECONOMIC FISCAL OUTLOOK IN 2001 - PROJECTED**

	2000	2001	2002	2003	2004	2005	2006
Revenues (\$millions)	1956	2019	2081	2147	2236	2341	2529
Outlays (\$millions)	1790	1835	1895	1963	2041	2125	2224
Surplus (\$millions)	166	184	186	185	194	215	305

Source: Office of Management and Budget, President’s Budget, Fiscal Year 2001

However the events of 2000 and 2001 soon brought a new reality. Fiscal and monetary policy was forced to adapt to the changed situation. The Federal Reserve adopted a very aggressive monetary policy, lowering short term interest rates to 1% in 2001, a forty year low. In part due to the long lag time in monetary policy, these measures were slow to have an effect, and unemployment remained high during 2002 and 2003. The deteriorating economic situation during 2001 and 2002 prompted the President and the Congress to rely on fiscal policy measures as well. Table 3 describes the key features of the fiscal policy measures adopted during 2001 - 2004.

**TABLE 3  
TAX CUTS AND TAX REFORMS OF 2001 - 2004**

- 2001: Economic Growth and Tax Relief Reconciliation Act (EGTRRA)-expire Dec 2010
    - Reduced marginal income tax rates from 39.6% to 35%, 36% to 33%, 31% to 28%, and 28% to 25% (effective 2003-2004 only)
    - Established a new 10% tax rate for certain lower income taxpayers (vs. 15%)
    - Eliminated the marriage penalty
    - Increased the child care credit from \$500 to \$1000
    - Increased the exemption for the Alternative Minimum Tax
    - Phase out the Inheritance Tax from 60% to 0 by 2009, then expire Dec 2010
  - 2003: Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) – expire Dec 2008
    - Accelerated certain of the tax reductions of the 2001 Act
    - Reduced tax on dividends and long term capital gains – expire Dec 2008
  - 2004: Working Family Tax Relief Act (WFTRA)
    - Extended many of the 2003 Act tax cuts until Dec 2010
    - Extended the exemption of the Alternative Minimum Tax for one additional year
- Source: Congressional Budget Office (2007)

It is important to understand the purpose and intent of each of these fiscal policy changes. Some were intended to correct inequities in the tax code, such as the marriage penalty and the Inheritance Tax. The marriage penalty resulted in a higher income tax on two single taxpayers than on the same two taxpayers as a married couple filing jointly. The inheritance tax, then 55% on estates above \$1 million,

placed a heavy burden on small business and family business after they already had paid tax on the income of their estates over many years.

Another important purpose of the tax reforms was to encourage investment and work. Lower tax rates increase the incentive to take risk and produce income. The evidence from the Kennedy tax cuts of 1962 and the Reagan tax cuts of 1980 – 1984 supports this policy goal.

The Alternative Minimum Tax presents a special problem. The AMT was established in 1969 when it was discovered that 21 high income persons escaped paying any income tax due to exclusions and deductions. The AMT applies to certain taxpayers with high deductions and exemptions, and it taxes most income at rates of 24% or 26%. It was not indexed for inflation, so within the next few years as many as 40% of all taxpayers are expected to come under its reach. This was not the intent of the AMT, but correcting this feature requires offsetting tax increases or outlay reductions that are difficult to negotiate. The Bush tax policies of 2001 - 2004 attempted to reduce the impact of the AMT on middle income taxpayers, but it remains a looming problem.

To evaluate the results of these tax cuts and tax reforms of 2001 - 2004, we will need to consider the purpose and justification of each measure.

## **RESULTS OF THE 2001-2004 TAX CUTS AND TAX REFORMS**

Five years have passed since the last recession and the initiation of tax reforms. Now it is possible to review the results of these tax reforms for fiscal policy. These results can be viewed in terms of the trend in federal government revenues and outlays and the resulting budget surplus or deficit. In addition we can look at the pattern of Real GDP, unemployment rate, and the number of net new jobs created over the business cycle. This review will provide an evaluation of past policy and suggestions for future fiscal policy.

Table 4 shows the actual fiscal results for the federal government through fiscal year 2006. Note that federal tax revenues declined from a peak in FY 2000 by almost 12% to \$1,783 billion in FY 2003, largely a result of the recession and terrorism-related disruptions. During these years the federal budget surplus of \$236 billion in FY2000 plunged to a deficit of \$412 billion in FY2004. It appears that most of this swing in the budget balance is due to the tax reforms targeted to lower income taxpayers: the child care credit, marriage penalty relief, the 10% tax bracket, and the AMT extension. A much smaller portion of this swing was due to tax measures benefiting the “rich”: reduced capital gains and dividend tax rates and estate tax elimination.

Starting in FY 2004 the new tax reforms were in place, and the economy began to respond with strong Real GDP growth, reduced unemployment, and creation of new jobs. Soon after the 2003 tax cuts were in place, the “jobless recovery” of 2001 - 2003 became a strong expansion, with the creation of over 7 million jobs during 2004 - 2006. Real GDP grew above 3% annually after 2003, and the unemployment rate continued to drop to levels last seen before the internet bubble in 1997.

A recent analysis published by the Heritage Foundation delved into the reasons for the FY 2006 deficit as compared to the FY 2006 surplus that was projected in the President’s Budget of FY 2000. A number of events led to a deteriorating fiscal situation between 2000 and 2006. Among them are the stock market collapse, the terrorism attacks, and the sharp increase in federal spending.

Between 2000 and 2006, the projected budget surplus of \$325 billion turned in to a deficit of \$247, a swing of \$572 billion. Of this swing in fiscal results, Heritage estimates that \$58 billion was due to lower tax revenues and \$514 billion was due to increased federal spending. Much of this spending was related to the war in Iraq, rebuilding New York, and increased security measures. The conclusion is that we cannot blame the tax cuts and tax reforms. These reforms no doubt lessened the shortfall by encouraging increased work and risk taking, as evidenced by the sharp increase in tax revenues during 2003 - 2006 by 35%.

**TABLE 4  
FISCAL AND REAL ECONOMIC RESULTS - ACTUAL**

	2000	2001	2002	2003	2004	2005	2006
Revenues (\$millions)	2025	1991	1853	1783	1880	2154	2407
Outlays (\$millions)	1789	1863	2011	2160	2293	2472	2655
Surplus/deficit (\$millions)	236	128	-158	-378	-412	-318	-248
Real GDP Growth (%)	3.7	0.8	1.6	2.5	3.9	3.2	3.4
Unemployment Rate (%)	4.0	4.7	5.8	6.0	5.5	5.1	4.6
Jobs created (000)	2792	41	-1000	-342	1436	2268	3468

Source: Office of Management and Budget, President's Budget, Fiscal Year 2008

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