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The Role of Fiscal Policy in The Post-2001 U.S. Economic Expansion

*This ACCF Center for Policy Research report presents highlights from a recent analysis of the impact of the tax cuts and federal spending over the 2001-2006 period. This retrospective analysis, which was prepared by Dr. Allen Sinai, Chief Global Economist, Decision Economics, Inc., in late 2006, is especially relevant now as policymakers confront the challenge of maintaining strong U.S. economic growth without adding to inflationary pressures.**

SUMMARY: In a recent study, Dr. Allen Sinai, Chief Global Economist, Decision Economics, Inc. (DE) finds that the tax reductions in 2001, 2002, 2003 and 2004 for individuals and business had a very positive effect on U.S. economic performance from 2001 through 2006, the period analyzed. While easier monetary policy, increased federal spending and globalization also contributed, tax cuts, including those for individual capital gains and dividends received, contributed significantly to economic growth, job creation and real per capita income during this period.

THE U.S. ECONOMY'S STRONG PERFORMANCE IN 2001-2006

On virtually all accounts, U.S. economic performance over the 2001-2006 period was quite impressive-absolutely and relatively, Dr. Sinai notes (see **Table 1** and **Chart 1**).

The record over that time is all the more impressive considering the negative external shocks that buffeted the economy - the 9/11 terrorist attack, global terrorism and geopolitical events like the wars in Afghanistan and Iraq, Hurricanes Katrina and others in 2005, and the overlay of public and private infrastructure costs necessary to combat terrorism and to provide security for American citizens. In addition, sharply higher crude oil and gasoline prices over the years also was an impediment.

U.S. economic growth really began to accelerate in 2003 as the tax cuts ramped up (see **Table 2**). Real GDP grew by 2.5% per annum over 2001-06, but at a much higher 3.2% per year from 2003-2006. Average GDP growth over 2003-06 was double that of 2001-03 (3.2% vs. 1.6%). At the end of 2006, the labor market was essentially at full employment, with an unemployment rate of 4.4% (see Table 1). In addition, workers' real wages rose as workers started to catch up after an admittedly long period of rising income and wealth inequality, Dr. Sinai states.

Other signs of the strong economy were stunningly strong corporate earnings, up an estimated 20% year-over-year in the third quarter of 2006 on the S&P500 (see Table 1). Operating earnings per share were even higher than the already quite high double-digit earn-

*"The Record of U.S. Economic Performance: Policies, Public Mood, Politics and Prospect," by Allen Sinai, Economic Studies Series, January 7, 2007, Decision Economics, Inc. The study was published in *Aspenia 35* "L'ultimo Bush o il primo?" © Aspen Institute Italia, Rome, December 2006 and was written before the congressional elections of November 2006. Dr. Sinai is Chief Global Economist and President of Decision Economics, Inc. (DE). He was an invited presenter at the December 1992 Little Rock Economic Summit, an attendee at the White House Conference on the New Economy in April 2000, and consulted from time-to-time by various Clinton Administration officials. He was also consulted by the Bush (I and II) and Reagan Administrations.

Table 1. U.S. Economic Performance: 2001, 2003, 2006, Latest (in 2006) and Overall (2001-06)

	2001	2003	2006E	Latest	2001-03 Avg.	2003-06F Avg.	Overall Avg. Per Annum
Economy							
Real GDP Growth (% Chg.)	0.8	2.5	3.2	1.6*	1.6	3.2	2.5
Inflation							
Consumer Price Index (% Chg.)	2.8	2.3	3.3	2.1**	2.2	2.9	2.7
Compensation (% Chg.)	4.0	4.0	6.9	6.7**	3.9	4.7	4.4
Jobs and Employment							
Nonfarm Payroll (Mils.)	131.83	129.99	135.35	135.84	130.72	132.56	132.07
Unemployment Rate (%)	4.8	6.0	4.6	4.4	5.5	5.3	5.3
Business Profits							
S&P500 Operating EPS(% Chg.)	-19.8	15.4	15.5	20.0F	0.7	16.3	8.7
Stock Market							
S&P500 (Level)	1192.0	963.9	1301.6	1364.3	1050.5	1150.8	1121.8
D-J Industrials (Level)	10,189.5	8,993.6	11,339.8	11,986.0	9,469.7	10,299.6	10,102.3
Interest Rates (%)							
Federal Funds	3.83	1.12	4.97	5.25	2.20	2.66	2.69
T-Bill	3.45	1.02	4.83	5.00	2.03	2.61	2.58
10-Year Treasury	5.01	4.00	4.83	4.72	4.53	4.34	4.50
Standard-of-Living							
Real Disp. Income Per Capita ($ Thous.)	25,698	26,553	27,922	28,135	26,162	27,262	26,830
Real Consumption Per Capita ($ Thous.)	24,215	25,060	27,013	27,126	24,635	26,070	25,521

E - Estimated F - DE Forecast
* Third quarter advance GDP, 2006.
** Percent change year ago.

ings growth of the previous several years. Stock markets--the S&P500, Dow-Jones Industrials, NASDAQ and Russell 2000 were much stronger -- with new highs for the D-J Industrials, the NASDAQ, and the S&P500.

The federal budget deficit was substantially reduced, to 1.9% of GDP for FY2006 after a swing from a large surplus in FY2001 to a large deficit in FY2003. Credit for the smaller deficit goes to the surge in corporate and personal income tax receipts stemming from the strong U.S. economic expansion.

Another indicator of the robustness of the U.S. economy was record high increases in real (inflation adjusted) per capita disposable income, from $25,698 in 2001 to $27,922 in 2006 for a 9% increase (see Table 1). Real per capita consumption also went up, rising a strong 12% over the same period, from $24,215 in 2001 to $27,013 in 2006.

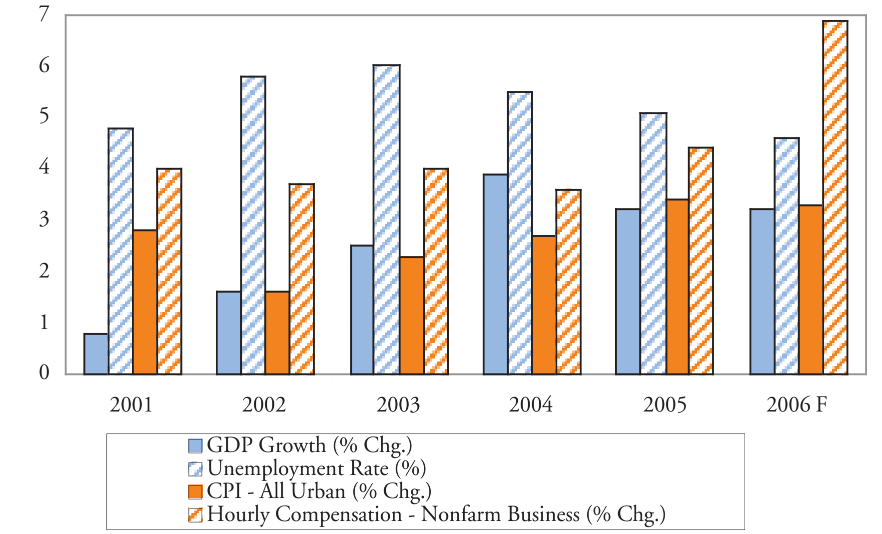
Why Did the U.S. Economy Perform So Well?

Dr. Sinai concludes that the U.S. economy's strong performance over 2001-2006 was due largely to: (1) accommodative monetary policy; (2) fiscal policy changes, including higher levels of federal government spending; and (3) tax reductions for individuals and business.

■ Monetary Policy

Federal Reserve monetary policy was aggressively eased in 2001 because of a collapse in business spending, in hiring, and in the U.S. stock market, which took the U.S. into recession. The aggressive easing of monetary policy, which included a series of reductions in the federal funds rate from 6-1/2% to 1-3/4% in just 12 months and to 1% over 30 months, was a necessary, although not sufficient, condition to cushion the downturn and set in place the backdrop for an upturn (see Table 1). However, given the nature of the economic slide, which principally came from the downturn in business activity, lower interest rates alone were not sufficient to revive the economy. Business spending and hiring are interest rate inelastic.

Chart 1. U.S. Economic Growth, Unemployment, Inflation and Labor Compensation: 2001 - 2006



■ Fiscal Policy

According to Dr. Sinai, federal tax cuts and spending increases were the most significant contributor to recovery and subsequent expansion over 2001-2006. Aggregate demand stimulus of the old-fashioned "Keynesian" kind occurred in the form of numerous large income tax reductions for individuals and "supply-side tax cuts" on capital gains and dividends received. There were tax cuts for business, increases in investment tax credits, for example, and federal government spending rose sharply. The five tax reductions over 2001-2004 provided a lot of the upward impetus, raising private sector aggregate demand, increasing savings flows, stimulating entrepreneurship, and increasing the economy's potential output. The economic recovery technically was dated as beginning in November 2001 but functionally did not really start until mid-2003, principally from the 2001 and 2003 Bush Administration tax reduction programs.

Table 2 shows the ex-ante costs of the tax reductions (ex-ante means the static revenue loss) before taking account of the growth-enhancing effects of tax reductions on the overall economy. Tax reductions have been a pillar of Bush Administration and Republican economic policies for many years, going back to President Reagan in 1981 under what came to be called Reaganomics. The five tax reduction programs legislated between 2001 and 2004 provided varying degrees of stimulus, ranging from 0.7% of GDP in 2001 to as high as 2.5% in 2004. The tax cut stimulus will fade from 2006 to 2008, but not by a lot until 2011 when many of the tax reductions will expire.

How Would the U.S. Economy Have Fared Without the Tax Cuts and Spending Increases?

Using the Sinai-Boston Quarterly Econometric Model of the U.S., a large-scale macroeconometric model, Dr. Sinai "backcast" to estimate how the U.S. economy would have performed over 2001-2006 if *none* of the tax cuts had been enacted and if federal spending had not increased. His analysis shows that U.S. GDP growth would have been 0.7% less each year and that the unemployment rate would have been 1.2 percentage points higher over 2001-2006 than it actually was (see **Charts 2** and 3). Considerably less consumption spending would have occurred without the tax cuts (see **Chart** 4) although high-grade corporate bond rates would have been lower (see **Chart** 5). While inflation rose a bit (see **Chart 6**) and the federal deficit was higher than it would have been absent the tax cuts (see **Chart** 7), Dr. Sinai concludes that the "tradeoff" was worth it because of the increased economic growth,

Table 2. Fiscal Policy Stimulus From the Tax Reductions of the Bush Administration (Ex-Ante Costs)
(Fiscal Years; Bils of $s; 2001-2014; Minus (-) Revenue Loss)

Tax Reduction Program	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Total	Total
EGGTRA (1) May 2001	-73.8	-37.8	-90.6	-107.7	-107.4	-135.2	-151.7	-160.1	-167.8	-187.0	-129.5				**2001-06** -552.5	**2001-11** -552.5
JCWAA (2) March 2002	-51.2	-43.4	-29.1	-3.4	16.3	16.9	16.2	13.7	10.2	7.2	4.7				**2002-07** -94.0	**2002-12** -41.9
JGTRA (3) May 2003			-60.8	-148.7	-82.2	-20.7	-13.7	-16.8	-11.2	-4.1	4.2	2.6	1.7		**2003-08** -342.9	**2003-13** -349.7
WFTRA (4) Sep. 2004					-29.2	-42.2	-24.6	-20.2	-16.7	-10.8	-1.4	-0.3	-0.3	-0.3	**2005-09** -132.8	**2005-14** -145.9
AJCA (5) Oct. 2004					-5.7	-7.8	-4.2	2.6	6.5	2.4	1.8	1.9	1.4	1.1	**2005-09** -8.7	**2005-09** 0.0
Total	-73.8	-89.0	-194.9	-285.5	-227.9	-189.6	-177.2	-178.3	-175.5	-189.3	-117.6	9.0	2.8	0.8	--	--
Ex-Ante Cost as Pct. of GDP	-0.7	-0.9	-1.8	-2.5	-1.9	-1.5	-1.3	-1.2	NA	NA	NA	NA	NA	NA	NA	NA

Sources: Calculated from Joint Committee on Taxation data. Historical GDP from Bureau of Economic Analysis. GDP for 2006 to 2008 from DE.
1. EGTRAA, Economic Growth and Tax Relief Reconciliation Act of 2001.
2. JCWAA, Jobs Creation and Worker Assistance Act of 2002.
3. JGTRA, Jobs and Growth Tax Relief Reconciliation Act of 2003.
4. WFTRA, Working Families Tax Relief Act of 2004.
5. AJCA, American Jobs Creation Act of 2004.

higher profits, more jobs, greater amount of entrepreneurial activity and lower unemployment rates.

Given the strong pickup in the economic expansion around mid-2003 and the timing and amounts of the tax reductions, fiscal stimulus (tax cuts and spending increases) appears to have been a main contributor to the U.S economic upturn which began in 2001. There can be little doubt that the U.S.'s trading partners must have benefited as well.

How Did The Tax Cuts Work?[1]

■ After-tax income rose

Dr. Sinai notes that the tax cuts raised after-tax disposable income, thereby increasing consumption, raising national income and corporate profits with their derived positive effects for business spending on capital goods, employment, as well as imports and non-U.S. economic activity. This, in turn, through multiplier and accelerator effects, further increased incomes and profits, raised consumer spending, induced more business sales, etc.

■ Private savings increased

Private savings rose, essentially through a transfer of funds from the federal government to the private sector, to be spent or saved. Stronger housing activity, rising real estate prices, and a stronger stock market increased realized capital gains and thus consumption, saving, and government tax receipts. Savings were invested in cash, bonds or stocks, or used to pay down debt, providing funding back to the economy through financial intermediaries, these days many of them nonbank, for private sector economic activity, and with a lot flowing to growing new businesses.

1. These effects are as structured in the 2006-07 version of the Sinai-Boston (SB) Macroeconometric Model of the U.S. Economy.

The Impact of Tax Cuts and Federal Government Spending on the U.S. Economy: A 2001-2006 Retrospective

Chart 2. Real Gross Domestic Product
(Percent Change)

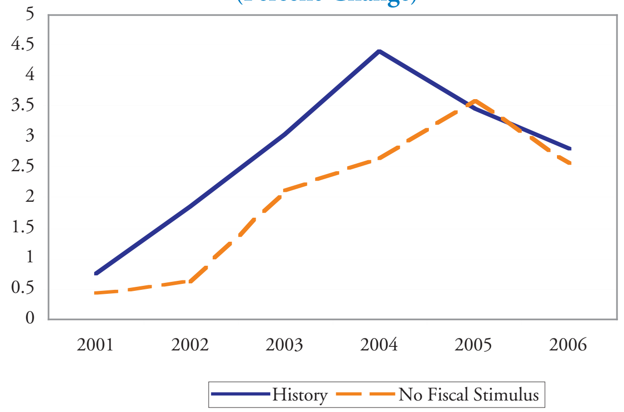


Chart 3. Unemployment Rate
(Percent)

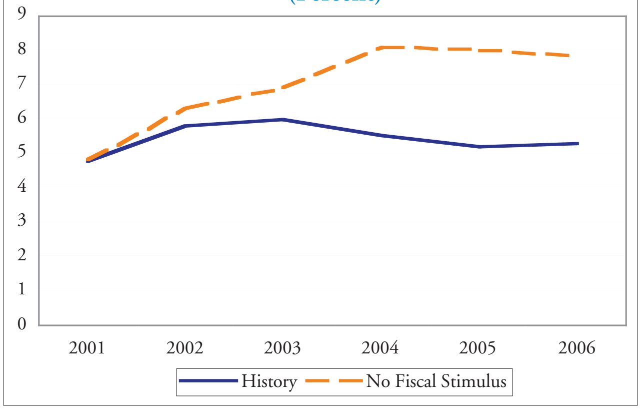


Chart 4. Real Consumption
(Bils. of 2000 $'s)

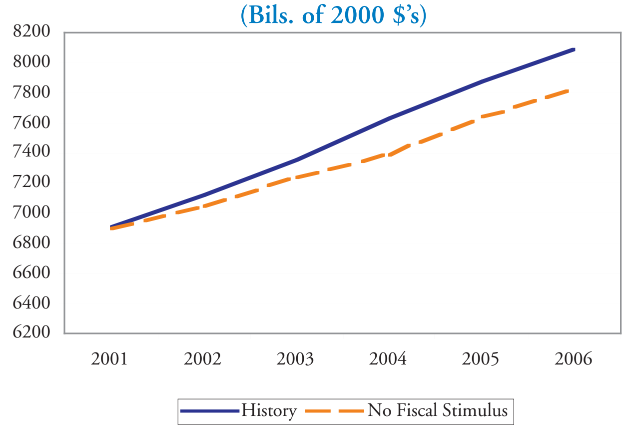


Chart 5. AAA-Equivalent Corporate New Issue Rate
(Percent)

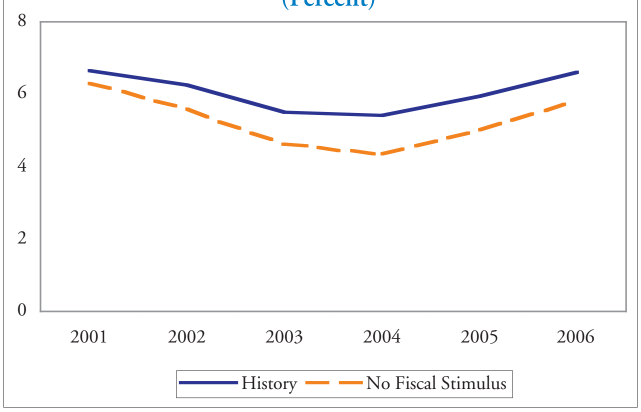


Chart 6. Consumer Price Index Inflation
(Percent)

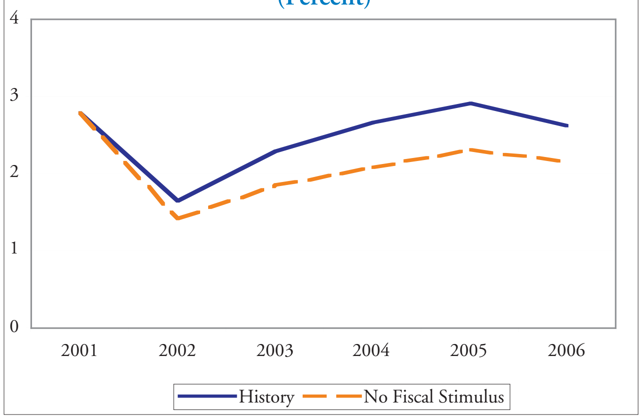
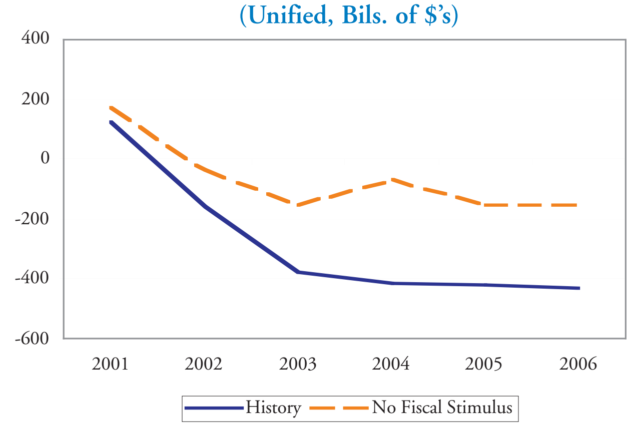


Chart 7. Federal Budget
(Unified, Bils. of $'s)



*All tax reductions and increased federal government spending removed from history in simulation with the Sinai Boston (SB) Model of the U.S. Economy. Monetary policy unchanged, i.e., federal funds rate held at Baseline levels. "History" refers to the actual economic data available in the third quarter of 2006 when the "backcast" was performed.

■ Entrepreneurship rose due to tax cuts for Income, capital gains and dividends

The tax cut on individual capital gains and reductions in the taxation of dividends, as well as lower personal income tax rates, raised the after-tax real returns on saving, shifting and allocating funds toward savings and away from other uses. The economy responds to lower tax rates, which bring about more entrepreneurship, competition, enterprise and financing, small business initiations and development, and more self-employed. In addition, the stock market improved from increased corporate earnings, a lower cost-of-capital (discount rate), and higher valuations. The lower cost of capital stimulated business capital spending, capital formation, productivity growth and potential output--"supply-side" effects.

Another benefit of the business expansion after the series of tax cuts is that government tax receipts were much higher than expected. The higher tax receipts were a reflection of the surprisingly strong business profits and business tax receipts and higher individual tax receipts on both ordinary income and capital gains. These additional funds produced a strong cyclical improvement in the federal budget deficit despite higher-than-expected growth in federal government spending. The stronger tax receipts generated by the system (which almost always result from every episode of tax reductions) suggest that the "energy" of the economy shifts up, i.e., business development, finance and entrepreneurship, in the presence of lower tax rates and produces changes in behavior which would not have occurred without the tax cuts.

Globalization and Technology: What Role in U.S Economic Growth?

In addition to tax cuts and the stimulus of additional federal spending, Dr. Sinai concludes that another source of strong U.S. economic performance has been globalization. Globalization--which refers to an increasingly open and interrelated world economy more open to trade, production around-the-world, the hiring and outsourcing of labor, purchases and production assembled at, and shipped from, various global locations--has revolutionized production and lowered costs for numerous companies, especially those that are U.S.-based.

Finally, increased efficiency at all levels-production, distribution, and management -- made a significant difference. U.S. productivity growth rose significantly during the first few years of this decade despite sluggish economic growth and has continued at a relatively high rate until only very recently. Improved application and use of the "new technology" is one reason.

Conclusions

The record of the U.S. economy from 2001 through 2006 was quite good--five years of business expansion, solid economic growth, especially in the later years, a low unemployment rate, relatively low inflation and relatively low interest rates, strong growth in corporate profits, large numbers of people finding work and strong jobs creation, stock markets at or approaching record-highs, the consumption standard-of-living of Americans at an all-time high, and even, at least cyclically, the federal budget deficit relatively low as a percentage of GDP.

While globalization and technology played a role in the good U.S. economic performance, empirical evidence and retrospective simulations with a large-scale model of the U.S. economy suggest that tax cuts and increased federal spending were mainly responsible for the U.S. economic upturn in 2003-06 and the sustained strong economy during this period.